BANKING MANAGEMENT

PGDF-201

BLOCK 1:
CONCEPTS AND CONSTITUENTS OF MONEY DEMAND AND SUPPLY

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BANKING MANAGEMENT

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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included may tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

BANKING MANAGEMENT

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BLOCK 1: CONCEPTS AND CONSTITUENTS OF MONEY DEMAND AND SUPPLY

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Block Introduction

Money is an inevitable part of our lives as all the work we do is to earn money for livelihood. Yet not many of us can define it precisely and explain its meaning clearly. Capital can be employed for different purposes by imparting mobility and productivity to it which is done by converting money into real capital. It is studied that inflation can be calculated by inflation rate of price index which is normally Consumer Price Index. This index will calculate prices of goods and services which are bought by consumer. The inflation rate is the percentage rate of change of a price index over time.

In this block, you will get knowledge about money and money supply with knowledge about its constituents and determinants. The concept of Velocity of Circulation of Money and RBI's measure of money Supply are well explained with features and characteristics. The block will detail about Demands for Money and its precautionary measure where study of certain technical motive with idea about speculation is shown. The knowledge about working and role of Ultimate Wealth Holders are detailed.

After studying this block, you will be able to understand correctly about inflation and types of inflation with more on its control measures. The concept of deflation and its effect along with its controlling measures gives knowledge to student which will help them know and compare about deflation with inflation. The comparison between features, characteristics and control measures regarding inflation and disinflation allow you to understand more about cause and effect of inflation.

Block Objective

After learning this block, you will be able understand:

- Functions of money
- Money Supply and its constituents

- Velocity of Circulation of Money
- RBI's measure of money Supply
- Information on Precautionary Motive
- Basic of Total Demand for Money
- Characteristics about Inflation
- Demand-Pull Inflation
- Basic of Control Measures of inflation
- Comparison between Deflation, Inflation and Disinflation

Block Structure

Unit 1: Demand and Supply of Money

Unit 2: Inflation and Deflation

UNIT 1: DEMAND AND SUPPLY OF MONEY

Unit Structure

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Constitutes of Money Supply.
- Determinants of Money Supply.
- Velocity of Circulation of Money.

- Demands for Money.

1.1 Introduction

Let us therefore try to give a formal meaning or definition of it. Coveter in his book, An Outline of Money says "Money can be anything that is generally acceptable as a means of exchange and that at the same time acts as measure and store of value". According to Alfred Marshall "money constitutes all those things which are at any time and place generally accepted without doubt or special enquiry as a means of purchasing commodities a/id services and of defraying expenses". The meaning and purpose for which money is used are clearly brought out by D. H. Robertson by stating "Money is anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations". All these definitions explain the meaning of money through its functions. That is what Walker tells us by defining money as "Money is what money does".

1.2 Functions of Money

Money through its basic functions helped us to overcome the problems of barter system. The important functions of money are summed up in a couplet: "Money is a matter of four functions: A medium, a measure, a standard, a store".

The first two are called the primary functions of money as they are basic or fundamental functions of money, while the other two functions are called secondary or derived functions of money as these are derived from the primary functions.

A) Primary Functions:

There are basic or fundamental functions of money which ensure smooth working of the economy. They may be discussed as under:

i) **Medium of exchange:**

Money acts as medium of exchange as it has general acceptability. On the payment of money, purchase of goods and services can be made i.e. goods and services are exchanged for money. As a medium of exchange, money removes the need for double coincidence of wants as required under the barter system. It differentiates buying and selling activities separately so it facilitates the exchange transactions.

ii) **Measure of value:**

Money is common measure of value so it is possible to determine the rate of exchange between various goods and services purchased by the people. Exchange value of commodity is expressed in terms of money.

B) Secondary Functions:

These functions are derived from primary functions.

i) **Store of Value:**

Money acts as a store of value. Money being generally acceptable and its value being more or less stable, it is ideal for use as a store of value. Being non-perishable and also comparatively stable in value, the value of other assets can be stored in the form of money. Property can be sold and its value be held in money and converted into other assets as and when necessary. As an asset its value in payment equals its value in receipt.

ii) **Standard of deferred payment:**

As money is used as a unit of value and a medium of exchange, it is also inevitably used as the unit in Terms of which all future or deferred payments are stated. Future transactions can be carried on in terms of money. The loans, which are taken at present, can be repaid in money in future. The value of the future payments is regulated by money.

iii) **Transfer of value:**

Value of an asset can be transferred from one -person to another or to any institution or to any place by transferring money. The transfer of money can take place irrespective of places, time and circumstances. Transfer of purchasing power, which is necessary in commerce and other transactions, has become available because of money.

C) Contingent Functions:

Apart from primary and secondary functions, money also performs Contingent functions such as:

i) **Equalization of marginal utilities/productivities:**

On the basis of prevailing money prices in the market marginal utilities can be equalized. So also the factors of production can be employed and substituted till the marginal productivity of different factors arc

equalised. In this way money ensures maximum satisfaction to consumers and maximum profits to producers.

ii) **Measurement and distribution of National Income:**
Money helps to measure national income. The value of national income is expressed in terms of money. Moreover, distribution of national income among factors of production becomes easier because of money.

iii) **Basis of credit**:
With the growing commercial and other economic activities, it has become necessary to develop a credit system. Money is very useful in this respect's provides necessary basis for the credit system.

iv) **Liquidity**:
Money is hundred percent liquid i.e. it can be converted into any type of goods or services available in the market. It is superior to all assets in terms of liquidity.

v) **Increase in productivity of capital:**
Capital takes different forms. Money is one of them and known as money capital. Because of its liquid nature money can be put to any use.

D) Residuary Functions:

i) Liquidity of capital:

Money not only increases productivity of capital but also imparts liquidity to capital. Money helps to keep capital in liquid form for various purposes such as transaction, precautionary, speculative motive etc.

ii) Utilisation of resources:

Money can ensure full utilisation of resources. Idle resources can be mobilised by means of money and put to productive uses for the purpose of satisfaction of human wants and also to bring about general economic development of a country.

Check your progress 1

1. Which is correct in case Money?

   a. Money is hundred percent liquid

   b. Money helps to measure national income

   c. Money ensures utilisation of resources

   d. all of above

1.3 Money Supply: Meaning

In Economics, the money delivery or money standard is the total amount of money feasible in an economy at a precise point in time. There are numerous approaches to describe "money," furthermore standard allocations normally constitute currency in rotation as well as demand securities (depositors' easily-accessed balances on the books of financial institutions).

Money deliver confirmation are logged as well as advertised, normally by the government or the central bank of the country. Public as well as private domain analysts hold extensive monitored alterations in money contribution on account of its potential consequences on the charge category, inflation as well as the business course.

That association between assets as well as charges is formerly affiliated with the amount conception of money. There is authoritative analytical authentication of administer association between long-term charge inflation along with money-supply growth, at least for fast advances in the measure of money in the austerity.

Hence the money contribute consists of diversified financial contraptions (normally currency, demand deposits along with manifold estranged categories of deposits), the measure of money in an economy is benchmarked by accumulating together these financial conveniences constructing a monetary increment.

Modern monetary theory distinguishes among different ways to measure the money supply, reflected in different types of monetary aggregates, using a categorization system that focuses on the liquidity of the financial instrument used as money. The most commonly used monetary aggregates (or types of money) are conventionally designated M1, M2 and M3. The measures of money are described further in the unit.

Check your progress 2

1. Money is also known as:

a. currency

b. financial instruments

c. financial conveniences

d. all of above

1.4 Constitutes of Money Supply

Economists are not unanimous about the constituents of money supply. Let us therefore explain some of the important constituents and concepts of money supply.

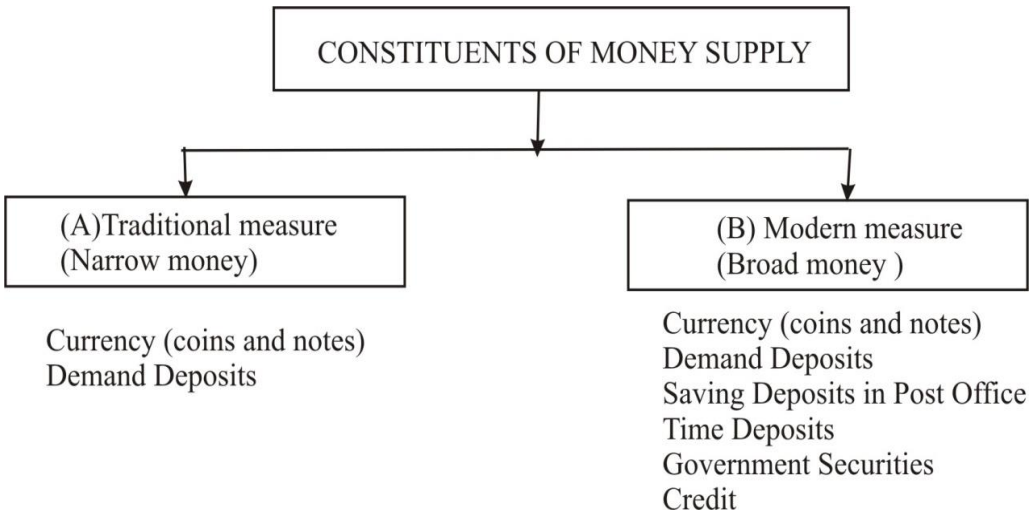

Fig 1.1 Constituents of money supply

A] Traditional Measure or Narrow Money:

Money is a means of payment or a medium of exchange. Therefore, according to the traditional approach, the stock of money should include such items that can be spent immediately. On this criterion, the components of money supply can comprise only of those things, which are readily accepted as a medium of exchange. Currency (coins and notes) and demand deposits with the bank are the liquid form of money which is readily accepted by everyone as a medium of exchange. Only demand deposits in the banks are treated as money since drawing cheques against them can do payments. Time deposits are excluded from the traditional measure of money, as it is not possible to draw a cheque against them.

However irrespective of type of deposits, if they can be withdrawn or a payment can be done by drawing cheque on these accounts, then they should be treated as demand deposits. The traditional money is sometimes called "narrow money" since the components of money supply are confined to currency and demand deposits only. Some economists call it transaction measure or "transaction money", as it includes those items that are actually used for transactions. The traditional measure of money supply can be expressed as:

$M_1 = C + DD$

Where M_1 = Traditional measure or Narrow Money.

C = Currency (Coins & Notes)

DD = Demand deposits (The cheque able deposits)

The M_1 measure is very near to the RBI's concept of M, which includes C, DD and other deposits (OD) with RBI Being negligible can be ignored for all practical purpose.

B] Modern Measure or Broad Money:

A broader concept of money supply has been evolved to include all very close substitutes of money in the measure of money supply. It is also called "broad money" since it brings in the items which while not quite as liquid, are extremely liquid. Economists like Milton Friedman, Gurley John G, Shaw Edwards (Gurley-Shaw) and Radcliff Committee (The committee appointed to study the working of monetary system in England) are closely associated with the modern approach.

i) According to Milton Friedman the money supply concept is wider and includes savings and time deposits with commercial banks, because, time deposits can be made available for spending purposes with limited cost.

ii) According to Gurley-Shaw, even liabilities of NBFI and bonds, shares i.e. various grades of near money are included which affect aggregate expenditure. Money supply is measured as weighted average 01 currency, demand deposits and near-money assets.

iii) According to the Central Bank approach, all the funds lent by financial institutions should be included because the total money supply is an important policy variable.

The modern measure of money comprises M and other liquid assets or near money. The items included in the list of liquid asset are:

(a) Saving deposits with limitations on amount of withdrawals.

(b) Term deposits in banks with prior notice.

(c) Government securities, bonds and financial assets

(d) Credit in terms of domestic non-financial sectors debit through mortgages, bonds and similar instruments.

If the items listed in a, b, c and d where M_2 is Modern measure, then items included in M differ in liquidity, as liquidity declines from a to d. As per broad, money can be sub-divided into M_2, M_3 and M_4.

$M_2 = M_1 + a + b$

$M_3 = M_2 + c$

$M_4 = M_3 + d$

It should be noted that there is no unanimity about the exact components of modern measure of money. Monetary authorities of each country decide the item to be included depending upon their impact on economic activities.

Money supply does not include

i) Cash balances held by the Central government and state governments with the central Bank because such money is not in circulation.

ii) Time deposits held by the public with commercial banks because they can be withdrawn only after the maturity period. (They are not included until they are withdrawn after the maturity period or before the maturity period in some exceptional circumstances.)

In recent years commercial banks have worked out schemes under which time deposits can also be withdrawn like demand deposits.

iii) Overdrafts until they are used by concerned individuals.

iv) Monetary gold held in reserve by the Central Bank because it is not in circulation in the economy.

v) Cash balances held by the Central Bank and Commercial Banks as reserves to support demand deposits.

The above mentioned components are not available to the community for spending purposes; hence they do not constitute money supply.

The supply of money is stock at a point of time, but it is a flow over a period of time. When money supply is viewed at a point of time, it is a stock of money held by the public at a point of time. The flow of money refers to a given stock of money multiplied by the velocity of circulation of money.

Money Supply = M x V (as a flow concept)

Where M = Money Stock, V = Velocity of Circulation

(Velocity of circulation is the number of times a unit of money circulated during a period of time, say, a year).

Check your progress 3

1. Which is the correct formula for calculating money flow, where M is money stock and V is circulation velocity?

   a. Money Flow = M x V

   b. Money Flow = M + V

   c. Money Flow = M – V

   d. Money Flow = M/ V

1.5 Determinants of Money Supply

The total money supply is determined by various factors, depending upon constituents of money supply. There are two views regarding the determination of money supply. According to the first view, the money supply is determined endogenously by changes in the economic activity of money, that is, charges in economic variables. The second view considers money supply as an exogenous variable, which is determined by the monetary authority on the basis of monetary and fiscal policies. Thus, the determinants of money supply are both exogenous as well as endogenous. They are discussed below.

1. **High-Powered Money / Reserve Money**: High-powered money (H) or Reserve Money (M_0) as RBI calls it, is the base of money supply. It is therefore called as **Base Money.** High-powered money includes currency

with the public (C) cash reserves of banks (R) and other deposits (OD) with the Reserve Bank. Thus High-powered money can be expressed as

H = C + R + OD

High-powered money differs from M_1 in terms of its second component. Let us state the components of both M_1 and H.

M_1 = C +DD + OD

H = C + R + OD

In M, DD is part of the total money supply. This component is absent in 11, instead we have R. DDs are held and also created by commercial banks, whereas, all the components of H are the creation of monetary authority and not by banks. The total amount of DD depends on the R. The capacity of the banks to create credit (DD) depends on the cash reserves of the banks (R). DDs therefore are a certain multiple of R. R is the base on which depends the expansion of DD, therefore R imparts on H the quality of high-power; qualifying it to be called High-powered money. For all practical purposes high-powered money can be taken to include only currency (C) and reserve money (R) as OD constitutes an insignificant traction of it, therefore,

H = C + R

2. **Money Multiplier**: Given the high-powered money (C + R), the total quantity of money supply depends on the value of money multiplier. The value of money multiplier is determined by:

   (i) Currency-deposit ratio

   (ii) Reserve ratio

(i) Currency-Deposit Ratio:

High-powered money (H) is demanded by people as currency (C) and by banks as reserves (R). People's preference for currency affects the money supply. If more cash is demanded by people, less will be available with the banks and thus lower will be the creation of credit. The preference by the public between currency and demand deposits is called currency-deposit ratio (k). This ratio depends on the banking habits of people, level of income, rate of interest etc.

(ii) Reserve Ratio

The primary deposits with banks are available for lending in the form of secondary deposits. The total quantity of money received by the banks is their reserve money (R). The reserves of banks can be divided into two types:

a. Required Reserves (RR)

Required reserves (RR) are the reserves which commercial banks are statutorily required to hold with the Central Bank.

A reduction in RR releases cash to commercial banks enabling them to create more credit.

b. Excess Reserves (ER)

Excess reserves (ER) are voluntarily held by banks. These reserves are required to meet their currency drain (net withdrawal of cash by depositors) and clearing drain (cash required to meet the cross-clearing of cheques among banks). The demand for cash for RR and ER determines the reserve deposit ratio (r). It is the r which finally determines the volume of credit that can be created by commercial banks.

Adopting the Dornbush-Fischer analysis, we may state that the money multiplier (mm) is the ratio of the stock of money to the stock of high powered money. The stock of high powered money depends on currency-deposit ratio (k) and reserve ratio (r). The reserve ratio (r) alone determines the deposit multiplier of the banks. If the banks have to keep 20 per cent as reserves then the value of deposit multiplier would be 1/r (1/0.20 = 5). The reserve ratio and currency deposit ratio together, determine the money multiplier.

$$\text{It can be stated as } mm = \frac{1 + k}{r + K}$$

The value of money multiplier depends on the currency-deposit and reserve ratios. The smaller the ratio, the higher is the value of money multiplier. Let us explain this with an example. If the currency-deposit ratio is 0.40 and reserve ratio is 0.20 then the,

$$\text{mm will be } mm = \frac{1 + 0.40}{0.20 + 0.40} = 2.33$$

The Reserve Bank of India measures money multiplier as a ratio of M_3 and Reserve Money (M_0), that is mm = M_3/M_0.

The change in total money supply is obtained by the product of money multiplier (mm) and high-powered money (H) i.e. mm x II or mm x $M_{()}$ where mm = $M_3/M_{()}$.

3. **Community's Choice**:

The community's choice to hold currency in relation to deposits in commercial banks also determines the money supply. If the community prefers payment by cheques than cash, the money supply will be large. This is because banks can create more money with larger deposits. The community's choice regarding currency deposit ratio is affected by banking habits, availability of banking services, the price level, level of income, etc.

Check your progress 4

1. High-powered money is also known as:

a. Reserve Money
c. Base Money
b. Supply Money
d. All of above

1.6 Velocity of Circulation of Money

The velocity of money is the average frequency with which a unit of money is spent in a specific period of time. Velocity associates the amount of economic activity associated with a given money supply. When the period is understood, the velocity may be present as a pure number; otherwise it should be given as a pure number over time. In the equation of exchange, velocity of money is one of the variables claimed to determine inflation.

Henry Hazlitt gave the following considerations about the velocity of circulation (V).

- Velocity of circulation is a result, not a cause. It is commonly a passive resultant of changes in people's relative valuations of money and goods.
- Velocity of circulation cannot fluctuate for long beyond a comparatively narrow range, because it is closely tied (except for speculation) to the rate of consumption and production.

- V does vary with the volume of speculation, but an increased volume of speculation may accompany either rising or falling prices.
- V is never an independent factor on the side of money, because the transfer of goods must speed up, other things being equal, to an equal amount. It is just as valid to think of the velocity of circulation of money being caused by what happens on the side of goods as by what happens on the side of money.
- Actually it is psychological factors — desire to buy and sell, produce and consume — that determine V.
- Monetary theory would gain immensely if the concept of an independent or causal velocity of circulation were completely abandoned. The valuation approach and the cash holdings approach are sufficient to explain the problems involved.

The velocity of money can further be segregated into:

1) Transaction Velocity:

It is the ratio of the annual volume of transaction to the stock of money. It is the speed at which a unit of money moves "around the circle of payments, from income to payments for goods and services and back again to income". Suppose the total supply of currency and demand deposits (M,) in a given period is Rs. 50,000 million and the transactions conducted are of Rs. 1,000.000 millions, the transaction velocity is 20. That is to say a given unit of money, say Re. 1, performs the function of Rs. 20. It indicates the average speed of a unit of money.

2) Income Velocity of Money:

It refers to the "average number of times a unit of money is used for making payments for final goods and services". The concept is more popular with national income accounting techniques. It is the ratio of GNP to money stock. If the GNP is Rs. 5, 00,000 million and money stock (M,) is Rs. 1, 00,000 million, the income velocity on money is 5. The income velocity is always lower than transaction velocity, since the former confines itself to the final goods and services. Transaction in financial assets and sales of existing land and building arc also excluded from income velocity.

Check your progress 5

1. If GNP is Rs. 4,000 million and money stock M is Rs. 100 millions, then what will be the income velocity?

   a. 40 c. 30

   b. 10 d. 10

1.7 RBI's Measure of Money Supply

The RBI has adopted a new measure of money supply since 1977. Prior to this, till 1967-68 its measure of money included only currency and demand deposits (M,). From 1967-68 till 1977 it adopted a broader measure of money supply terming it as Aggregate Monetary Resources (AMR). The new measure of money supply is stated as:

a) M, = C + DD + OD

C = Currency held by the public (Currency in circulation and cash in hand of all banks)

DD = Demand deposits with all commercial and cooperative banks (excluding inter-banking deposits)

OD = other deposits with Reserve Bank, of India. They include deposits of quasi- government and institutions, foreign central banks, foreign government and the World Bank.

The element of OD in money supply is very negligible proportion of the total money supply. M implies highest liquidity. M! is useful in formulation of monetary and fiscal policies.

b) $M_2 = M_1 + SD$

SD = Savings bank deposits with post offices. SD is more liquid than Time deposits.

c) $M_3 = M_1 + TD$

TD = Time deposits with all commercial banks and cooperative banks (excluding inter-banking deposits). M_3 is a broad money concept.

d) $M_4 = M_3 + TDP$

TDP = Total deposits with the post office (excluding national saving certificates)

The R.B.I, has taken a broad measure of money supply by bringing in total deposits from post offices. However post office deposits are less liquid than commercial bank deposits. Withdrawal of post office.

RBI's New Measure of Money Supply

The RBIs working group since 1998 has redefined the parameters for measuring money supply. A change is introduced in M_2. M_4 is totally abolished. Accordingly, now there are only three monetary aggregates, i.e. M_1 M_2 and M_3. Following table brings out the difference between the new and earlier measures of money supply.

Table Money Supply Measures in India

Original Concepts / Measures	Revised Concepts / Measures
M_1 = currency + demand deposits + other deposits C + DD + OD	M_1 = currency + demand deposits + other deposits C + DD + OD
M_2 = M_1 + savings deposits with post office savings banks	M_2 = M_1 + time liability portion of savings deposits with banks + CDs issued by banks + term deposits maturing within one year
M_3 = M_1 + time deposits of bank	M_3 = M_2 + term deposits over one year maturity + call / term borrowings of banks
M_4 = M_3 + total deposits with post office	M_4 = *Abolished*

In the revised measures M_1 remains unchanged.

M_4 had no practical significance over in the earlier monetary aggregates or measures.

On the line of broad money, the RBI, under the revised monetary aggregates, introduced a new concept of liquid resources.

Liquidity aggregates consist of $L_1 + L_2 + L_3$ that is $L_A = L_1 + L_2 + L_3$

Where, L_A = Liquidity Aggregates.

L_1 = New M_3 + All deposits with post offices savings banks (excluding NSCs)

+ Term deposits with term lending institutions + term borrowing of Fls + CDs issued by FL's.

L_3 = L_2 + public deposits of NBFCs the concept of L_A is wider than the revised money supply measure.

$M_1+M_2+M_3$

Check your progress 6

1. If M1 M2 and M3 are monetary aggregates, SD is Savings bank deposits and TDP is Total deposits, then monetary aggregate M2 is:

   a. M2 = M3 + TD + SD

   b. M2 = M3 - TD - SD

   c. M2 = M3 - TD + SD

   d. M2 = M3 - M1 + SD

1.8 Demands for Money

We live in a monetary economy i.e. where money is used as a means of payment. Besides means of payment, money is used as a store of value and also for many other purposes as explained earlier. The usefulness of money makes people demand money. People demand money either to spend on goods and services (transactions) or to hold it as idle cash (cash balances). The two important aspects involved in understanding the demand for money are: (i) why do people demand money? And (ii) what are the determinants of demand for money? Answers to these questions have been provided by many economists. We will analyse three major approaches: (i) the classical (ii) the neo-classical and (iii) the Keynesian.

The classical approach (cash Transaction approach)

The classical economists like David Hume, J. S. Mill, Irving Fisher etc, emphasized the transactions demand for money in terms of velocity of circulation of money. According to them, since money is a medium of exchange, people demand money for transaction purposes in order to carry out their economic transactions over a period of time. Money facilitates smooth transactions of goods and services in the economy.

So money according to this approach is demanded for carrying out day-to-day transactions. Irving Fisher's equation of exchange explains the transaction demand for money. The "equation of exchange" is expressed as

MV = PT

Where, M = Money supply, V = Transactions velocity of money,

P = Price level, T = Transactions.

The right hand side of the equation PT represents the demand for money based on total value of the transactions in the economy. MV represents supply of money which is given. In equilibrium, supply of money equals the demand for money. It should be noted that the transactions demand for money (PT) is determined by the level of full employment income because according to Say's Law, supply creates its own demand assuming the full employment level of income.

In the equation, demand for money is given by PT and supply of money is equal to MV. Money is demanded to carry out transactions. Based on the assumption of full employment, where T remains constant, the price level (P) and transaction (T) determine the demand for money (PT). The demand for money changes directly and proportionally with changes in the price level. The velocity of circulation of money (V) is another factor affecting demand for money. They are inversely related. An increase in the velocity of money reduces the demand for money and a decrease in the velocity of money requires the people to have more money. The velocity effect on demand for money is expressed as

Demand for Money; $M_d = PT/v$

Where M_d = Demand for Money

P = Price level, T = Transactions.

The main aspects of the classical approach are:

Money is demanded for transaction purposes as means of payments. Amount of money demanded depends on volume of transactions and price level.

A change in velocity of circulation of money changes the quantity of money demanded.

Neo-classical Approach

Cambridge economists expounded the neo-classical theory of demand for money. The main proponents of the theory were Alfred Marshall and A.C. Pigou. According to this theory people wish to hold the Value of certain proportion (K)

of national output in the form of money there exist a proportional relationship between the demand for money (M_d) and the money value of national output. For example, if the valued annual national output (Y) is Rs. 100,000 crores, the people wish to hold; part of this income worth Rs. 25,000 crores in the form of money then the value of K is 1/4. The demand for money can be expressed in the form of an equation.

$M_d = KY$

Where M_d = Demand for money.

K = is the constant proportion of Y.

The value of $K=0<K<1$.

Y = Money value of national output. The diagram below shows the demand for money.

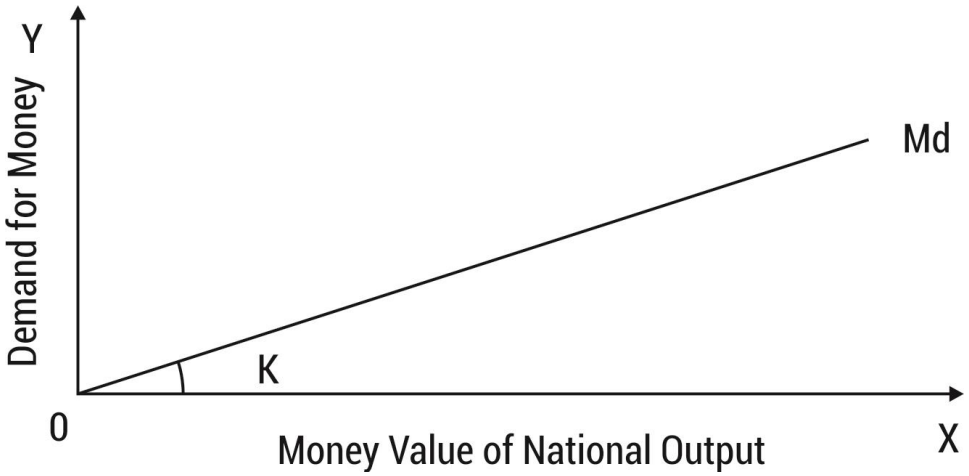

Fig 1.2 Money Value of National Output

The demand for money is the constant proportion (K) of Y. The change i demand is in direct proportion to the changes in (Y), the value of the proportion is equal to K.

Whenever there is a change in the price level or in the real national income the demand for money would also change in equal proportion. The price elasticity and income elasticity for money are equal to unity. It is expressed in the following equation.

= K. P, Y

I the equation explain the demand function for real money. It shows a proportional relationship of demand for money. (M_d) with price level (P) and level of income (Y).

Keynesian Approach

This approach to demand for money is based on its two important functions: (i) Medium of exchange and (ii) Store of value.

Prior to Keynes, economists failed to give these functions their due importance while analysing the theory of demand for money. Lord J.M. Keynes in his well-known book "The general theory of employment interest and money" explained the demand for money by emphasising more on "store of value" aspect of money, without, at the same time, neglecting the role of money as a "medium of exchange". Keynes explained the theory of demand for money by raising two fundamental questions:

i) Why is money demanded?

And

ii) What are the determinants of demand for money?

People's desire to hold money in the form of cash or their preference for liquidity, according to Keynes, is due to fear and uncertainty regarding the future. The desire to hold money is a "barometer of the degree of our distrust of our own calculations and conventions of the future. Fear and uncertainty about the future make us nervous and disquiet. The possession I of cash infuses confidence and "lulls our disquietude". Money besides providing confidence and courage, also helps us as a medium of exchange and store of value, thus together giving the reasons or motives for which money is held". Keynes lists three motives for holding money, they are:

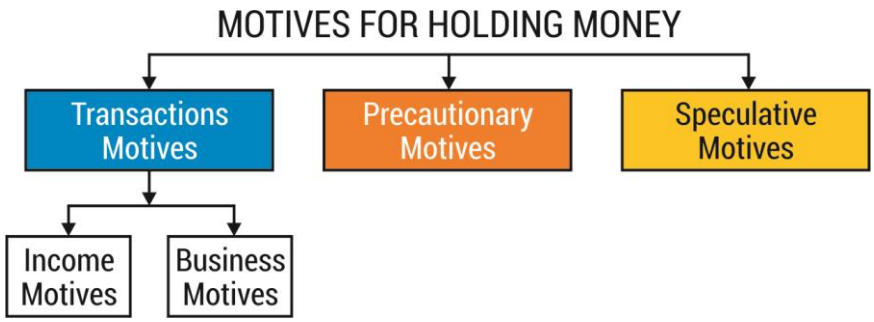

Fig 1.3 Motives of holding money

Transactions Motive:

People require money to carry out day-to-day transactions but most of them do not receive their income daily. The income is usually received once in a month though there may be cases where it is received once in a week or even daily as in the case of daily wage earners. There is a time gap between successive income

receipts but not between the expenditure incurred on various transactions. The transactions motive is further divided into

i) Income motive ii) Business motive

i) Income Motive:

It refers to the transactions demand for money by the wage and salary earners. They receive their income once in a month or in few case weekly i or daily. Money is required for these people to carry out transactions of all kinds. They may include regular payments like rent, electricity and grocery bills and all other payments. Suppose the time interval between two income receipts is a month, people require to hold money with them to meet their daily payments. (Money held for this purpose declines over the income] interval period, at the end of the period the balance being zero.

ii) Business Motive:

Business firm require holding money to meet their day-to-day transactions. The income interval of the firms may be a month or two or even longer; as there is always a time gap between production and realisation of its value. Meanwhile they require keeping money for payments of various bills such as electricity, rent, raw-material, wages etc. As in the case of individuals] the money held at the beginning of income interval period is high and declines over the period.

Income time interval is one of the determinants of transactions demand for money. The income interval and payment interval together determine income-expenditure period. 'The income - expenditure period is average interval between the receipt of income and its expenditure, or, ii terms of the behaviour of money balance, the average period flow which recurring receipts of income remain in the balance of the individual we can explain the average transactions balance based on income ti intervals with the following example. Two individuals A and B each receive Rs. 6000 per month. A receives his salary once in a month and B receive

Rs. 1500 per week throughout the income-expenditure period, having zero balance on the last-day. The transaction period and the average transaction balance are shown in the

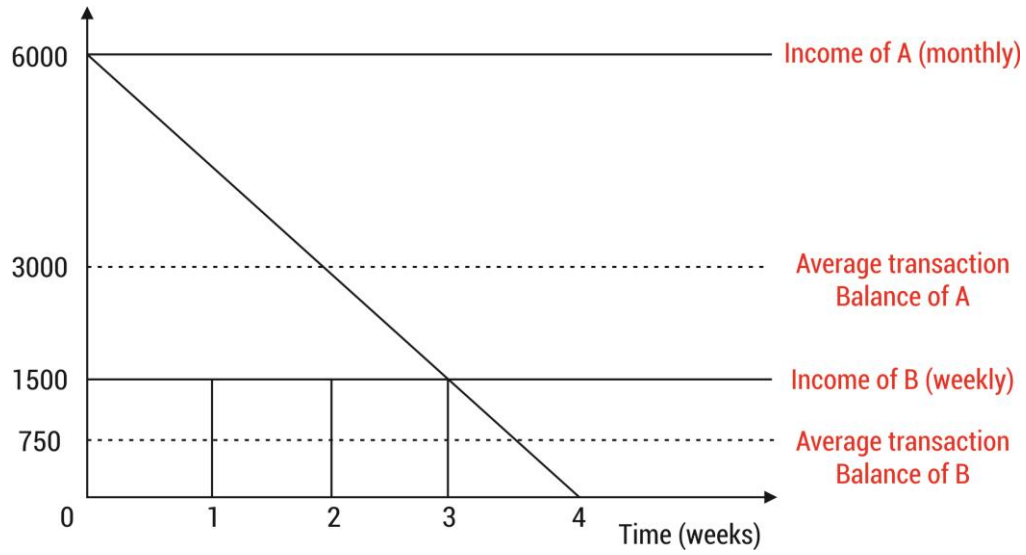

Fig 1.4 Transaction Period and the Average Transaction Balance

A's balance at the beginning of the income period is Rs. 6000 and B's 1500. At the end of the income-expenditure period both are left with zero balance.

1 A's average balance is Rs. 3000 i.e. 6000 x 1/2and B's average balance is

1500 x 1/2 = 750. 2

However the assumption of spending the income in equal amount throughout the income-expenditure period is unrealistic. In reality cash balances decline faster at the beginning since Most of the bills or payments are settled at the earlier part of the period leaving less for the later part of the time period. The amount of money held for transactions motive thus depends on the following factors.

(i) **Level of income**: Rich people whose income is more hold larger amount of money than the less well to-do. The poorest hold hardly any cash as their income being negligible.

(ii) **Time interval**: As discussed above, longer the income time interval more is the cash-balance and vice-versa. Those who earn their income daily do not require holding much cash.

(iii) **The Price Level**: Generally, during inflationary period transactions demand for money rises due to rising price level.

(iv) **Volume of employment:** When volume of employment and output rise, the transactions demand for money would rise.

Check your progress 7

1. What is the correct formula for Demand For Money?

a. Md = PT/v

c. Md = PT * v

b. Md = PT + v

d. Md = PT - v

1.9 Precautionary Motive

He is necessary to be cautious about the future which is uncertain. People suffer from "all sorts of vague doubts and fluctuating status of confidence and courage "Uncertainty is the important element in the Keynesian precautionary motive. An additional amount of money over and above for the known requirements is held "for contingencies requiring sudden expenditure and for unforeseen opportunities of advantageous purchase". Individuals hold money to meet unexpected increase in expenditure due to illness, accidents and any other unforeseen emergencies. Money may also be required to make up a fall in income due to temporary unemployment, Business people hold cash with them to meet any unforeseen expenditure or take advantage of favourable market conditions for their purchases.

Demand for precautionary motive; like the transaction motive, also depends on the level of income the amount of money kept for this motive varies directly with the income. Rich people will have a larger amount for this motive as against the poor who may have hardly any balance for this purpose, similarly business firm demand for money depends on their turnover. Here also the smaller firms will have a lesser amount. A firm's precautionary demand for money is influenced by political uncertainties too, when political conditions are unstable, firms tend to become more cautious and hold a larger amount of cash. The transactions and precautionary demand for money is a function of level of income as shown in Fig.

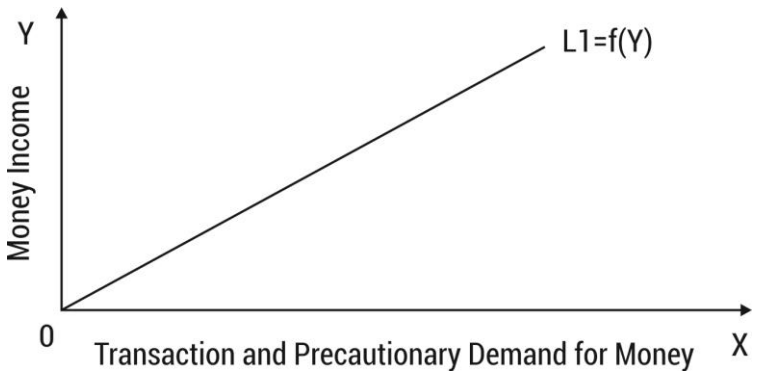

Fig 1.5 Transaction and precautionary demand for money

Both transaction and precautionary demand for money are based on the role of money as medium of payment and the level of income primarily influences both. Keynes clubbed them together. The combined demand for transactions and precautionary motive is expressed as $L_1 = f(y)$.

The demand for money for these motives is not influenced by rate of interest except perhaps at a very high rate. It is not unlikely that people may decide to reduce their cash balances in order to earn some additional income offered by attractive interest rate. In general, however the demand for money for transactions and precautionary motives is interest inelastic. This is shown in the In Fig Below the vertical line ML_1 indicates that the transaction and precautionary demand for money is unaffected by the changes in the rate of interest i.e. it is interest inelastic.

Demand for money held under transaction and a precautionary motive is known as demand for "active cash balances".

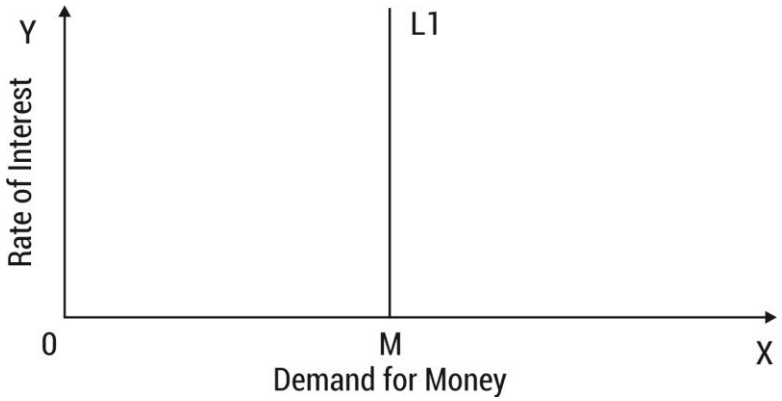

Fig 1.6 Transaction and Precautionary Demand for Money

Check your progress 8

1. The transaction motive depends on level of income the amount of money which is kept for motive which varies directly with _____.

   a. money

   b. income

   c. transaction

   d. none of above

1.10 Speculative Motive

The demand for money for speculative motive is related to the "store of value" function of money. The speculative motive is distinct from the earlier motives - transactions and precautionary - where money is held for performing the function of medium of exchange. The speculative demand is also called "asset demand for money".

People have the alternative of holding either cash money or financial assets like government bonds or equities. The speculative demand is also related to uncertainty. The element of uncertainty is concerned with uncertain capital value of financial assets. People desire to gain by purchasing the financial assets at a low price and selling when their prices rise. People indulge in speculation according to their own calculations. Those who expect the prices of bonds and equities to fall delay their purchases expecting further decline. Others who do not expect the prices to increase any further unload the bonds and securities held by them.

Speculative demand for money is interest elastic. At a higher rate of interest less money is held for this motive and vice-versa. Two important reasons account for such inverse relationship. First, holding cash when rate of interest is high has a greater opportunity cost. Second, there is an inverse relationship between the interest rate and security prices. Let us take the long-term government securities bearing fixed rate of interest. Though the return on government securities remains fixed, the rate of interest in the market does not remain constant. As the interest in the market increases people prefer to invest in' the market instead of in low yielding government securities. However if those who need cash offer government securities, they will be purchased at a lower price. Suppose a Rs. 100 government security brings a fixed return of 10 per cent, the market rate of interest at the same time goes up to 15 per cent, and then the price of the security in the market would be Rs. 66.66. Similarly, when the market rate of interest declines the security prices rise. In our example if the market interest declines to 8% then the security price would be Rs. 125. The changes in market rate of interest and security price can be expressed in the form of an equation.

$P - R/m \times N$

M Where, P = Market price of the security

R = Return on the securities

M = Market rate of interest

N = Original price of the security in our example R is 10% and m is 15%, then the price of securities will be:

P = 10/0.15 x100 = 66.66 OR

If m is 8%, the price of securities will be:

P = 0.10/0.08 x 100 = 125

The above explanation clearly establishes an inverse relationship between market rate of interest and market prices of the securities. Therefore people I do not hold cash when rate of interest is high. Since,

(i) The opportunity cost of holding cash is high and

(ii) Securities would be purchased as their prices at that time arc low.

It is profitable to purchase at this point and sell then when market rate of interest declines pushing up security prices. Whereas when the market rate of interest is low, people prefer to hold cash since the opportunity cost of holding cash is very low and is the opportune time to sell securities due to their high prices. Besides the above reasons, expectations regarding the market rate of interest and security prices also play an important role in determining the speculative demand for money. When the market rate of interest is low, it is expected that the interest rate will increase in the near future thus bringing down prices of the securities. Such expectations induce people to hold more cash. At a very high rate of interest, there are no expectations of any further increase therefore; the security prices are at their lowest, attracting the investors to purchase them. Such purchases at this point are with expectation of a decline in the rate of interest and consequent increase in security prices. It should be noted that people in general have their own concept of normal rate of interest in the market. Any expectation in the changes in rate of interest is with reference to this normal rate of interest.

Demand for money held under the speculative motive is referred to as the demand for "idle cash balances".

Demand for speculative motive (L_2) depends on the rate of interest (r). $L_?$ And rare inversely related.

Liquidity Trap:

It is found that an inverse relationship that shows between rate of interest and speculative demand in terms of money will changes to various form of relationship. According to Keynes, at low rate of interest, speculative demand for money will becomes fully elastic. He thinks that 2% rate of interest will be the

lowest, as below which, market rate of interest starts will not decline. He also suggested that this point, expectation for future fall in security prices will becomes high and further it spreads so people will hold the cash in order to have future market situation.

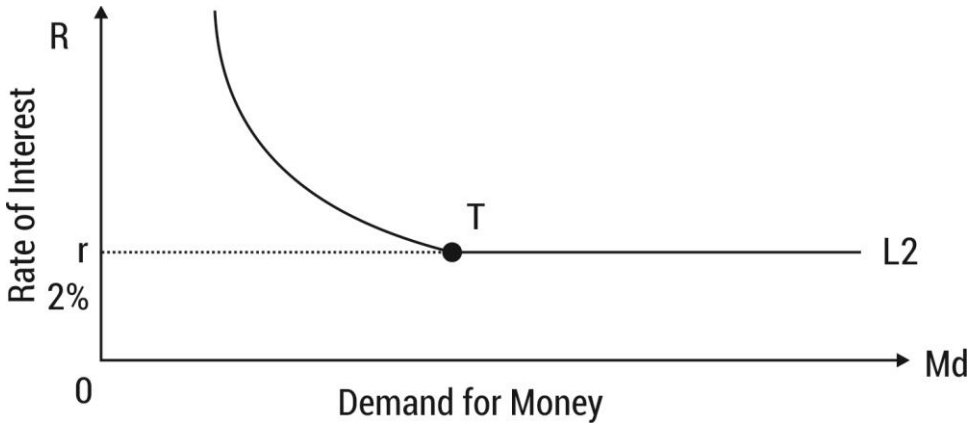

Fig 1.7 Rate of interest and speculative demand for money

In the figure it is seen that L_2 curve is sloping downwards till point T which shows an inverse relationship that occurs among speculative demand for money and market rate of interest. At point T, curve L_2 will form a straight line. The horizontal line of curve L_2 will result in liquidity trap that describes accurate elastic need for money for speculative motive. In such situation, people will prefer to keep cash rather than bonds as a result of fear of imminent declination in prices. Such situation shows significant monetary policy that will increase money supply that has no effect on rate of interest as it was already dropped to lowest level.

Check your progress 9

1. If P is Market price of security, R is Return on securities, m is Market rate of interest and N = Original price of security, then changes in market rate of interest and security price can be expressed as:

   a. P + R/m x N

   b. P – R/m - N

   c. P – R/m x N

   d. P + R/m x N

1.11 Total Demand for Money

Total money demand arises from three motives discussed as:

- Transactions
- Precautionary
- Speculative

It is found that the demand related to transactions and precautionary is mainly related to income determined and interest inelastic, whereas the speculative demand for money is basically interest elastic. So it is seen that the total demand can be represented as:

$M_d = L_1 (y) + L_2 (r)$

M_d = Demand for money

L_1 (y) = Transaction demand and precautionary motives shown on increasing function level of income.

L_2 (r) = Speculative demand showing declining function of rate of interest.

In Keynesian terms, we can write total demand for money as:

$M_d = L (yr)$

It is found that the transactions and precautionary demand for money is an active balance which is function of income that relates to level of income. The speculative demand is a demand for idle balance and is inversely related to the rate of interest.

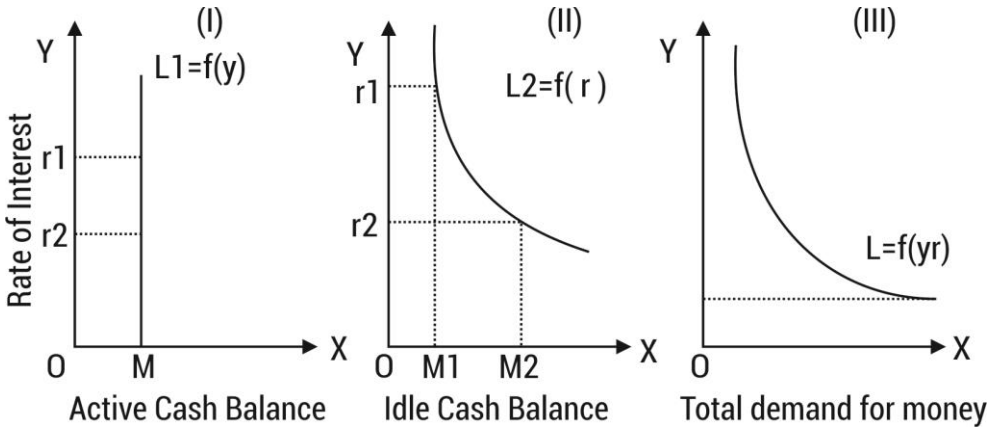

Fig 1.8 Total Demand for Money

In the first figure it is seen that OM, which is transactions and precautionary demand for money is at y level of income having varied interest rates. In second figure, it is seen that speculative demand for money is showing at varied interest

rates. In third figure, the total demand curve for money is shown which shows liquidity preference schedule of community.

Check your progress 10

1. In terms of Keynesian, the total demand for money can be expressed as:

a. Md=L(yr) c. Md+L(yr)

b. Md-L(yr) d. Md / L(yr)

1.12 Ultimate Wealth Holders

It is studied that households are real wealth holders as their need for money is similar as demand for durable consumer goods that will give flow of services. In this, the demand for money is not same for money itself but is demand for goods and services based on it. According to Friedman, determinants of demand for money are:

a) **Total Wealth:** As per Friedman's analysis, the complete wealth has physical and non-physical wealth. Bu Human wealth, we mean the present value of expected flow of labour income. In this, an income is applied as substitute for wealth where total income will cover property income and labour income.

b) **Human and Non-Human Forms of Wealth:** As per Friedman's, wealth has both human and non-human forms. The part of wealth kept in non-human form is important variable in economy. Requirement for money decreases as function of above fraction.

c) **Rate of return on money and other assets:** The desire to hold money or other assets depends on the expected return and cost of holding them. Money held on cash brings zero return.

Apart from above factors, demand for money depends on advantages of money that comes with other assets. As per Friedman, consistent economic conditions induce people to carry cash in an unstable situation that will carry physical assets. Friedman's demand function for money can be expressed as:

$(M)^d$

$P = f(y, w, r_3, r_g, r_e, p_g, U)$

M^d = Amount of money demanded.

P = General price level.

Y = Money value of national income. +

w =Fraction of wealth in non-human form

r_m. = Expected rate of return of money.

r§= Expected rate of return in fixed value including changes in their prices.

r_e= Expected rate of return on equities including expected change in their prices.

p_g = Expected rate of change of prices of goods

U = other variables affecting the utility- derived from the services of money.

The above equation deals with demand for money for an individual wealth holder.

Check your progress 11

1. As per Friedman's, wealth can be of:

   a. human form only

   b. non-human form only

   c. both human and non-human forms

   d. all of above

1.13 Let Us Sum Up

In this unit we have learnt that money by its basic functions helps to overcome problems of barter system. We see that the first two are called as primary functions of money or fundamental functions of money, while two functions are called secondary functions of money as derived from primary functions.

In Economics, the money supply is total amount of money available in an economy at a particular point in time. There are several ways to define "money," but standard measures usually include currency in circulation. Economists are not unanimous about the constituents of money supply demand deposits (depositors'

easily-accessed assets on the books of financial institutions). The constituents are Traditional Measure or Narrow Money and Modern Measure or Broad Money.

It is studied that money supply is influenced by central bank of country, government and commercial banks as such agencies by their actions either directly or indirectly affect the total supply of money.

1.14 Answer for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-d)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-c)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-b)

Check your progress 9

Answers: (1-c)

Check your progress 10

Answers: (1-a)

Check your progress 11

Answers: (1-c)

1.15 Glossary

1. **Market -** It is a place where people meet for buying and selling goods usually outside.
2. **Securities -** These are documents which evidence ownership or creditor position in corporation like stocks, bonds or coupons.
3. **Demand deposit -** Funds in a checking account subject to withdrawal on demand or by check.

1.16 Assignment

Explain the importance of Internet banking with respect to demand and supply of money.

1.17 Activities

Collect some information on Transaction motive.

1.18 Case Study

Discuss the different constituents of money supply and its determinants.

1.19 Further Readings

1. Government of India: Report of Banking Commission 1972.
2. An Introduction to Monetary Theory, Chandler L.V.

UNIT 2: INFLATION AND DEFLATION

Unit Structure

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Demand-Pull Inflation
- Measures to control inflation
- Effects Deflation

- Measures to Control Deflation

2.1 Introduction

Inflation explains about increase in amount of money in circulation. Today, economists use the word inflation to show the increase in price level. The increase in the money supply results in monetary inflation which distinguishes it from high pricing that clarifies price inflation.

Apart from this, economic concepts related to inflation are:

Deflation: It is lowering of general price level

Disinflation: It shows decrease in rate of inflation

Hyperinflation: It is called as out-of-control inflationary spiral

Stagflation: It shows combination of inflation which lowers the economic growth and high unemployment

Reflation: It is procedure to raise the general level of prices to counteract deflationary pressures.

Other price indices for calculating price inflation covers:

- **Producer price indices (PPIs):** It is measure of average changes in prices which is received from domestic producers. It is different from CPI as in this, the price subsidization, profits and taxes results in value received from producer. It is studied that PPI is also known as Wholesale Price Index.
- **Commodity price indices:** It measures the price of selected commodities. It is seen that today commodity price indices are calculated by relative importance of components.
- **Core price indices:** As the price of food and oil changes rapidly as a result of changing supply and demand conditions in food and oil markets, it becomes hard to analyse long run trends in price levels. It is found that the measure of' core inflation that takes volatile components from broad price index as CPI.

Various other inflation measures are:

- **GDP deflator:** It will find the price of goods and services which includes Gross Domestic Product (GDP).

- **Historical inflation:** It is seen that inflation data early in 20^{th} century depends on costs of goods instead of compiled at time which adjusts differences in standard of living.
- **Asset price inflation:** This result in undue increase in prices of assets just as stock and real estate.

2.2 Types of Inflation

Inflation is classified based on the several conditions like:

(I) Degree of price rise

(ii) Governments interference

(iii) Inflation cause

(iv) Time situation

(v) Other types

(1) On basis of Degree of Price Rise:

On this ground inflation is classified into four types:

(i) Creeping inflation

(ii) Walking inflation

(iii) Running inflation

(iv) Jumping or galloping or hyper-inflation

(v) Single digit and double digit inflation.

(i) **Creeping inflation**: It is a gentle type of inflation where the annual increase in price level is not more than 3%. It is necessary as it shows required incentive for promoting investment.

(ii) **Walking inflation**: In this, sustained increase in price results in between 3% to 6%. This is danger as it invariably leads to running inflation.

(iii) **Running inflation**: It occurs, if the rate of increase in price rises to 10% per annum. There are no two opinions about its undesirability.

(iv) **Jumping, Galloping or Hyperinflation: H**yperinflation is a serious form of inflation where price increases to 100% or more. In this, the price gets double or more than double every month.

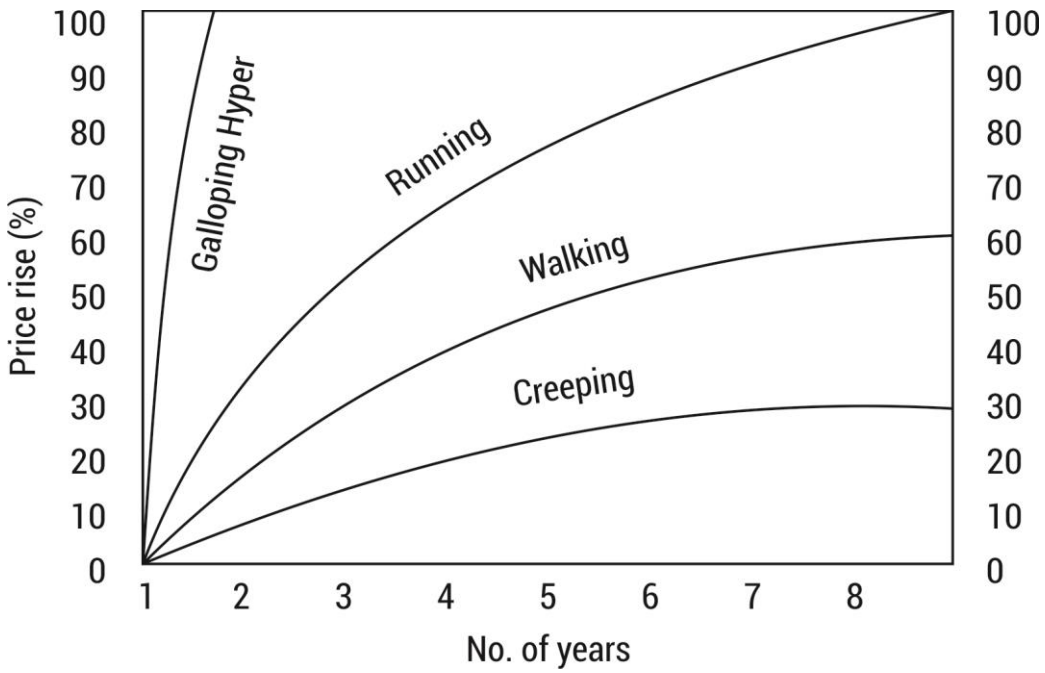

Fig 1.9 Types of inflation

(2) On basis of Government's Interference: Based on this criterion inflation may be open or suppressed.

(i) **Open inflation**: This comes in practice when government not involves with interfere in economic affairs. It allows free play of market forces, where price level rises freely.

(ii) **Suppressed inflation**: It is such type of inflation which is controlled by Government by way of various inflationary measures. It remains suppressed until anti-inflationary measures are in use.

(3) On basis of Causes: It results in causes, inflation which is categorised as demand pull, cost push, stagflation etc.

(4) On basis of Time Situation: It depends on time and are categorised as peace time and war and post war inflation.

(i) **Peace-time inflation:** In this, the government spends more on development and welfare activities.

(ii) **War and Post-war inflation**: It involves heavy defence expenditure. It involves flow of money in an unproductive direction. It is, however, not very difficult to suppress the war-time inflation.

(5) Other types of Inflation: There are certain types of inflation which are not brought under categories of inflation as:

(i) **Inertial inflation:** This inflation tends to stay till shocked by economic events. The inertial inflation with small rate carries for longer period. It will be disturbed by economic shocks.

(ii) **Ratchet inflation:** It shows the situation where prices remain stagnant throughout economic forces.

(iii) **Inflation in developing countries:** Developing countries are in the process of development. They are in a less than full employment situation. With unemployed or underemployed resources and man-power, therefore, strictly speaking they should not suffer from inflation.

Check your progress 1

1. Which is not covered under inflation?

a. demand pull
c. peace time inflation
b. war inflation
d. ratchet inflation

2.3 Causes of Inflation

There are several causes of inflation such as:

1. **Over-expansion of money supply:** Many a times a remarkable degree of correlation between the increase in money and rise in the price level may be observed.
2. **Increase in population:** Increase in population leads to increased demand for goods and services.
3. **Expansion of bank credit:** Rapid expansion of bank credit is also responsible for the inflationary trend in a country.
4. **Deficit financing:** Deficit financing spending more revenue. In this government accepts extra money from RBI to spend for public projects.

5. **High indirect taxes:** Incidence of high commodity taxation. Prices tend to rise on account of high excise duties imposed by the Government on raw materials and essentials.

6. **Black money:** It is widely condemned that black money in the hands of tax evaders and black marketers as an important source of inflation in a country

Check your progress 2

1. Which is not a reason for inflation?

   a. Excess of money supply

   b. Excess of manpower

   c. Excess of population

   d. Expansion of bank credit

2.4 Demand-Pull Inflation

It is seen that demand pull inflation exists when total demand for goods extends complete supply of goods at current prices making increase in price level. The factors which bring about increase in total demand for goods or rise in general level of prices that are grouped as:

- Factors operating on demand side
- Factors operating on supply side

(a) Factors operating on the demand side:

These are certain reasons which bring continuous rise in general price level such as:

1. **Increase in money supply:** With increase in money supply and increase in money income results from aggregate demand for goods and services.

2. **Increase in Government expenditure:** The increase in govt. expenditure will result from increase in adoption of development and welfare activities that further increases aggregate demand for goods and services making price level to go up.

3. **Increase in private expenditure:** With regular increase in consumption and investment expenditure in private sector, the demand for goods and services increases which further rises in prices.
4. **Increase in population:** The rapid rising population exerts pressure on the demand for goods and services.
5. **Black money:** The money generated through smuggling, tax evasion etc. raises the demand for luxury and other goods.

(b) Factors causing decrease in supply of goods:

In case of increase in total demand for a goods as well as services are matched with increase in supply of goods, then inflationary situation does not occur. If total supply of goods is slower pace as compared to growth in total demand, then it results in inflationary rise in prices.

(c) Cost-Push Inflation

Cost push inflation will arise when there is rise in cost of production of goods that is not related with excess demand. So the main causes of cost push inflation are:

(1) Increase in sellers which increase the value of goods to have profit margin.

(2) The manufacturer of commodities having monopoly in market gets higher profit margins without increase in elements of cost. The result of higher profit margins inflates price level.

(3) If rise in price of certain basic materials like gas, steel, chemicals, oil can be applied directly or indirectly in all industries resulting in increase of cost of production and price level.

(4) Higher taxes: On levying new taxes by govt. and increase in rates of old taxes normally produces burden on consumers. With rise in selling prices of commodities increases the inflationary trends.

(5) Import prices: On rise in imported goods price, results in sharing of Inflation.

Check your progress 3

1. In demand pull, which is not a factor which affects the demand side?

   a. Increase in money supply

   b. Increase in Government expenditure

   c. Increased demand for goods which matched with increased supply of goods

   d. Increase in private expenditure

2.5 Measures to Control Inflation

Inflation must be controlled at an appropriate level. Uncontrolled inflation is turn into hyperinflation. Since inflation occurs due to disequilibrium aggregate demand and aggregate supply, it/would be controlled by correcting the forces which cause such disequilibrium. Control of inflation quires a combination of monetary, fiscal and other measures.

1. Monetary Policy & Fiscal Policy

In keeping the emphasis on Monetarists growth rate of money by steady and monetary policy that handles the inflation. As per Keynesians, low aggregate demands at the time of economic expansions which rises demand at recession keeping inflation stable.

2. Wage and Price Control

Wage and price control will be successful at wartime atmosphere in combination with rationing.

3. Cost of Living allowance

It is seen that employment contracts, pension benefits and government entitlements are tied to cost-of-living index especially in consumer price index.

4. Gold Standard

It serves as monetary system where regional exchange media serves as paper notes which are freely convertible into pre-set standard quantities of gold.

(A) Monetary measures: Monetary measures relate to the control in the supply and circulation of money in the country.

1. **Bank rate policy:** In inflation, bank rate increases which controls supply of money.
2. **Open market operation:** In inflation, central bank will sells govt. securities and price bonds in open market to have agreements of money delivered.
3. **Variable reserve ratio:** To hold inflation, central bank rises reservation.

(B) Fiscal Measures: Measures in connection with public borrowing, public expenditures and public revenues are called fiscal measures.

1. **Public Borrowing:** In inflation, rise in public borrowing at deflation will lower the public borrowing.
2. **Public Revenues**: To hold inflation, public revenue increases by Govt.
3. **Public expenditures:** It helps to control inflation by lowering public expenditures by Govt.

(C) Realistic Measures:

1. Increase in supply of goods and services: On increasing the supply of goods and services, prices result in downside.
2. Population planning: To control population by using different measures of family planning, will further lower the demand and control in price.
3. Price control policy: The govt. Have strict price control policy with profiteers and hoarders.
4. Economic Planning: Effective economic planning is necessary to control the inflation in the country.

Check your progress 4

1. Which is not a measure to control inflation?

a. Monetary Policy & Fiscal Policy

b. Required supply of goods

c. Public expenditures

d. Price control policy

2.6 Deflation

Deflation in economics results when price falls. It is reverse of inflation. According to A.C. Pigou, deflation is a state of lowering the prices those results when output of goods and services rises fast as volume of money income in economy increases. Deflation occurs fall in general level of prices as:

- Increase in the value of money
- A decline in effective demand and
- An increase in unemployment.

Causes of Deflation:

Deflation occurs due to a number of reasons. Important among them are:

1. Capitalism characterized by sufficient existence of competition, is regarded as one of the factors responsible for the emergence of Deflation. In this case, with the improvement in the capital stocks, competition increases million fold. Escalation in the total number of competitors boosts up the supply of goods, indicating that the prices must decrease in order to stabilize the demand, thereby bringing in Deflation. Capitalism also brings in innovation and efficiency, which also contributes towards the initiation of Deflation.
2. In an economy based on credit, a decrease in money supply results in remarkably less lending trend, followed by a sharp decline in the money supply. As a result, there occurs a sharp reduction in the demand for goods. A decline in the demand is followed by a decline in the prices, owing to the development of a condition called the supply glut. Gradually, this assumes the form of a deflationary spiral, where the prices go down below the costs of financing production.
3. With the advent of deflationary spiral in an economy, the commercial sector of the country stops incurring profits, despite lowering the prices of their finished products. Ultimately, a situation arises where this commercial sector is forced to become liquidated. In order to prevent or slacken down the deflationary spiral, it is necessary for the banks to avoid the collection of non-performing loans.
4. According to the monetarist viewpoint, Deflation occurs when there is a decrease in the velocity of money and/or in the amount of monetary supply per person. Deflation helps the economy grow and develop at a rapid pace, even faster than the creation of hard money.

To sum up, deflation arises due to the following conditions stated below:

- Decrease in the money supply
- Increase in the supply of goods
- Fall in the demand for goods
- Escalation in the demand for money

Check your progress 5

1. Which among the following is not a cause of deflation?

   a. Increase in supply of money

   b. Increase in supply of goods

   c. Decrease in demand for goods

   d. Escalation in demand for money

2.7 Effects of Deflation

Deflation being the opposite situation of inflation, most of its effects-are also reverses of the effects of inflation. Let us briefly discuss some major effects of deflation.

Following are the diverse ways in which Deflation impacts the economic condition of a country:

1. Deflation results in the improvement of production efficiency, due to lowering of the overall price of commodities. The production efficiency of a country develops at a time when the economic producers of goods and services are propelled sufficiently by a promise of enhancing their profit margins, by improving the overall standard of their products. At this point, the consumers are required to make low payment while buying those goods. This increases the purchasing power and culminates into an economic condition called Deflation.
2. Deflation is considered to be a natural phenomenon, as far as hard currency economies are concerned. In this case, the rate of increase in money supply is not maintained in proportion to the positive population and the general growth of the economy. Under such circumstance, the per head availability of hard money reduces. This leads to the escalation in the purchasing power

of each unit of currency. This permanent deflationary condition is visible in the later part of the 19th century, with noticeable developments in the economy under the above-mentioned conditions.

3. Hard money economies claim that the economy involves no rigidity. Hence Deflation is a most welcome phenomenon here, for the economy to make diversified ventures in other fields as well, owing to the lowering of prices. This is always a good deflationary effect, as far as economic growth and development is concerned.

4. Deflation generally exerts negative impact on a country's economic conditions. This is because the advent of Deflation acts as a tax on the borrowers and the liquid asset holders simultaneously. This in turn, acts as a benefit, as far as the liquid cash and asset holders and the savers are concerned. Thus, Deflation is just the opposite economic situation to Inflation, levying tax on money lenders and holders, in the interest of short-term consumption and that of the borrowers. As per the contemporary economic thoughts, the concept of Deflation is associated with a certain amount of risk. Here, the risk-adjusted return of assets becomes negative in nature, thereby encouraging the purchasers and investors to gather money, rather than investing it in solid and assured securities. This leads to the formation of a theoretical condition known as Liquidity Trap. Liquidity trap is regarded as a critical condition as it stagnates the economy, where the nominal rate of interest becomes zero or close to zero.

5. Deflation discourages both investment and expenditure. In contemporary economic conditions, the penalties associated with Deflation have increased. This escalation results from lengthy loan terms, essential for the continuation of general commercial activities and building of a country. In fact, Deflation brings with it, a fall in the aggregate demand. Emergence of deflationary spiral is considered to be one of the primary impacts of Deflation. In this case, there is fall in the prices, resulting in the creation of a vicious circle. This makes a problematic situation to worsen, rather than reaching any amicable solution. Perhaps, the greatest instance of deflationary spiral is the Great Depression, occurring in the United States of America during the Civil War.

6. With the emergence of deflationary spiral, the solution to the decreasing collective demand acts as an incentive to the central bank of a nation, asking for the expansion in the supply of money. It also stimulates the country's

fiscal authorities to increase demand, as well as lend money at low interest rates than those available with the private commercial bodies.

7. According to the Monetarist Theory of Deflation, Deflation affects an economy by decreasing the velocity of money or the number of commercial transactions more or less permanently. This leads to the emergence of a remarkable contraction in the supply of money.

Check your progress 6

1. Which among the following is not the actual result of deflation/

   a. Improvement of production efficiency

   b. Consumers will make less payment for buying goods

   c. Rate of increase in money supply is not maintained

   d. Encourages investment and expenditure

2.8 Measures to Control Deflation

Anti-deflationary measures are opposite of those used to control inflation.

1. **Monetary policy:** Central Bank will have to follow cheap money policy – reducing the bank rate, organising open market purchase of securities, reducing margin requirements, etc to encourage borrowing. But because of falling prices and low marginal efficiency of capital, cheap money policy of the central bank may not be very effective in controlling deflation.

2. **Fiscal Policy:** Fiscal measures like deficit financing, reduction in tax rates, tax concessions, public works programmers, may prove to be more efficient in improving the situation than the monetary measures.

3. **Other measures:** Price support programmes, rationing of essential commodities, import of essential goods, grant of subsidies, development of infrastructure, marketing facilities etc., to some extent may ease the situation.

4. **Both inflation and deflation are dangerous:** Of the two deflations is more dangerous as it cripples the system and establishes a hopeless situation everywhere.

Check your progress 7

1. Which among the following is not a Fiscal Policy measure to control deflation?

a. deficit financing

b. reduction in tax rates

c. tax concessions

d. grant of subsidies

2.9 Public Investment

Investment can be many things such as investment in machinery, buildings, facilities and computers. Operating expenditure on training, education and research is sometimes also regarded as investment.

Physical investment is the most obvious, as it involves constructing new buildings, roads and facilities. This is the type of investment included in the public capital budgets and it is also the focus area of the Government's strategic investment programme.

However, this does not mean that operating expenditure on training, education and research is unimportant for the growth of a society. Expenditure in these areas is often and rightly so, regarded as valuable investment for both individuals and society as a whole. However, such expenditure is not covered here because it is not included in the investment budget.

Total public investment encompasses investment in physical infrastructure made by central government, local government and public corporations

It is the most effective instrument for reviving economic activities and checking falling prices. Government need not depend on profit or other favourable market conditions. Public works projects can be undertaken in a very wide scale. This will provide the much needed employment and income to the people. As the people spend their income, demand and price level start rising providing the required support. It could be recalled, that Keynes advocated' government expenditure through public works during the 1930s depression.

Check your progress 8

1. Which is not covered under public investment?

   a. investment in arranging international tournaments

   b. investment in physical infrastructure

   c. investment in arranging public transport

   d. all of above

2.10 Inflation vs. Deflation

Both Inflation and Deflation are socially bad, but inflation may be considered to be the lesser of the two evils. Inflation is unjust in its effects on the following counts:

1. Inflation redistributes income in the favour of the rich and the profiteer class at the cost of the poor masses - the wage-earners and consumers.
2. Through its redistributive effects, inflation increases the inequality of income in the community by widening the gulf between higher income groups and lower income groups. The rich become richer and the poor become poorer during inflation.
3. Inflation is regressive in effect in the sense that it hits hard those who are already weak and cannot protect themselves. It is specially the middle class which suffers most due to inflation.
4. Inflation is unjust because it affects different classes of people in society in different ways and different degrees .if inflation were to affect everyone in the society in exactly the same manner and to the same degree, it would not alter the economic and social relationships in the community. But inflation takes away wealth from some people and transfers to others arbitrarily without taking into consideration the sound maxim of social equity.
5. Inflation is also unjust because it breaks public morale. From the point of view of social ethics, inflation is always demoralizing; it introduces the spirit of gambling. It promotes speculation, hoarding and diverts business skill and efficiency from productive purposes to speculative purposes.
6. Inflation erodes real savings by deterioration in the value of money.

7. Inflation creates money illusion and generates artificial prosperity, which is not permanent.

On the other hand, Deflation is inexpedient and, therefore, not advisable. It is considered inexpedient for the following reasons;

1. Deflation means falling prices in general which adversely affect the marginal efficiency of capital. Consequently, investment volume tends to contract causing unemployment to increase.
2. Deflation paves the way for depression. In a depressionary phase, economic activity contracts, scale of production is curtailed, output shrinks no new investment if forthcoming; on the contrary, investment is curtailed.
3. By reducing aggregate income, it also pauperizes every group in society. It inflicts on society the harsh punishment of mass unemployment. Volume of employment falls, money income of the community diminishes and, therefore, even though people's purchasing power is increased due to falling prices, they are unable to buy goods in the required quantity. Thus, aggregate demand falls, profit falls producers suffer heavy losses and curtail investment and output further, leading to a further decline in employment and income.

This clearly shows that though inflation is unjust, it is better than deflation. Prof. Keynes showed a preference for inflation, because it is the lesser of the two evils.

The following points bring out the fact that inflation is a lesser evil:

1. Inflation, though it redistributes income and wealth in the community in an unjust manner, does not reduce the national income of the community. Deflation, on the other hand, reduces the national income of the community and pauperizes society as a whole.
2. Deflation increases the level of unemployment in the economy, whereas inflation at least implies that all factors are employed in some way or another. Inflation is a post-full employment phenomenon; deflation is an under-employment phenomenon aggravating the problem of unemployment.
3. It is easy to control inflation by a clear money policy, coordinated by appropriate fiscal policy, but it is difficult to recover from deflation. Once a deflationary tendency starts, it increases business pessimism, the marginal

efficiency of capital diminishes and investment is contracted and ultimately a severe depression sets in. Monetary policy becomes helpless here and no amount of increase in the money supply can revive the price level and business expectations or marginal efficiency or capital in the economy during depression. On the other hand, an inflationary spiral can be reflated by controlling credit and money supply.

Check your progress 9

1. Which is not an outcome of inflation?

a. affects different classes of people in society

b. increases level of unemployment in economy

c. introduces the spirit of gambling

d. all of above

2.11 Reflation

Reflation is the act of motivating the economy by increasing the money supply or by reducing taxes. It is the opposite of disinflation. It can refer to an economic policy whereby a government uses fiscal or monetary incentive in order to expand a country's output. This can possibly be achieved by methods that include reducing tax, changing the money supply or even adjusting interest rates. Just as disinflation is considered an acceptable antidote to high inflation, reflation is considered to be an antidote to deflation (which, unlike inflation, is considered bad regardless how high it is).

Originally it was used to describe a recovery of price to a previous desirable level after a fall caused by a recession. Today it also (in addition to the above) describes the first phase in the recovery of an economy which is beginning to experience increasing prices at the end of a slump. With rising prices, employment, output and income also increase till the economy reaches the level of full employment.

Check your progress 10

1. Which is not a feature of Reflation?

a. It motivates the economy by increasing money supply

b. It motivates the economy by reducing taxes

c. It uses fiscal or monetary incentive to expand economy

d. none of above

2.12 Disinflation

Disinflation is a decrease in the rate of inflation – a slowdown in the rate of increase of the general price level of goods and services in a nation's gross domestic product over time. It is the opposite of reflation.

If the inflation rate is not very high to start with, disinflation can lead to deflation – decreases in the general price level of goods and services. For example if the annual inflation rate one month is 5% and it is 4% the following month, prices disinflated by 1% but are still increasing at a 4% annual rate. If the current rate is 1% and it is the -2% the following month, prices disinflated by 3% and are decreasing at a 2% annual rate.

There is widespread consensus among economists that inflation is caused by increases in the supply of money available for use in a nation's economy. Inflation can also occur when the economy 'overheats' because of excess aggregate demand (this is called demand-pull inflation). The causes of disinflation are the opposite, either a decrease in the growth rate of the money supply or a business cycle contraction (recession). During a recession, competition among businesses for customers becomes more intense and so retailers are no longer able to pass on higher prices to their customers. In contrast, deflation occurs when prices are actually dropping.

Check your progress 11

1. Which is a feature about Disinflation?

   a. It motivates the economy by increasing money supply

   b. It motivates the economy by reducing taxes

   c. It uses fiscal or monetary incentive to expand economy

   d. It decrease the rate of inflation

2.13 Let Us Sum Up

In this unit we have learnt that inflation results in increase in amount of money in circulation and also refer to a rise in price level. Further it is seen that an increase in money supply is called as monetary inflation which is different from rising prices. It is studied that demand pull inflation occurs when aggregate demand for goods exceeds aggregate supply of goods at current prices making an increase in price level. There are certain factors which bring about increase in aggregate demand for goods as (i) Factors operating on demand side (ii) Factors operating on the supply side.

The cost push inflation occurs when there is an increase in cost of production of goods and which is not linked with excess demand. It occurs due to increase in money wage rate, profit push inflation, material push inflation, higher taxes and import prices. On the other hand we see that deflation results when general level of prices falls. It is reverse of inflation. It occurs when general level of prices increase in value of money, decline in effective demand and when an increase in unemployment occurs.

By public investment we mean that the investment that is related to machinery, buildings, facilities and computers. Operating expenditure on training, education and research is sometimes also regarded as investment. Reflation is stimulation of economy by increasing money supply or reducing taxes. This is reverse of disinflation. It can be called as economic policy as government uses fiscal or monetary stimulus to expand country's output. Disinflation is a decrease in the rate of inflation – a slowdown in the rate of increase of the general price level of goods and services in a nation's gross domestic product over time. It is the opposite of reflation.

2.14 Answer for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-c)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-d)

Check your progress 8

Answers: (1-a)

Check your progress 9

Answers: (1-b)

Check your progress 10

Answers: (1-d)

Check your progress 11

Answers: (1-d)

2.15 Glossary

1. **Inflation** - In economics, inflation is referred to as increases in amount of money in circulation.
2. **Cost push inflation** - It is increase in cost of production of goods with no relevance with excess demand.
3. **Deflation** - In economics, deflation is falling off price of goods.

2.16 Assignment

Write summary on causes of inflation?

2.17 Activities

Explain the meaning and types of inflation. Differentiate between demand-pull and cost-push inflation.

2.18 Case Study

Collect some information and compare about inflation and disinflation.

2.19 Further Readings

1. Government of India: Report of Banking Commission 1972.
2. An Introduction to Monetary Theory, Chandler L.V.
3. Reserve bank of India: Report of second working group on money supply on India- Concepts. Complaint and analysis, 1977.

Block Summary

This block gives detailed information about money and money supply with knowledge on its constituents and determinants. The idea of Velocity of Circulation of Money and RBI's measure of money supply are detailed with features and characteristics. The block explained more about demand for Money and its precautionary measure which will help to gather related to speculation. The knowledge about working and role of Ultimate Wealth Holders are detailed.

After studying this block, you understand correctly about inflation and types of inflation with more information on its control. The concept of deflation and its effect along with its controlling measures gives knowledge to student which will help them know to compare about deflation with inflation. The comparison, features, characteristics and control measures regarding inflation and disinflation allow you to understand more about cause and effect of inflation.

Block Assignment

Short Answer Questions

1. What is Cost push inflation?
2. Explain the concept of Velocity of Circulation of Money?
3. State the role of Ultimate Wealth Holders?
4. What is RBI's measure in terms of money supply?
5. What is disinflation?

Long Answer Questions

1. Differentiate between demand-pull and cost-push inflation?
2. Write short note on Inflation vs. Deflation?
3. What are the controlling factors of inflation?

Enrolment No. ☐

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
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BANKING MANAGEMENT

PGDF-201

BLOCK 2:
EVOLUTION OF BANKING

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BANKING MANAGEMENT

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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included may tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

BANKING MANAGEMENT

Contents

Manner of Arising Deposit, Multiple Expansion of Credit, Technique of Credit Creation, Credit Contraction, Criticism of the Theory of Credit Creation.

BLOCK 3: STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

UNIT 1 MONEY MARKET

Introduction, Meaning and Function of financial system, Functions of Money Market, Components or Structured of Indian Money Market: Organized Sector of Indian Money Market, Unorganized Sector of Indian Money Market, Features (or Defects) of-Indian Money Market, Reforms in Indian Money Market

UNIT 2 CAPITAL MARKET AND RBI

Capital market, Significance (or Role) of Capital Market in Economic Development, Structure of Capital Market in India, Market Capitalisation, Introduction to RBI, Traditional or General Functions of the RBI, Development Function of RBI, RBI'S Monetary Policy, Objectives of RBIs Monetary Policy, Instruments of RBls Monetary Management, Recent Changes in RBI's Monetary Management, Evaluation of RBIs Monetary Policy

BLOCK 4: SOURCES AND USES OF FUNDS

UNIT 1 SOURCE AND USES OF FUNDS IN BANKS

Introduction, Type of Financing, Repayment Method, Venture Capital, Factoring Services, Banknet, Automated Teller Machine (ATM), Phone Banking, Net Banking or Internet Banking, Gold Deposit Scheme

UNIT 2 MERCHANT AND RETAIL BANKING

Assistance provided by Merchant bankers, Guidelines on Merchant Banking, Meaning and Definition of Credit Card, Other Types of Cards, Operation of the Credit Card, Advantages of Credit Card, Disadvantages of Credit Card, New Scheme of Farmers Credit Card, Debit Cards,

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BANKING MANAGEMENT

BLOCK 2: EVOLUTION OF BANKING

BLOCK 2: EVOLUTION OF BANKING

Block Introduction

The financial system of India has shown a great deal of resilience. It is sheltered from any crisis triggered by any external macroeconomics shock as other East Asian Countries suffered. This is all due to a flexible exchange rate regime, the foreign reserves are high, the capital account is not yet fully convertible and banks and their customers have limited foreign exchange exposure.

In this block, students will get knowledge about functions of commercial banks and services rendered by such banks with knowledge about certain agency services. The concept of General Utility Services and Systems of Banking are well explained with features and characteristics. The block will detail about Group Banking and Chain Banking along with advantages and disadvantages of Branch Banking and Unit Banking are explained.

After studying this block, students will be able to understand correctly about Balance Sheet of Commercial Banks and Commercial Bank and Credit Creation with technical details. The concept of multiple expansion of credit and criticism theory of Credit Creation gives knowledge to student which will help them know about certain credit norms. The concepts of Window Dressing will allow students to understand more about banking strategies.

Block Objective

After learning this block, you will be able understand:

- The working of Commercial Banks.
- Idea about Agency Services.
- Detailed about Banking Systems.
- Comparison about Group Banking and Chain Banking.
- Generalisation about Unit Banking and Branch Banking.
- Features about Mixed banking.
- Knowledge related to Universal and Merchant Banking.
- Basic about forms of Loans and Advances.

- Studying the characteristics of Balance Sheet of Commercial Banks.
- Knowledge about Window Dressing.
- Functionality about Commercial Banking.
- Various forms of technique of Credit Creation and Contraction.
- Criticism of Theory of Credit Creation.

Block Structure

Unit 1: Types of Banking and Their Services

Unit 2: Loan, Investment and Credit Creation

UNIT 1: TYPES OF BANKING AND THEIR SERVICES

Unit Structure

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Functions of Commercial Banks
- Utility Services
- Group Banking and Chain Banking
- Investment Banking and Mixed banking

1.1 Introduction

For the past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main reasons of India's growth process.

The evolution of banking system can be explained in the following phases:

1. Early phase from 1786 to 1969 of Indian Banks
2. Nationalization of Indian Banks and up to 1991 prior to Indian banking sector reforms
3. New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991

Phase I

The General Bank of India was set up in the year 1786. Next came Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholders banks, mostly Europeans shareholders. In 1865 Allahabad Bank was established and first time exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were set up. Reserve Bank of India came in 1935.

During the first phase the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 banks,

mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority. During those day's public has lesser confidence in the banks. As an aftermath deposit mobilization was slow. Abreast of it the savings bank facility provided by the Postal department was comparatively safer. Moreover, funds were largely given to traders.

Phase II

Government took major steps in this Indian Banking Sector Reform after independence. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale especially in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all over the country.

Seven banks forming subsidiary of State Bank of India was nationalized in 1960 on 19th July, 1969, major process of nationalization was carried out. It was the effort of the then Prime Minister of India, Mrs. Indira Gandhi. 14 major commercial banks in the country were nationalized.

Second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government ownership. The following are the steps taken by the Government of India to Regulate Banking Institutions in the Country:

1949: Enactment of Banking Regulation Act.

1955: Nationalization of State Bank of India.

1959: Nationalization of SBI subsidiaries.

1961: Insurance cover extended to deposits.

1969: Nationalization of 14 major banks.

1971: Creation of credit guarantee corporation.

1975: Creation of regional rural banks.

1980: Nationalization of seven banks with deposits over 200 crore.

After the nationalization of banks, the branches of the public sector bank India rose to approximately 800% in deposits and advances took a huge jump by 11,000%. Banking in the sunshine of Government ownership gave the public

implicit faith and immense confidence about the sustainability of these institutions.

Phase III

This phase has introduced many more products and facilities in the banking sector in its reforms measure. In 1991, under the chairmanship of M Narasimham, a committee was set up by his name which worked for the liberalization of banking practices.

The country is flooded with foreign banks and their ATM stations. Efforts are being put to give a satisfactory service to customers. Phone banking and net banking is introduced. The entire system became more convenient and swift. Time is given more importance than money.

1.2 Functions of Commercial Banks and Services Rendered By them

The functions of commercial banks are divided into two categories:

i) Primary functions

ii) Secondary functions including agency functions

i) Primary functions:

The primary functions of a commercial bank include:

a) Accepting deposits

b) Granting loans and advances

a) Accepting deposits: The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

b) **Granting loans and advances:** The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts.

The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the Loans is the main source of a bank's income.

Modes of short-term financial assistance

Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

1. **Cash Credit:** Cash credit is an arrangement whereby the bank allows the borrower to draw amounts up to a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash Credit is granted as per agreed terms and conditions with the customers.
2. **Overdraft: Overdraft** is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit is allowed either on the security of assets or on personal security or both.
3. **Discounting of Bills:** Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonoured on the due date, the bank can recover the amount from the customer

ii) Secondary functions

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

1. Issuing letters of credit, travellers' cheque, circular notes etc.
2. Undertaking safe custody of valuables, important documents and securities by providing safe deposit vaults or lockers;
3. Providing customers with facilities of foreign exchange.
4. Transferring money from one place to another; and from one branch to another branch of the bank.
5. Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc.
6. Collecting and supplying business information;
7. Issuing demand drafts and pay orders; and,
8. Providing reports on the credit worthiness of customers.

Besides the two main activities, commercial banks also render a number of ancillary services. These services supplement the main activities of the banks. They are essentially non-banking in nature and broadly fall under two categories:

i) Agency services.

ii) General utility services.

Check your progress 1

1. Which is not a main function of commercial bank?

a. Accepting deposits

b. Granting loans

c. Granting advances

d. Issuing of Cheques

1.3 Agency Services

A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank and paid directly into their bank accounts or for the bank to detach coupons from bearer bonds and present them for payment and to act upon announcements in the Press of drawn bonds, coupons payable, etc. Orders for the purchase or sale of stock exchange securities are

executed through the banks' brokers who will also give their opinions on securities or lists of securities. Similarly, banks will make applications on behalf of their customers for allotments arising from new capital issues, pay calls as they fall due and ultimately obtain share certificates or other documents of title. On certain agreed terms the banks will allow their names to appear on approved prospectuses or other documents as bankers for the issue of new capital; they will receive applications and carry out other instructions.

A commercial bank undertakes the payment of subscriptions, premia, rent, etc., on behalf of its customers. Similarly, it collects cheques, bills of exchange, promissory notes, etc., on behalf of its customers. It also acts as a correspondent or representative of its customers, other banks and financial corporations.

Most of the commercial banks have an 'Executor and Trustee Department'; some may have affiliated companies to deal with this branch of business. They aim to provide a complete range of trustee, executor or advisory services for a small charge. The business banks acting as trustees, executors, administrators, etc has continuously expanded with considerable usefulness to their customers. By appointing a bank as an executor or trustee of his/her Will, the customer secures the advantage of continuity and avoids having to make changes; impartiality in dealing with beneficiaries and in the exercise of discretions; and the legal and specialized knowledge pertaining to executor and trustee services. When a person dies without making a Will, the next-of-kin can employ the bank to act as administrator and to deal with the estate in accordance with the rules relating to intestacies. Alternatively, if a testator makes a Will but fails to appoint an executor or if an executor is unable or unwilling to act, the bank can usually undertake the administration with the consent, of line persons who are immediately concerned. Banks will at solely or jointly with others in these matters, as also in the case of trustee for stocks, shares, funds, properties or other investments.

Under a declaration of trust, a bank undertakes the supervision of investments and distribution of income; a customer's investments can be transferred into the bank's name or control, thus enabling it to act immediately upon a notice of rights issue, allotment letters, etc. Alternatively, where it is not desired to appoint the bank as nominee, these services may still be carried out by appointing the bank as attorney. Where business is included in an estate or trust, a bank will provide for its management for an limited period, pending its sale to the best advantage as a going concern or transfer to a beneficiary. Private companies wishing to set up Pension Funds may appoint a bank as custodian, trustee and

investment advisor, while retaining the administration of the Scheme in the hands of the management of the Fund. Most banks will undertake on behalf of their customers the preparation of income tax returns and claims for the recovery of overpaid tax; they also assist. The customers in checking the assessments. In addition to the usual claims involving personal allowances and reliefs, claims are prepared on behalf of residents abroad, minors, charities, etc.

Check your progress 2

1. Which among the following is a function of commercial bank?

   a. To undertake payment of subscriptions

   b. To collect cheques

   c. To issue promissory notes

   d. All of above

1.4 General Utility Services

These services are those in which the bank's position is not that of an agent for his customer. They include the issue of credit instruments like letters of Credit and of offsetting inter-bank indebtedness arising from the transfer of deposits by a customer of a particular bank to another bank.

The mechanism of offsetting inter-bank indebtedness through a clearing house operates as follows. Officials representing various banks meet at a common place, the clearing house, every day. Each representative then delivers to the others cheques and other claims which his bank holds against them. So also he receives from the others the claims which their respective banks hold against his bank. Cheques and other documents dishonoured will be returned to the representative of the respective bank. The various amounts of receipts and deliveries are added up and a balance is struck therein. And the final settlement is effected by the supervisor of the clearing house by transferring the balance kept at the central bank by these various clearing banks.

The advantages which a clearing house confers on society are manifold. It prevents the waste and cost involved in collecting each and every cheque and claim which a bank holds against another across the counter with all the danger of loss in transit incumbent upon it. Great economy is also achieved in the

employment of liquid cash by settling the difference by simple transfer of credit from one account to another, thereby minimizing the necessity of holding large idle cash balances.

Check your progress 3

1. Which is not a utility service of a commercial bank?

   a. issue of pan card

   b. issue of letters of credit

   c. issue of offsetting inter-bank indebtedness

   d. issue of transfer of deposit by customer

1.5 Systems of Banking

With the full-fledged development of banking institutions, various systems of commercial banks like 'Unit Banking', 'Branch Banking', 'Group Banking' otherwise known as 'Holding Company Banking' and 'Chain Banking' have come into vogue. The typical commercial bank functioning in most countries is of the branch banking type. Under this system, banking is conducted by institutions with head offices in large cities operating numerous branches throughout the country. In contrast to this, under the unit banking system banking tends to be localized, each maintaining a single office. In exceptional cases, it may also have branches; but within a strictly limited area. In addition to these systems, there are group banking and chain banking systems. Under the former system, which is also known as holding company banking system, a certain number of banks?

Combine together through the ownership of stock by holding companies. Under the latter, chains of banks are formed by the common stock ownership without any intervention of holding companies or by interlocking directorates.

Check your progress 4

1. Which among the following is not a system of commercial banks?

   a. Unit Banking

   b. Net Banking

   c. Branch Banking

   d. Group Banking

1.6 Group Banking and Chain Banking

Group banking and chain banking systems are commonly found in the United States of America. Their origin may either be attributed to the attempt to achieve the advantages of large scale operations or to satisfy the desire for power. Whatever it may be, as compared to the other systems of banking such as, unit banking and branch banking, these systems cannot be considered as worthy of adoption. It is true that in the United States of America they are subjected to a number of Governmental regulations ranging from statutory prohibition to start certain types of holding companies to special investigation and control by the authorities concerned.

According to the holding company banking system, a group of banks are brought under one centralized management and this centralized management exerts control over all the units. Although each bank has got a separate entity in itself, its affairs are controlled by a holding company. It is not uncommon for such a holding company to be affiliated with larger banks, in which case the policies of the whole group are influenced by that bank. This system of banking has been used, besides for the purpose of unifying the management, for bringing into closer relations banking corporations and other trading corporations. This is because the holding companies may include not only banking corporations but also non-banking corporations as their subsidiaries in certain cases.

The supporters of holding company banking system point out certain merits of the system. They say that in the case of holding company banking system, it is not necessary to maintain large amounts of cash reserve by each and every bank of the system because such reserves can be centralized in one of the bigger members of the group. This member of the group will be willing to help other banks in the group whenever required although there is no legal obligation for any member of the group to help another. Further, all the members of the group can participate in loans given to large borrowers who, in the absence of such a group, would look elsewhere for accommodation. Finally, economies of large scale operations can be achieved by cutting down operating costs, by purchasing supplies in bulk and by improving the efficiency of management.

As against these, certain disadvantages may also be pointed put. It is definitely undesirable to tie up banking corporations with non-banking corporations. Under group banking system, a banking corporation as well as a non-banking corporation may be subsidiaries of the same holding company and the holding company, in its effort to secure more profits, may overlook sound banking principles, thus landing the banking corporation in danger. The banking

crisis of the United States of America during the early thirties stands as a testimony to this danger. Of course, in the United States of America, the law now protects the banks from this serious disadvantage by prohibiting bank holding companies to own the voting shares of non-banking corporations. It is also illegal, in that country, for any bank to make loans or to purchase the securities of a holding company of which it is a subsidiary or any other subsidiary, of the same holding company. Another disadvantage of this system of banking is that it may lead to monopolies, thereby restraining healthy competition among banks, which is highly necessary for a balanced development of banking.

Chain banking involving stock ownership in a number of banks by one or a number of individuals and interlocking directorates closely resembles group banking. The main difference between these systems lies in the fact that in the case of group banking the affairs of the group are controlled by a holding company whereas in the case of chain banking there is no such intervention from any central organisation.

Without much needless repetition, it may be pointed out that the advantages of the chain banking system are more or less similar to those of group banking system and they arise from the economies of large scale operations, centralization of reserves, parallel management, etc. So also the disadvantages may be said to arise from mismanagement and exploitation.

Check your progress 5

1. Which is not possible under group banking?

   a. banking corporation is a subsidiaries of similar holding company

   b. non-banking corporation is a subsidiaries of similar holding company

   c. it may lead to monopolies

   d. it involves stock ownership

1.7 Unit Banking and Branch Banking

The banking systems in different countries vary considerably from one another. Broadly speaking, however, there are two important types of banking systems, namely, unit banking and branch banking.

A. Unit Banking

'Unit banking' means a system of banking under which banking services are provided by a single banking organisation. Such banks have single office or place of work. They have their own governing body or board of directors. They function independently and are not controlled by any other individual, firm or body corporate. They do not control any other bank. Such banks can become member of the clearing house and also of the Banker's Association.

B. Branch Banking System

It means a system of banking in which a banking organisation works at more than one place. The main place of business is called head office and the other places of business are called branches. The head office controls and co-ordinates the work at branches. The day-to-day operations are performed by the branch manager as per the policies and directions issued from time to time by the head office.

This system of banking is prevalent throughout the world. In India also, all the major banks have been operating under branch banking system.

Check your progress 6

1. Which is in-correct in case of Unit Banking?

   a. They are not controlled by individual, firm or body corporate

   b. It is a multiple banking organisation

   c. They have their own governing body

   d. These banks can serve as member of clearing house

1.8 Advantages and Disadvantages of Branch Banking and Unit Banking

1. Unit Banking:

The advantages and disadvantages of Unit banking are as under:

Advantages of Unit Banking

a) **Efficient Management:** One of the most important advantages of unit banking system is that it can be managed efficiently because of its size and work. Co-ordination and control becomes effective. There is no communication gap between the persons making decisions and those executing such decisions.

b) **Better Service:** Unit banks can render efficient service to their customers. Their area of operation being limited, they can concentrate well on that limited area and provide best possible service. Moreover, they can take care of all banking requirements of a particular area.

c) **Close Customer-banker Relations:** Since the area of operation is limited the customers can have direct contact. Their grievances can be redressed then and there.

d) **No Evil Effects due to Strikes or Closures:** In case there is a strike or closure of a unit, it does not have much impact on the trade and industry because of it's small size. It does not affect the entire banking system.

e) **No Monopolistic Practices:** Since the size of the bank and area of its operation are limited, it is difficult for the bank to adopt monopolistic practices. Moreover, there is free competition. It will not be possible for the bank to indulge in monopolistic practices

f) **No Risks of Fraud:** Due to small size of the bank, there is stricter and closer control of management. Therefore, the employees will not be able to commit fraud.

g) **Closure of Inefficient Banks:** Inefficient banks will be automatically closed as they would not be able to satisfy their customers by providing deficient service.

h) **Local Development:** Unit banking is localized banking. The unit bank has the specialized knowledge of the local problems and serves the requirement of the local people in a better manner than branch

banking. The funds of the locality are utilized for the local development and are not transferred to other areas.

i) **Promotes Regional Balance:** Under unit banking system, there is no transfer of resources from rural and backward areas to the big industrial and commercial centers. This tends to reduce regional imbalance.

Disadvantages of Unit Banking:

a) **No Economies of Large Scale:** Since the size of a unit bank is small, it cannot reap the advantages of large scale viz., division of labour and specialization.

b) **Lack of Uniformity in Interest Rates:** In unit banking system there will be large number of banks in operation. There will be lack of control and therefore their rates of interest would differ widely from place to place. Moreover, transfer of funds will be difficult and costly.

c) **Lack of Control:** Since the number of unit banks is very large, their co-ordination and control would become very difficult.

d) **Risks of Bank's Failure:** Unit banks are more exposed to closure risks. Bigger unit can compensate their losses at some branches against profits at the others. This is not possible in case of smaller banks. Hence, they have to face closure sooner or later.

e) **Limited Resources:** Under unit banking system, the size of bank is small. Consequently its resources are also limited. Hence, they cannot meet the requirements of large scale industries.

f) **Unhealthy Competition:** A number of unit banks come into existence at an important business centre. In order to attract customers they indulge in unhealthy competition.

g) **Wastage of National Resources:** Unit banks concentrate in big metropolitan cities whereas they do not have their places of work in rural areas. Consequently there is uneven and unbalanced growth of banking facilities.

h) **No Banking Development in Backward Areas:** Unit banks, because of their limited resources, cannot afford to open uneconomic branches in smaller towns and rural areas. As such, these areas remain unbanked.

i) **Local Pressure:** Since unit banks are highly localized in their business, local pressures and interferences generally disrupt their normal functioning.

2. Branch Banking:

The advantages and disadvantages of Branch banking are as under:

Advantages of Branch Banking

a) **Better Banking Services:** Such banks, because of their large size can enjoy the economies of large scale viz., division of work and specialisation. These banks can also afford to have the specialised services of bank personnel which the unit banks can hardly afford.

b) **Extensive Service:** Branch banking can provide extensive service to cover large area. They can open their branches throughout the country and even in foreign countries.

c) **Decentralisation of Risks:** In branch banking system branches are not concentrated at one place or in one industry. These are decentralised at different places and in different industries. Hence the risks are also distributed.

d) **Uniform Rates of Interest:** In branch banking, there is better control and co-ordination of the central bank. Consequently interest rates can be uniform.

e) **Better Cash Management:** In branch banking there can be better cash management as cash easily is transferred from one branch to another. Therefore, there will be lesser need to keep the cash idle for meeting contingencies.

f) **Better Training Facilities to Employees:** Under branch banking the size of the bank is quite large. Therefore, such banks can afford to provide better training facilities to their employees. Almost every nationalised bank in India has its separate training college.

g) **Easy and Economical Transfer of Funds:** Under branch banking, a bank has a widespread of branches. Therefore, it is easier and economical to transfer funds from one branch to the other.

h) **Better Investment of Funds:** Such bank can afford the services of specialised and expert staff. Therefore they invest their funds in such industries where they get the highest return and appreciation without sacrificing the safety and liquidity of funds.

i) **Effective Central Bank Control:** Under branch banking, the central bank has to deal only with a few big banks controlling a large number of branches. It is always easier and more convenient to the central bank to regulate and control the credit policies of a few big banks, than to regulate and control the activities of a large number of small unit banks. This ensures better implementation of monetary policy.

j) **Contacts with the whole Country:** Under branch banking, the bank maintains continual contacts with all parts of the country. This helps it to acquire correct and reliable knowledge about economic conditions in various parts of the country. This knowledge enables the bank to make a proper and profitable investment of its surplus funds.

k) **Greater Public Confidence:** A bank, with huge financial resources and number of branches spread throughout the country, can command greater public confidence than a small unit bank with limited resources and one or a few branches.

Disadvantages of Branch Banking

a) **Difficulties of Management, Supervision and Control:** Since there are hundreds of branches of a bank under this system, management, supervision and control became more inconvenient and difficult. There are possibilities of mismanagement in branches. Branch managers may misuse their position and misappropriate funds. There is great scope for fraud. Thus there are possibilities of fraud and irregularities in the financial management of the bank.

b) **Lack of Initiative:** The branches of the bank under this system suffer from a complete lack of initiative on important banking problems confronting them. No branch of the bank can take decision on important problems without consulting the head office. Consequently, the branches of the bank find themselves unable to carry on banking activities in accordance with the requirements of the local situation. This makes the banking system rigid and inelastic in its functioning. This also leads to "red-tapism" which means "official delay."

c) **Monopolistic Tendencies:** Branch banking encourages monopolistic tendencies in the banking system. A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources in the hands of a small number of men. Such a monopoly power is a source of danger to the community, whose goal is a socialistic pattern of society.

d) **Regional Imbalances:** Under the branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the country.

e) **Continuance of Non-profitable Branches:** Under branch banking, the weak and unprofitable branches continue to operate under the protection cover of the stronger and profitable branches.

f) **Unnecessary Competition:** Branch banking is delocalised banking, under branch banking system, the branches of different banks get concentrated at certain places, particularly in big towns and cities. This gives rise to unnecessary and unhealthy competition among them. The branches of the competing banks try to tempt customers by offering extra inducements and facilities to them. This naturally increases the banking expenditure.

g) **Expensiveness:** Branch banking system is much more expensive than the unit banking system. When a bank opens a number of branches at different places, then there arises the problem of co-coordinating their activities with others. This necessitates the employment of expensive staff by the bank.

h) **Losses by some Branches affect others:** When some branches suffer losses due to certain reasons, this has its repercussions on other branches of the bank.

Thus, branch banking system as well as unit banking system suffers from defects and drawbacks. But the branch banking system is, on the whole, better than the unit banking system. In fact, the branch banking system has proved more suitable for backward and developing countries like India. Branch banking is very popular and successful in India. A comparison between unit banking and branch banking is essentially a comparison between small-scale and large-scale operations.

Check your progress 7

1. Which is not an advantage of Unit Banking?

a. They can be managed efficiently

b. There arises communication gap between persons making decisions and person executing decisions

c. They offer efficient service to customers

d. They have direct contact with customers

1.9 Investment Banking and Mixed banking

An investment bank is a financial institution that assists individuals, corporations and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also assist companies involved in mergers and acquisitions and provides ancillary services such as market making, trading of derivatives, fixed income instruments, foreign exchange, commodities and equity securities.

Investment banking:

Investment banking is a particular form of banking which finances capital requirements of an enterprise. Investment banking assists as it performs IPOs, private placement and bond offerings, acts as broker and carries through mergers and acquisitions.

Functions of Investment Banking:

Investment banks have multilateral functions to perform. Some of the most important functions of investment banking can be jot down as follows:

a) Investment banking help public and private corporations in issuing securities in the primary market, guarantee by standby underwriting or best efforts selling and foreign exchange management. Other services include acting as intermediaries in trading for clients.

b) Investment banking provides financial advice to investors and serves them by assisting in purchasing securities, managing financial assets and trading securities.

c) Investment banking differs from commercial banking in the sense that they do not accept deposits and grant retail loans. However, the dividing line has

become flimsy with loans and securities becoming almost substitutable ways of raising funds.

d) Small firms providing services of investment banking are called boutiques. These mainly specialize in bond trading, advising for mergers and acquisitions, providing technical analysis or program trading.

Mixed Banking:

There are some banks which are involved in both commercial and industrial banking. This banking system is called as mixed banking. The main purpose of mixed banking is to raise capital and draw deposits and loans from the public and make them available for both short term and long term requirements of industries. The long-established outlook of banking was that commercial bank are only required to provide short term lending and maintain a high level of liquidity as they are traders in other's deposits. But some European countries banks are involved in activity of lending to industries for long term and subscribe to share capital of new companies. Such banks in Germany are known as universal bank or mixed banks as they combine commercial banking with industrial finance.

Check your progress 8

1. Which is not a function of Investment Banking?

   a. It helps public and private corporations in issuing securities in primary market

   b. It provides financial advice to investors

   c. It grant retail loans

   d. It raises capital

1.10 Universal Banking

It is a multipurpose and multi-functional financial supermarket providing both 'Banking and Financial Services' through a single window.

As per the World Bank," In Universal Banking, large banks operate extensive network of branches, provide many different services, hold several claims on firms (including equity and debt) and participate directly in the Corporate Governance of firms that rely on the banks for funding or as insurance underwriters."

In a nutshell, a Universal Banking is a superstore for financial products, under one roof. Corporate can get loans and avail of other handy services, while individuals can bank and borrow. It includes not only services related to savings and loans but also investment. However in practice the term 'Universal Banking' refers to those banks that offer wide range of financial services beyond the commercial banking functions like Mutual Funds, Merchant Banking, Factoring, Insurance, Credit Cards, Retail loans, Housing Finance, Auto Loans, etc.

The solution of Universal Banking was having many factors to deal with, which can be further analysed by the pros and cons.

Advantages of Universal Banking

a) **Economies of Scale:** The main advantage of Universal Banking is that it results in greater economic efficiency in the form of lower cost, higher output and better products. Many Committees and reports by Reserve Bank of India are in favour of Universal banking as it enables banks to exploit economies of scale and scope.

b) **Profitable Diversions:** By diversifying the activities, the bank can use its existing expertise in one type of financial service in providing other types. So, it entails less cost in performing all the functions by one entity instead of separate bodies.

c) **Resource Utilization:** A bank possesses the information on the risk characteristics of the clients, which can be used to pursue other activities with the same clients. A data collection about the market trends, risk and returns associated with portfolios of Mutual Funds, diversifiable and non-diversifiable risk analysis, etc., is useful for other clients and information seekers. Automatically, a bank will get the benefit of being involved in the researching

d) **Easy Marketing on the Foundation of a Brand Name:** A bank's existing branches can act as shops of selling for selling financial products like Insurance, Mutual Funds without spending much efforts on marketing, as the branch will act here as a parent company or source. In this way, a bank can reach the client even in the remotest area without having to take resource to an agent.

e) **One-stop shopping:** The idea of 'one-stop shopping' saves a lot of transaction costs and increases the speed of economic activities. It is beneficial for the bank as well as its customers.

f) **Investor Friendly Activities:** Another manifestation of Universal Banking is bank holding stakes in a form: a bank's equity holding in a borrower firm, acts as a signal for other investor on to the health of the firm since the lending bank is in a better position to monitor the firm's activities.

Disadvantages of Universal Banking

a) **Grey Area of Universal Bank:** The path of universal banking for DFIs is strewn with obstacles. The biggest one is overcoming the differences in regulatory requirement for a bank and DFI. Unlike banks, DFIs are not required to keep a portion of their deposits as cash reserves.

b) **No Expertise in Long-term lending:** In the case of traditional project finance, an area where DFIs tread carefully, becoming a bank may not make a big difference to a DFI. Project finance and Infrastructure finance are generally long- gestation projects and would require DFIs to borrow long-term. Therefore, the transformation into a bank may not be of great assistance in lending long-term.

c) **NPA Problem Remained Intact:** The most serious problem that the DFIs have had to encounter is bad loans or Non-Performing Assets (NPAs). For the DFIs and Universal Banking or installation of cutting-edge-technology in operations are unlikely to improve the situation concerning NPAs.

Check your progress 9

1. Which among the following are the advantages of Universal Banking?

   a. It result in higher economic efficiency

   b. It uses low cost in doing all functions

   c. It increases the speed of economic activities

   d. all of above

1.11 Merchant Banking

Merchant banking is defined as an activity that includes corporate finance activities, such as advice on complex financings, merger and acquisition advice and at times direct equity investments in companies. Merchant banking is a service-oriented industry. They render various services in relation to promotion and operation of industrial projects, flotation of new companies and preparation, planning and execution of new projects for which guidance and advice must be offered

Merchant banking is the business of money. Its primary purpose is to link users of capital with providers of capital, seeking optimum financial efficiency for both. It is the intermediary channel through which capital is distributed efficiently and exchanged effectively. As such, merchant banking claims to be a critical mechanism for facilitating the resource allocation decisions that epitomize the free market system.

The functions of merchant banks are flexible and client oriented. They provide following services:

1. Capital Restructuring Services

The basic objective behind capital restructuring is to enable projects to achieve their maximum potential through effective capital structures and suggest various strategies to widen and restructure the capital base and also to diversify operations and implement schemes for amalgamations or merger or change in the status of business.. Capital restructuring services are intended to provide specialized advice on strengthening, widening or restructuring the existing capital structure. These services include:

- Examining capital structures
- Rejuvenating capital structure ratios
- Suggesting mergers, takeovers, amalgamations and change in business status.

2. Credit Syndication

Also known as credit procurement and project finance service. It includes:

- Estimating the total cost
- Drawing a financial plan for the whole project.
- Preparing loan applications for financial assistance

- Selecting institutions and banks for participation in financing
- Assessing the working capital requirements.

3. Issue Management

The term 'issue management' refers to the work involved in issuing shares and other securities to the public. Merchant banks play a vital role in assisting companies in raising capital by issue of securities. Specifically, issue management service includes:

- Advising the company regarding the issue
- Preparation of prospectus and other related information
- Advising the management on the company's financing structure
- Tie-up with financiers
- Selecting brokers, bankers and advertisers for the issue
- Coordinating with the stock exchanges
- Preparing plan and budget for total expenses of the issue.
- Drafting prospectus.
- Selecting underwriters
- Selecting advertising agency for pre-issue and post-issue publicity.

4. Private Placements

Private placement refers to raising capital by 'placing' the shares and other securities with selected investors. In this regard merchant bankers help companies in:

- Identifying potential investors
- Arranging a meeting with potential investors
- Complying with legal and regulatory requirements

5. Portfolio Management Services

Portfolio management involves making of decisions to invest cash resources into marketable securities. Merchant banks advises investors on the optimum investment mix, taking into account factors like objective of investment, tax bracket of the investor, need for maximizing returns and capital appreciation etc.

6. Foreign (Non-Resident) Investment

This is one of the important activities of merchant banks to bring foreign capital resources for being invested in India.

- Advice on selection of investment
- Critical evaluation of investment portfolio
- Securing approval from RBI for sale or purchase of securities
- Advise the non-residents on market conditions prevailing in India

7. Working Capital Finance

Working capital finance refers to the day-to-day finance required by a company or a project.. Merchant banks kelp companies in:

- Assessing the requirement of working capital finance
- Preparing necessary application for submission to bankers
- Assisting in negotiations for sanction of appropriate credit facilities.

8. Acceptance Credit and Bill Discounting

Accepting bills of exchange on behalf of other parties for a commission is the primary activity of merchant banks round the world, particularly in UK, but, in India this facility is not provided by the merchant bankers to the business community. Acceptance given by a reputed banker to any bill of exchange increases its liquidity and enhances its marketability.

9. Mergers and Takeover

Merchant banks play a vital role in mergers, acquisition and takeovers of companies. Some of the areas where they are involved include the following:

- Formulating schemes of mergers and acquisition
- Obtaining approval from creditors, shareholders, government and other authorities
- Monitoring the implementing the scheme of mergers and acquisition
- Identifying potential targets for takeover
- Appraising mergers and takeover proposals from the perspective of financial viability and technical feasibility
- Determining the purchase consideration and the appropriate exchange ratio

- Assisting in compliance with procedural and legal requirements.

10. Rehabilitation of Sick Companies

Rejuvenating ailing companies and sick units is a major service provided by merchant banks. Specifically, the following services are provided in this regard:

- Evolving rehabilitation programs/ packages which can be acceptable to financial institutions and banks.
- Exploring possibility for merger amalgamation wherever feasible
- Assisting in complying with legal and procedural requirement
- Monitoring implementation of schemes of rehabilitation

11. Project Appraisal

New projects, which involve heavy capital expenditure, are becoming increasingly more exposed to uncertainties. There is need for appraising and control of new project. Merchant banks are involved in the entire process of project management starting from preparatory phase to the trial-run phase and conducting detailed analysis for appraising the project.

Check your progress 10

1. Which is not a function of Merchant Banking?

a. It promotes industrial projects

b. It involves in flotation of new companies

c. It plans for cash deposits

d. It plans for new projects

1.12 Virtual Banking

The practice of banking has undergone significant transformation in the 1990s. While banks are striving to strengthen customer relationship and moving towards "relationship banking", customers are increasingly moving away from the confines of traditional branch banking and are seeking the convenience of remote electronic banking services. And, even within the broad spectrum of electronic banking, the aspect of banking which has gained currency is virtual banking.

Broadly speaking, 'virtual banking' denotes the provision of banking and related services through extensive use of information technology without direct recourse to the bank by the customer. The origin of virtual banking in the developed countries can be traced back to the seventies with the installation of Automated Teller Machines (ATMs). Subsequently, driven by the Competitive market environment as various technological and customer pressures, other types of virtual banking services have grown in prominence throughout the world.

It is possible to delineate the principal types of virtual banking services. These include Automated Teller Machines (ATMs), Shared ATM Networks, Electronic Funds Transfer at Point of Sale (EFTPoS), Smart Cards, Stored—Value Cards, Phone Banking and more recently, internet and internet banking. The salient features of these services are the overwhelming reliance on information technology and the absence of physical bank branches to deliver these services to the customers.

Three evolutionary phases of virtual banking services, which represent the impact that particular application has achieved within the industry have been described in the literature. These include (a) the inception phase, where technology behind the application is in its infancy and a substantial amount of investment is required so as to make the application widely available commercially; (b) the growth phase, where the application is increasingly available to the customers and the technology behind the application is widely available; and (c) the maturity phase, wherein the application is in widespread use and institutions not offering such applications are likely to be at a competitive disadvantage.

The financial benefits of virtual banking are manifold. Firstly, virtual banking has the advantage of having a lower cost of handling a transaction via the virtual resource compared to the cost of handling the transaction via the branch. Secondly, the increased speed of response to customer requirements under virtual banking vis-à-vis branch banking can enhance customer satisfaction and, circumstances remaining the same can lead to higher profits via handling a large number of customer accounts. It also implies the possibility of access to a greater number of potential customers for the bank without the concomitant costs of physically opening branches. Thirdly, the lower cost of operating branch network along with reduced staff costs leads to cost efficiency under virtual banking. Fourthly, virtual banking allows the possibility of improved quality and an enlarged range of services being available to the customer more rapidly and accurately at his convenience.

Check your progress 11

1. The Automated Teller Machines (ATMs) is an example of:

a. Core Banking
c. Virtual Banking
b. Merchant Banking
d. None of above

1.13 Commercial Banks

According to Prof. Hart, "a bank is one who in the ordinary course of business receives money which he repays by honouring cheques of persons from whom or on whose account he receives it". Commercial banks constitute the major portion of the country's credit and banking institutions. In simple term a bank is a dealer in money like a trader in goods.

Commercial Banks in India are organised as joint stock companies and known as banking companies. These banks are primarily classified into Scheduled banks and Non-scheduled banks. Scheduled Banks include nationalised banks, State Bank of India and its subsidiaries, Private sector banks and foreign banks. Non-scheduled banks are those which are not included in the 2nd schedule to RBI Act.

(a) Scheduled Banks

The second schedule of the Reserve Bank of India Act contains a list of Banks which are described as "Scheduled Banks". A bank in order to be designated as a Scheduled Bank should have a paid up capital and reserves as prescribed by the Act. In terms of Sec. 42(6) of RBI Act, 1934, the required amount is only Rs. 5.00 lakh. However, presently to start a Commercial Bank, the RBI prescribed a minimum capital of Rs. 1000 million and its business must be managed in a manner which, in the opinion of Reserve Bank of India, is not detrimental to the interests of its depositors. The Scheduled Banks are also required to maintain with the Reserve Bank of India a deposit in the form of Cash Reserve Ratio, based on its demand and time liabilities at prescribed rate.

The scheduled banks enjoy several privileges. An account with a scheduled bank carries a greater assurance of safety and prestige value than an account with a Non-scheduled bank. It is entitled to receive refinance facility as applicable. It may also get currency chest facility. In times of urgent need, it may obtain finance from the Reserve Bank of India to help it tiding over temporary financial difficulties. Furthermore, the settlement of accounts between scheduled banks is

facilitated by the use of the "Bankers" clearing House procedure". On the other hand, scheduled banks have to submit several returns to the Reserve Bank of India and are obliged to comply with the directions received from the Reserve Bank. Some of these returns have to be submitted in each week usually on Friday. The affairs of Scheduled Banks are closely watched and largely controlled by the Reserve Bank of India, in order to safeguard the general health of the Banking industry as a whole.

(b) Nationalised Banks

The Nationalised banks include the fourteen banks nationalised on 19th July 1969 and the 6 banks nationalised on 15th April 1980. They are also scheduled banks. After

Nationalisation these banks render various types of functions by assuming social responsibilities. Through these banks, the government tries to implement its fiscal policies and various welfare schemes. These banks occupy a pivotal place in the Indian Banking system. They are also called public sector banks. State Bank of India and its subsidiaries are also commercial banks providing services similar to that of nationalised banks.

(c) Non-Scheduled Banks

The commercial banks, not included in the Second Schedule of the RBI Act are known as Non-scheduled Banks. They are not entitled to get facilities like refinance and redis -counting of bills, etc. from RBI. They do not get the prestige like Scheduled Banks. They are mainly engaged in lending money, discounting and collecting bills and various agency services. They insist higher security for loans. As on December 1999, there was only one non-scheduled bank viz. Sikkim Bank Ltd. is in operation. RBI currently does not encourage the opening of non-scheduled banks. Efforts are on to merge the only non-scheduled bank viz. Sikkim Bank Ltd. with Union Bank of India.

Check your progress 12

1. Which among the following comes in category of Non Schedule Bank?

   a. State Bank of India

   b. Sikkim Bank Ltd

   c. Allahabad Bank

   d. Punjab National Bank

1.14 Let Us Sum Up

In this unit we have learnt that the evolution of banking system arises during its early phase from 1786 to 1969, where nationalised Indian Banks came up in 1991 with new phase of Indian Banking System after 1991. It is found that the functions of commercial banks are Primary and Secondary which has main emphasis on accepting of deposits, granting loans and advances.

In case of two banking system like Group banking and chain banking, the advantages of large scale operations as compared to other systems of banking cannot be considered as worthy of adoption. The Unit Banking services are provided by single banking organisation having single office and having its own governing body or board of directors which function independently and are not controlled by any other individual, firm or body corporate.

By Branch Banking System, we mean a system of banking where banking organisation works more than one place that is the head office and branches. The head office controls and co-ordinates the work at branches. The Investment banking is a special form of banking that finances capital requirements of an enterprise. This will assist the performance IPOs, private placement and bond offerings, which acts as broker and carries through mergers and acquisitions.

We can say that a Merchant banking is corporate finance activities involvement operations such as complex financings, merger and acquisition which will advise during direct equity investments in companies.

1.15 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-d)

Check your progress 6

Answers: (1-b)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-d)

Check your progress 10

Answers: (1-c)

Check your progress 11

Answers: (1-c)

Check your progress 12

Answers: (1-b)

1.16 Glossary

1. **Bank capital** - The difference between the value of a bank's assets and its liabilities.
2. **Market** - A place, where are meeting people for buying and selling goods, usually outside.

1.17 Assignment

Write note on Virtual Banking.

1.18 Activities

Collect information on role of Merchant Banking.

1.19 Case Study

Are Group Banking and Chain Bank having similar functions? Comment.

1.20 Further Readings

1. Business Cycles, Hamberg, W.
2. A Contribution to the Theory of the Trade Cycle, Hicks, J. R.
3. The Demand for Money: Some Theoretical and Empi¬rical Results, Friedman, M., Journal of Political Economy, Vol. 67, June 1959.
4. The Demand for Money Theories and Evidences, Laidler, D.
5. Introduction to Macro-Economics, Harney, J. and Johnson, M.
6. Liquidity Functions in the American Economy, Bronfenbrenner and Mayer.
7. Money and Banking, Ran'ett, J. G.

UNIT 2: LOAN, INVESTMENT AND CREDIT CREATION

Unit Structure

2.0 Learning Objectives

After reading this unit, you will be able to understand:

- Loans and Advances.
- Balance Sheet of Commercial Banks.
- Investment Policy of Commercial Banks.
- Technique of Credit Creation.

2.1 Introduction

The loan amount is paid in cash or by credit to customer account which the customer can draw at any time. The interest is charged for the full amount whether he withdraws the money from his account or not. Short-term loans are granted to meet the working capital requirements whereas long-term loans granted to meet capital expenditure. Advances which are given on the personal security of the debtor and for which no tangible or collateral security is taken; this type of advance is given either when the amount of the advance is very small or when the borrower is known to the Banker and the Banker has complete confidence in him (Clean Advance).Advances which are covered by tangible or collateral security. In this section of the study we are concerned with this type of advance and with different types of securities which a Banker may accept for such advances (Secured Advance).

2.2 Classification of Loans and Advances

The commercial banks provide loans and advances in various forms. They are given below:

1. **Overdraft:** This facility is given to holders of current accounts only. This is an arrangement with the bankers thereby the customer is allowed to draw money over and above the balance in his/her account. This facility of overdrawing his account is generally pre-arranged with the bank up to a certain limit. It is a short-term temporary fund facility from bank and the bank will charge interest over the amount overdrawn. This facility is generally available to business firms and companies.

2. **Cash Credit:** Cash credit is a form of working capital credit given to the business firms. Under this arrangement, the customer opens an account and the sanctioned amount is credited with that account. The customer can operate that account within the sanctioned limit as and when required. It is made against security of goods, personal security etc. On the basis of operation, the period of credit facility may be extended further. One advantage under this method is that bank charges interest only on the amount utilized and not on total amount sanctioned or credited to the account. Reserve Bank discourages this type of facility to business firms as it imposes an uncertainty on money supply. Hence this method of slowly phased out from bank and replaced by loan accounts. Cash credit system is not in use in developed countries.

3. **Discounting of Bills:** Discounting of Bills may be another form of bank credit. The bank may purchase inland and foreign bills before these are due for payment by the drawer debtors at discounted values, i.e., values a little lower than the face values. The Banker's discount is generally the interest on the full amount for the unexpired period of the bill. The banks' reserve the right of debiting the accounts of the customers in case the bills are ultimately not paid, i.e., dishonoured. The bill passes to the Banker after endorsement. Dis- f counting of bills by banks provides immediate finance to sellers of goods. This helps them to carry on their business. Banks can discount only genuine commercial bills i.e., those drawn against sale of goods on Credit. Banks will not discount Accommodation Bills.

4. **Loans and Advances:** It includes both demand and term loans, direct loans and advances given to all type of customers, mainly to businessmen and investors against personal security. Previously interest on loan was also regulated by RBI Currently; banks can determine the rate themselves. Each bank is, however required to fix a minimum rate known as Prime Lending Rate (PLR)

   Advances given against the personal security of the debtor but for which the Banker also holds in addition the guarantee of one or more sureties. This type of advance is often given by Banker to persons who are not known to them but whose surety is known to the Banker. Bankers also often take the personal guarantee of the Directors of a company to whom they agree to advance a clean or unsecured loan. Loans are also given against the security of Fixed Deposit receipts.

5. **Housing Finance:** Nowadays the commercial banks are competing among themselves in providing housing finance facilities to their customers. It is mainly to increase the housing facilities in the country. State Bank of India, Indian Bank, Canara Bank, Punjab National Bank, has formed housing subsidiaries to provide housing finance. The other banks are also providing housing finances to the public. Government of India also encourages banks to provide adequate housing finance. Borrowers of housing finance get tax exemption benefits on interest paid. Further housing finance up to Rs. 5 lakh is treated as priority sector advances for banks. The limit has been raised to Rs. 10 lakhs per borrower in cities

6. **Educational Loan Scheme:** The Reserve Bank of India, from August, 1999 introduced a new Educational Loan Scheme for students of full time graduate/post-graduate professional courses in private professional colleges. Under the scheme all public sector banks have been directed to provide educational loan up to Rs. 15,000 for free seat and Rs. 50,000 for payment seat student at interest not more than 12 per cent per annum. This loan is on clean basis i.e., without calling for security. This loan is available only for students whose annual family income does not exceed Rs. 1, 00,000. The loan has to be repaid together with interest within five years from the date of completion of the course. Studies in respect of the following subjects/areas are covered under the scheme.

   a. Medical and dental course

   b. Engineering course

   c. Chemical Technology

   d. Management courses like MBA

   e. Law studies

   f. Computer Science and Applications

   This apart, some of the banks have other educational loan schemes against security etc., one can check up the details with the banks.

7. **Loans against Shares/Securities:** Commercial banks provide loans against the security of shares/debentures of reputed companies. Loans are usually given only up to 50% value (Market Value) of the shares subject to a maximum amount permissible as per RBI directives. Presently one can obtain a loan up to Rs.10 lakhs against the physical shares and up to Rs. 20 lakhs against dematerialised shares.

8. **Loans against Savings Certificates:** Banks are also providing loans up to certain value of savings certificates like National Savings Certificate, Fixed Deposit Receipt, and Indira Vikas Patra etc. The loan may be obtained for personal or business purposes.

9. **Consumer Loans and Advances:** One of the important areas for bank financing in recent years is towards purchase of consumer durables like TV sets, Washing Machines, Micro Oven, etc. Banks also provide liberal Car finance. These days banks are competing with one another to lend money for these purposes as default of payment is not high in these areas as the borrowers are usually salaried persons having regular income? Further, bank's interest rate is also higher. Hence, banks improve their profit through such profitable loans.

10. **Securitization of Loans:** Banks are recently trying to securities a part of their part of loan portfolio and sell it to another investor. Under this method, banks will convert their business loans into a security or a document and sell it to some Investment or Fund Manager for cash to enhance their liquidity position. It is a process of transferring credit risk from the banker to the buyer of securities loans. It involves a cost to the banker but it helps the bank to ensure proper recovery of loan. Accordingly, securitisation is the process of changing an illiquid asset into a liquid asset.

11. **Others:** Commercial banks provide other types of advances such as venture capital advances, jewel loans, etc.

Check your progress 1

1. Overdraft is allowed in which of the following deposit?

a. Recurring Deposit
c. Savings deposit
b. Fixed Deposit
d. Current Deposit

2.3 Balance Sheet of Commercial Banks

Banking is a business, much like any other business. An indication of the financial position of a business concern may be obtained by examining its statement of liabilities and assets, called the 'Balance Sheet'.

A balance sheet is always prepared in two sections. In one section it is customary to record liabilities, normally on the left side and assets in the other section on the right side. Liabilities are the debts or amounts of money owned to others. The liabilities of a bank consist mainly of the claims of its shareholders, creditors and the depositors. The assets, on the other hand, include such items as cash, accounts receivable, loans and investments, etc.

A balance sheet always balances in total, but no individual items necessarily match another. We can easily understand this if we have some elementary knowledge of double-entry accounting. Any change in the one side of the balance sheet must be precisely offset by an equal change in some other item on the other side. The equality of assets and liabilities is not peculiar to banking alone. Every balance-sheet balances. But a bank's business is, in a very special sense, a balancing of assets and liabilities. A bank acquires assets by increasing its liabilities directly, unlike any other business where liabilities are acquired indirectly as a result of trading. Thus, the first thing we want to know about a bank and its operations is the amount of its debts and credits.

Liabilities

The liabilities of the balance sheet of a bank are comparatively simple. The liabilities represent others' claims on the bank. The liabilities side of the balance sheet shows how the bank raises funds to function as a dealer in debts and credits. The liabilities of a bank usually consist of the following items:

(1) **Capital:** The bank capital from its shareholders by issuing various types of shares, such as ordinary, preference, deferred shares, etc. The balance sheet may show the amounts of authorized capital, issued capital and subscribed capital. But the actual liability of a bank to its shareholders consists of the capital originally paid in and any accumulation of undistributed profits.

(2) **Reserve Fund:** It is the amount accumulated over the years out of undistributed profits. The bank may use this fund to offset its unexpected losses in certain years. Sometimes a bank is required by low to transfer a

part of its annual profits to the reserve fund so long as amount in the fund does not become equal to its paid-up capital.

(3) **Deposits:** Deposits from the public constitute the biggest proportion of bank's working funds. The deposits are categorized as the demand deposits and the time deposits. It is the former that represents the bulk of the money supply with public. It is on the basis of their deposit liabilities that the banks make loan and investments after keeping ascertain cash reserve ratio.

Demand deposits are distinguished from time deposits. Time deposits are those against which cheques cannot be written. Demand deposits may arise out of the credits created by a bank as a claim against itself. But in simple terms, a customer is said to have "made a deposit" when he gives the bank cash or its equivalent and the bank gives him a deposit credit. A deposit, therefore, is the promise that the bank gives the depositor in exchange for the cash he "deposits". The cash in an asset, the deposit is a liability. The depositor is a creditor of the bank having lent its cash and he can claim repayment at any time.

(4) **Inter-bank borrowings:** Liabilities are created when a bank borrows from another bank on a temporary basis. A large bank, in particular, may have deposit liabilities not only for the account of the general public but also for other banks in the country.

The bank may also borrow form the central bank of the country on the basis of the eligible securities or get financial accommodation in times of need or stringency by rediscounting their bills of exchange.

(5) **Liabilities relating to bills:** The bank may have some bills which are payable by it out of its resources. It may also accept some bills from its customers for collection. The amount when collected is credited to the accounts of the customers. Hence the amount under this head is shown on both the sides of the balance sheet. They become the liabilities of the bank after collection, but they are to be treated as assets before collection. The banks also accept of endorse the bills of exchange on behalf of their customers, which simply means that the bank guarantees the payment of bills at maturity. Thus, when the bank has accepted bills for its customers it is technically liable to meet them on maturity, but since the customers are expected to meet them and have presumably given due security, this liability of the customers to the bank is an offsetting asset against the acceptance.

In addition to the above, the banks make some provision for the contingent

or unforeseeable liabilities. The profit earner by the bank is also shown as the liability because it is payable to the shareholders.

It may be emphasized, however, that the assets of a bank are based on its liabilities. Banks, unlike other business organisation, acquire only a very small part of their total assets by issuing capital-account claims. An even more important point is that the volume of capital-account claims or share capital changes only slowly and within narrow limits relative to bank assets. Bank reserves, borrowings from other banks and the central bank are also very small relative to total assets. Most of the assets of banks are acquired by creating and issuing bank credits in the form of deposit claims. The volume of deposits that the banking system can issue depends on its reserve requirements enforced by the central bank and the currency volume of reserves available to banks.

Assets

We shall now briefly describe the main items of a bank's assets in descending order or liquidity and ascending order of profitability and show how they reflect these two considerations.

1. Cash Balances

The first asset in the portfolio of a commercial bank's assets is cash-with itself and with the central bank of the country. In certain countries, as in India, every commercial bank is required by law to keep some cash reserves against its deposits. Cash is called the primary reserve of a bank. By experience a bank knows how much cash reserves will have to be kept to meet the demands of depositors. Part of this cash is kept in the bank's premises, a certain portion with other commercial banks for purposes of inter-bank adjustments and a certain portion is kept as deposit with the central bank of the country. A deposit with other commercial banks or with the central bank is regarded as cash by a commercial bank. In India, commercial banks are obliged, by law, to keep a certain proportion of total deposits in the form of cash reserves with the Reserve Bank of India.

The success of a bank depends upon the maintenance of sufficient cash reserves to honour the cheques presented by the clients. But only a small percentage of depositors may be withdrawing their deposits through cheques and other methods at any particular time. At the same time, if some are withdrawing, others may be depositing. A commercial bank has; therefore, to adjust its business

in such a way that the amount of cash flowing in and the amount of cash flowing out should be equal, keeping of course a margin of extra cash for the sake of safety. Too much of cash will reduce the profit-earning capacity of a bank, at the same time, it should not keep too low cash reserves below the minimum considered necessary or prudent.

2. Money at call and Short Notice

Cash, being a barren asset, should not be kept beyond the minimum necessary for safety. But a bank may feel that there may be a heavy pressure on its cash reserves due to seasonal changes in depositors' and borrowers' requirements. To meet this pressure, it may be forced to carry large cash reserves even in times when they are not required at all. The other and better alternative for the bank is to keep some highly liquid but earning assets which can be converted into cash quickly and without loss. There are two types of such assets, viz., (a) call and short notice loans to the brokers in the stock market., dealers in the discount market and to other banks, (b) short-term treasury bills (borrowings of the government for short periods). These assets can be quickly converted into cash and without loss, when the bank wants. Hence banks regard such assets as secondary reserves as different from cash which is their primary reserve. At the same time, these assets bring in some revenue income to the bank.

3. Short-term Bills

A commercial bank like to acquire assets which are for short period (generally for 90 days) and which are easily marketable and hence sufficiently liquid and at the same time bring in some interest income to the bank. Such assets are sometimes called "self-liquidating" because there is evidence of genuine commercial transactions, at the end of which the necessary finance will be realized to repay the original loan. These self-liquidating bills consist mainly of bills of exchange. A bill of exchange is written promises by a merchant, who has ordered certain goods, to pay a specified sum of money on a specified sum of money on a specified date. This bill may be guaranteed by a bank or a well-known merchant house-known in London as the Acceptance Houses. Besides commercial bills, there is short-dated Treasury bill through which the government borrows funds for short periods.

Commercial banks like short-dated paper or bill for a number of reasons: First of all, these assets are highly negotiable and can be easily bought and sold. In countries like England, there is a special bill market in which these bills are bought and sold (or discounted). Therefore, if a commercial bank requires additional funds, it can easily rediscount the bills in the bill market or the discount market. Secondly, these bills are eligible for rediscounting with the central bank of the country. That is, if a commercial bank wants cash, it can rediscount (or sell) the short-term bills with the central bank. Thirdly, these bills bring in handsome interest for the commercial banks. Thus, commercial banks prefer these short-dated bills because of their high marketability as well as their interest income; they are regarded as ideal bank assets because they satisfy the twin considerations of liquidity and profit.

4. Loans and Advances

The most profitable of all assets is bank loans and advances. This asset is universally sought after by banks. Bank loans and advances may be made to businessmen either by the system of overdrafts of an agreed amount or by discounting bills of exchange. Loans and advances carry a high rate of interest because of the risk involved, low liquidity and the difficulty of shifting them. They involve great risk to the bank because of the possible failure of the borrowers and in extreme cases because of their insolvency and liquidation. Again, these loans and advances have a low liquidity and low shift ability in the sense that they cannot be converted into cash easily as and when the bank requires additional cash to meet withdrawals, nor is there any possibility of shifting them to other banks or institution. As a matter of fact, all bank failure may be ascribed to faulty policies regarding loans and advances. From the point of view of safety of the bank and its liquidity, loans and advances are poor assets. But the high yield of these assets compensates for the difficulties associated with them. These assets, thus, have low liquidity but high yield.

5. Investments

Banks make investments in the profit-yielding securities. Investments in government securities represent the book value of central and state government securities, including treasury bills and treasury deposit receipts etc. Banks may make investments in other approved securities as well. The different types of investments are shown separately in the balance sheet. Banks regard their short-term investments as their secondary reserves as different from cash which is their primary reserve.

6. Properties

Building, furniture and fixtures etc. are the other assets of the banks. These fixed assets are often referred to as "Dead Stock". They are generally shown at their depreciated value. These are, in a way, the secret reserves of the banks which can be availed of in case of crises or collapse.

The amount of assets that a bank can command depends upon the amount of its liabilities. Many types of assets are available to a bank, profitless and profitable, liquid and non-liquid. A bank must therefore formulate a portfolio policy determining what types and proportions of assets it will acquire and hold.

Check your progress 2

1. In balance sheet, assets will include:

a. cash
b. loans
c. investments
d. all of above

2.4 Window Dressing

One must be hearing about banks resorting to 'Window Dressing' especially during the time of finalisation of the annual accounts. What does it mean?

Window Dressing is a practice adopted by some banks for temporarily marking up the deposits or assets or profits of the banks in order to produce a more favourable position than it actually warrants. It is a deliberate attempt to produce a favourable result through manipulative practices. The manipulation is done in some of the assets or liabilities depending upon the intention of the banks. In 1970s and 1980s banks used to inflate their deposit figures by creating compulsory deposits against loans or delaying repayment of deposits during balance sheets date. In certain cases, in order to increase the liquidity position of the institution temporarily, it may resort to selling off certain assets like securities. What is important to know in window dressing is that a temporary manipulation in assets or liabilities is resorted to produce a favourable result or to inflate their performance level. Window dressing may be adopted by corporates also to show a rosy picture of their performance. RBI does not approve window dressing measures by banks. While analysing the balance sheet of banks or corporates, one may have to keep this aspect in mind.

Check your progress 3

1. Banks adopt Window Dressing for:

   a. temporarily marking deposits to have good position

   b. marking assets to have good position

   c. marking profits to have good position

   d. all of above

2.5 Investment Policy of Commercial Banks

The banker, while making advances/investments, has to observe certain important principles. They are known as principles of good lending. The bankers have to follow these principles when appraising the proposal for advancing loans. They may be classified as follows:

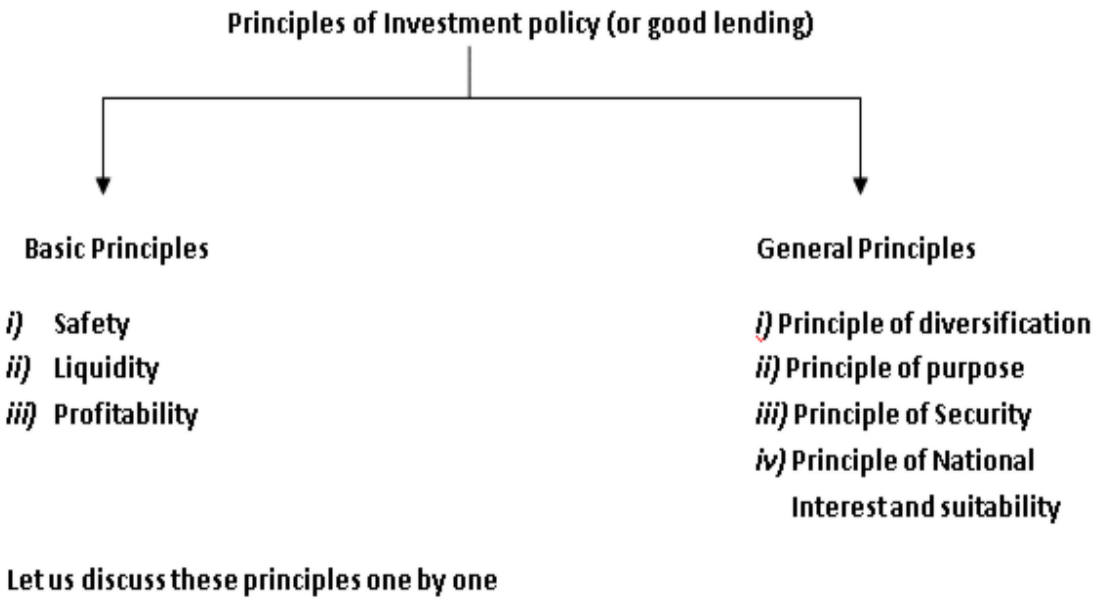

Fig 2.1 Principles of Investment Policy

A. Basic Principles

These are considered as prime because the success of the bank depends upon these principles. They include the following:

(l) Safety:

A bank is a dealer in other people's money. So, it cannot indulge in reckless risk. It should ensure the safety of funds while taking decision regarding leadings and investments. One of the important risks involved in lending money is the credit risk i e the possibility of borrowers not repaying the money on due dates, it is therefore necessary for the banks to maintain expert staff to appraise every credit proposal received by it." Borrowers may default in payment, due to circumstances beyond his control. For example, due to recessionary conditions in the economy, due to destruction of manufacturing activity by natural calamity Hence Kinks have to appraise every credit proposal by taking into consideration market risk individual borrower risk etc. To avoid credit risk, the bank may call for acceptable securities' which will give full values on default. Likewise, the market risk can be avoided by preferring high-grade securities of shorter terms. While lending, a bank should grant advances only for short periods to creditworthy borrower and avoid granting advances for unproductive purposes. The lending and investment policies of a bank are generally decided by the Board of Directors. In India the RBI also used to prescribe certain sound lending/investment policies to avoid credit or market risk. For example, as per RBI guidelines a bank should not lend more than 25 per cent of its owned funds [i.e., in simple term paid up capital, free reserves and accumulated profits] to a single borrower. This prescription is known as Single Exposure Norm or Limit. International banks have such limit restricted to 15% of owned fund For Indian banks; this single exposure limit is being reduced to 20% from April 2000 as per RBI policy guidelines. Safety of an advance or loan is determined on the basis of regular payment of interest and principal repayment as and when due.

Liquidity means the ability of a bank to meet the demand of customers for his money. Simply to put it, the ability of bank to produce cash on demand, it is very importantly to observed by every bank. Banks are able to obtain deposits from public on the basis of the confidence created by it to pay back the money when needed by depositors It can do so only when it has invested certain portion of the deposit in such investments (like Government NX-untied which can be sold quickly to convert them into cash. This is the reason for which Statutory

Liquidity Ratio (SLR) has been prescribed by RBI. A bank must have sufficient liquid assets to meet the demands of the depositors. The liquid assets should have the following characteristics.

(a) It should be convertible into cash quickly and easily.

(b) It should be convertible into cash without any risk of loss of value.

The need of liquidity arises on account of the following reasons:

Banks accept deposits from the public. The public can demand their deposits back at any time. Inability to pay back deposits leads to failure of the banking system itself. Hence, a bank must maintain adequate liquidity.

Factors Determining Liquidity of Banks

The liquidity of banks depend upon the banking habits of the people, the volume and number of monetary transactions, nature of business conditions, the liquid reserve considerations, the structure of banking system and money market etc.

In India banks have to keep reserves as legal requirements.

(i) Under Sec. 42 of the RBI Act, 1934 — the commercial banks have to keep a certain minimum reserve with RBI called CRR which is not less than 3 per cent and not exceeding 15 per cent of total Net Demand and Time Liabilities (NDTL).

(ii) Under Sec. 24 of the Banking Regulation Act, 1949 every commercial bank have to maintain liquid assets in the form of cash, gold and gilt edged securities - SLR which is not less than 25 per cent and not more than 40 per cent of NDTL (Hi) Profitability

SLR Calculation

For the basic understanding of students, the concept of Net Demand and Time Liabilities (NDTL) may be explained roughly as follows:

BANK XYZ Ltd. (As on a Reporting Friday)

Demand Deposits:	1000 million
Time Deposits:	5000 million
Other outside Liability:	400 million
Total outside liabilities:	6400 million

Plus: Net position of payables

(Liabilities) over receivables (Assets) : 100 million

(Only Excess of liabilities included)

Total NDTL: 6500 million

If the bank is required to maintain SLR at 25 per cent, then 25 per cent of NDTL of Rs. 6500 million, i.e. 1625 million is maintained in the form of investment in approved (mainly Govt) securities, cash and/or gold.

The basic objective of commercial banks is aiming at profit. That is, the bank carries on its entire functions to earn profit. Sound banking demands the use of bank funds in such a way so as to get the highest return/profit It must earn sufficient profit to meet out its expenses and to pay adequate return to its shareholders. -

But there is a trade-off between liquidity and profitability. For example the most liquid asset is not most profitable and vice versa. From the liquidity point of view, banks are expected to invest in high-grade securities of short-term. But they are not profitable as income from such investment is very low. Banks prefer long-term securities which yield higher returns. The objective of liquidity and profitability are contradictory.

The success of the bank depends upon its ability to balance between liquidity and profitability. Crowther has stressed the same by remarking as "the secret of successful banking is to distribute resources between the various forms of assets in such a way so as to get a sound balance between liquidity and profitability".

These three attributes or elements of banking are like three legs of a stool.

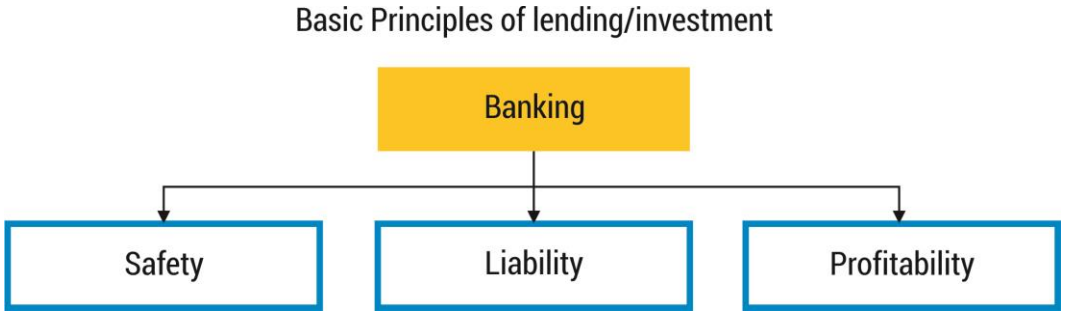

Fig 2.2 Principles of Lending/Investment

Each depends on the others. No one or two can stand alone. If one leg of a stool is weaker or shorter, the stool of banking will be unstable. In effective banking, all the three elements are equal, interrelated and interdependent. They are all equally important.

B. General Principles

Besides the above basic principles, the banks have to follow certain other general principles in order to make a safe lending. They are:

(i) **Principle of Diversity:** Another important principle of good lending is the diversification of advances. An element of risk is always present in every advance however secure it? It might appear to be. In fact, the entire banking business is one of taking calculated risks and a successful banker is an expert in assessing such risks and avoiding or minimising it in its 1 operation. The bank is keen on spreading the risks involved in lending, over a large number ^ of borrowers, over a large number of industries and areas and over different types of securities. For example, if it has advanced too large a proportion of its funds against only one type of security, it will run a big risk if that class of security steeply depreciates. The bank has numerous branches spread over the country; it gets a wide assortment of securities against 1 the advances. Slump does not normally affect all industries and business centres simultaneously. Unless there is a general recession in the economy, the principle of diversity is simply thus: do not put all your eggs in a single basket to avoid total loss.

(ii) **Principle of Purpose or End use:** A banker must closely scrutinise the purpose for which? The money is required and ensures as far as he can, that the money borrowed for a particular I purpose is applied by the borrower accordingly. The purpose should be productive so that i the money not only remains safe but also provides a definite source of repayment The purpose should also be short-termed so that it ensures liquidity. Banks discourage advances for hoarding stocks or for speculative activities. There are obvious risks involved therein apart from the anti-social nature of such transactions. Purpose has assumed a special significance in the present day concept of banking. This principle ensures end use of funds. In fact as per RBI guidelines, banks should ensure end use of funds in respect of large advances.

(iii) **Principle of Security:** It has been a practice of banks not to lend as far as possible except against security. Security is considered as insurance or a cushion to fall back upon in case of an emergency. The bankers carefully scrutinise all the different aspects of an advance before granting it. Thus the security serves as a safety valve for an

unexpected emergency. This is commonly accepted prudent lending policy.

(iv) **Principle of National Interest and Suitability:** The consideration of national interest serves as a good principle of lending and investment. The Reserve Bank of India has issued directives prohibiting banks to allow certain particular type of advances. For example, banks are not permitted to lend money to speculation in share or for real estate business. It because that these activities are considered socially not desirable. The law and order situation at the place where the borrower carries on his business may not be satisfactory. The advance may be on the security of manufactured goods, of which proper valuation is not possible. There may be other reasons of a like nature for which it may not be suitable for the bank to grant the advance in the changing concept of banking, factors such as purpose of advance and national interest are assuming a greater importance than security, especially in advances to agriculture, small borrowers and export oriented industries.

(v) **Fee Based Services of Banks:** Remittance Facilities Banks are financial intermediaries. Apart from mobilizing deposits from savers and lending them to needy borrowers, banks help the savers and borrowers to transfer funds from one place to another in a secured way without physically moving the funds. Usually the following methods are adopted by banks for transfer of funds:

(i) Mail Transfer

(ii) Telegraphic Transfer

(iii) Demand Drafts

(iv) Pay orders

(v) Electronic hands Transfer

Mail Transfer

Under Mail Transfer system, the remitter of funds is required to deposit the amount required to be remitted together with a challan detailing the particulars of remittance. This information will relate to the value of funds to be transferred, the bank account number and address of the receiver of funds, particulars of remitter and purpose of remittance etc. Under this system it is necessary that both the parties to the remittance maintain bank accounts with the same bank, albeit with

different branches / places. This method of transfer of funds is called Mail Transfer since the advice of remittance is sent by mail / post by the remitting bank to the branch where the beneficiary has his account. On receipt of remittance information, the receiving branch will credit the account of the beneficiary. Thus it is an intra-bank fund transfer.

The banks do not accept large cash (usually restricted to Rs. 20,000/-) for remittances. If the required remittance is large, bank will ask the remitter to draw a cheque on his account for the purpose of remitting funds. Banks also charge fees for this type of service. This facility of fund transfer is provided usually to their own customers. Funds can be transferred only between branches of the same bank and not between one bank to another. It is also necessary that both the parties to the transfer maintain account with the same bank. It is however a slow method for transfer of funds as advice regarding remittance is forwarded only through post. The paying branch will credit the account of the beneficiary only on receipt of the advice received from the remitting bank.

Telegraphic Transfer / Telex Transfer

The method followed for transfer of funds under Telegraphic Transfer / Telex Transfer (TT) is the same as in the case with Mail Transfer. However, the advice regarding remittance of funds will be sent by a telegram / telex by the remitting bank to the receiving bank. As such the fund transfer will be quick and fast. Since the advice is sent by telegraphic/ telex message, this mode of transfer of funds will be costlier than that of Mail Transfer. However, the additional cost will be insignificant if we take into consideration the immediate availability of funds to the beneficiary. This method will be costly mainly for those who remit small amounts of money.

Demand Drafts

Drafts are basically Bills of Exchange. As in the case of Bill of Exchange, a draft is drawn by one party on another party and made payable to the drawer himself or someone else. Demand Drafts are drafts drawn by a bank on its own branches at different places and made payable to third parties or purchaser of the draft. Supposing you as a student desire to remit certain fees for taking up a competitive examination conducted by the Service Board, usually the Board asks all the candidates to remit the examination fees by demand drafts issued by banks. In such a case, you may pay the requisite sum to a bank along with the prescribed challan detailing the name of the payee, purchaser or remitter, amount, place where it should be remitted, etc. The bank on receipt of the amount will issue a draft which has to be sent by the candidates to the Board along with the

application. For obtaining money or credit to the account, the payee (in the present case the Board) has to present the draft to the paying bank. Since these drafts are payable immediately on presentation by the payee, they are called demand drafts. The drafts can be crossed as "Account Payee" to restrict its transfer. Demand Drafts can be defined as cheques issued by a bank on its own branches or on other banks under corresponding arrangement.

Pay Order

Pay Orders are drafts issued by an office / branch of a bank on itself. In other words the issuing branch / office and paying branch / office are one and the same. Pay orders are issued by banks only against receipt of funds first. Suppose a candidate desires to remit certain examination/admission fees to a particular educational authority. In case both the candidate and the educational authority happen to maintain accounts with the same branch, then the candidate may remit the fees by obtaining a Pay Order instead of a demand draft. If the fees can be paid to any branches of the bank, then a demand draft can be obtained. Thus, the main difference between pay order and a demand draft is that whereas a demand draft is issued by a bank on any of its branches, a pay order is issued on itself. In both the cases the bank will issue the instruments only after receipt of funds first.

Electronic Funds Transfer

Normally remittance or transfer of funds between banks gets originated by a paper instrument. For example, under Mail Transfer, the remitter has to fill up necessary challan and give it to the bank along with a cheque or cash for transfer of funds. Under Electronic Funds Transfer, the transaction of funds transfer is initiated through electronic equipment.

In India, the Reserve Bank of India has introduced Electronic Funds Transfer (EFT) Scheme to assist banks in providing their customers fund transfer facility from one account to another either with the same bank or with different banks.

Under this system a customer desiring to remit certain amount to another place fills in the prescribed EFT application form together with the details like, beneficiary's name, bank account number, name of the bank & branch, location of the branch, etc. and hands over the m form and a cheque drawn on his account. The remitting bank through one of its designated branches for this purpose transmits the details of transfer to the Reserve Bank of India. The Reserve Bank at the transaction originating centres consolidates all such transfer advice and ; W transmit information of transfer to its various centres for advising the concerned

banks for providing the requisite credit to the beneficiaries. Thus, it acts as an intermediary between the remitting bank and receiving bank and affects the transfer. The Reserve Bank allows up to Ks. 2.00 crore per transaction to be transferred in this way. Further it charges only Ks. 5.00 per transaction to banks. The banks will charge separately fees on their customers for availing of this facility. However, fees charged by banks for transfer of funds under EFT system will be smaller as compared to remittance facilities under MT, TT and Demand Drafts. This system of funds transfer is available with all the public sector banks and many of the private sector and State Cooperative banks. Fund transfer under EFT is possible from any branch to branch with the same bank or with other banks.

Check your progress 4

1. The Statutory Liquidity Ratio cannot be maintained by:

   a. Cash

   b. Gold

   c. Goods

   d. Unencumbered approved securities

2.6 Other Fee Based Services

These services can be identified as:

1. Issue of Guarantees
2. Locker Facilities
3. Issue of Credit Cards
4. Portfolio Management Services (PMS)
5. Tax Advice
6. Investment Guidance
7. Acting as Agents for selling financial products
8. Sale of Insurance products
9. Project Consultancy
10. (Demat) Dematerialized Accounts
11. Issue of Letters of Credit

12. (xii) Custodial Services
13. (xiii) Loans from Overseas Market for customers
14. (xiv) Other Fee Based Services.

Check your progress 5

1. Which among the following is not a fee based services?

a. Issue of Guarantees

b. Debit card

c. Locker Facilities

d. Issue of Credit Cards

2.7 Commercial Bank and Credit Creation

The Banker is both a borrower as a well as a lender. He accepts deposits from public and lends them to those who need it. He therefore plays a dual role of a borrower and a lender. He borrows to lend. The banks act as an intermediary between those who have money to spare and those who require it for their purpose. They do not, however, lend out just what they receive from the people but actively determine the amount of credit coming into existence.

When a bank receives a deposit, it issues its promise to pay in return. All the money received by a bank is not kept in safe custody for the reason that the bank knows that all the money so deposited will not be demanded by the depositors at one and the same time. Banks are therefore, in a position to lend a part of it. It is an open secret that the banks do not keep cent percent reserve against deposits in order to meet the demands of the depositors.

A depositor has to be content simply with the bank's promise or undertaking to repay the amount on demand. However the success of the whole banking business depends upon the confidence of the public in the banker's ability to meet his liabilities on demand. If his reserves are enormous, nobody will question his ability to pay on demand.

As mentioned above, the banks do not keep all cash received by way of deposits into an iron locker, but a part of it is lent out by keeping certain cash

reserve to meet the demand of the depositors. There are two ways in which a credit is created by the bank.

a. By advancing loans on the cash credit basis or by overdraft arrangement

b. By purchasing securities and paying for them with its own cheques.

In both these cases, deposits are created (or credit is created for the borrower) and credit of the bank is embodied in a definite transaction.

It is a mistake to think that the commercial banker has unlimited power of credit creation. From the account of credit creation given above, it would seem that the bank reap where they have not sown. They advance loans or buy securities without actually paying cash. But they earn interest on the loans they give or earn dividend on securities they purchase. This is very tempting. They make profits without investing cash. They would of course like to make as much profit as they can. But they cannot go on expanding credit indefinitely. In their own interest they have to apply the brake and they do actually apply it, for it is well know that the profits made by the bank are not very high. The overriding limitation arises from the aggregate deposits of banks. They are:-

1. The total amount of cash in the country.

2. The proportion of cash the public wishes to hold.

3. The minimum ratio of cash to deposits that banks consider safe to maintain.

As regards the first it may be said that the credit can be created on the basis of cash. The banker lays his hands on cash of creation of credit.

The commercial banks need cash for two reasons:

a. To meet the claims from the public wanting currency for its day to day purchases and

b. From the fellow banks in settlement of clearing house balances i.e. interbank liabilities.

The larger the cash in the country, i.e. 'legal tender money', the larger the amount of credit that can be created. But the amount of cash that a bank may have is subject to the control of the Central Bank, because it has a monopoly of issue of notes. The total supply of cash in the country depends on the Central Bank policy. The central bank possesses certain weapons of credit control to limit its availability. If the Central Bank wants commercial banks to increase their deposits, it should increase the supply of cash and vice versa. If the Central bank feels that the credit has expanded excessively and it is injurious, it can curtail it by

stringent monetary policy. So long as monetary management is in the hands of the Central Bank, it will have a check on the total cash position of the community and consequently the bankers' power to create money. But mere increase in the total supply of cash will not lead to expansion in credit creation unless and until the increase cash comes to the bank in the form of deposits. Here operates the second limitation and that is how much cash the public wishes to hold.

According to the second limitation, the power of banks to create credit is limited by the amount of cash which the public wishes to hold. If they wish to hold more cash with them rather than keeping it with banks, the banks would be able to create only a small credit and vice versa. The total amount of ach which the public would like to hold depends upon the volume of employment, population, monetary habits and above all the psychology of the individual. If people are in the habit of using cash and not cheques, as in India, then as soon as the credit is granted by the bank to the borrower, he will draw the cheques and get cash When the banks cash reserve is thus reduced, its power to create credit is correspondingly reduced. On the other hand, if people use cash only for very small and odd transactions, then the cash reserves of the bank is not much drawn upon and there power of creating credit remains unaffected. Further if the people are in the habit of keeping cash with them and not depositing in the bank, then even if the total supply of money in the country is increased, the total credit will not increase correspondingly, because the people will hold cash back and the deposits of the bank will not increase.

The third limitation is the most important. The necessity for keeping a cash reserve arises from the fact that the banks may be required to meet the demands of the depositors at any time. To ensure the safety and liquidity, cash-reserve should be maintained by the bank. The cash reserves are only a percentage of total deposits. Banks find by experience the safe percentage of reserves to be kept against deposits. Convention or in some cases law lays down this percentage. If the percentage of cash reserve to that of deposits is more, then the power of the banks to create credit is also limited. Therefore, the reserve ratio of a bank will largely decide how much credit a bank can create. The cash reserve of banks and their cash reserve ratio set the maximum limit for banks in the matter of creating credit.

To these three limitations may be added two more. A bank will agree to lend credit only when the securities offered are found acceptable. If approved securities are not available the bank cannot create credit without inviting dangers. Naturally the availability of good borrowers as well as of good securities sets the limit to the

creation of credit. Sayers observes rightly that 'The banks put this newly created money into the hands not of everybody at once, but of those individuals who can offer to the bank, the kind of asset the bank thinks attractive. The banks are important not only because they create money but also because they distribute money into proper channels."

From this we find that the banks cannot create credit without acquiring assets. An asset is a form of wealth. The bank only turns immobile wealth into mobile wealth. Therefore, Crowther rightly observes that "The bank does not create money out of thin air; it transforms other forms of wealth into money." The creation of credit depends upon the existence of wealth in the community. Banks cannot create money out of nothing; in fact, they only change other forms of wealth into money. The banker converts fixed wealth into liquid resource.

Another limit on the power of the bank is set by the conditions of business and trade. Banks can give loans to people only when there is a demand for them. They can purchase assets only when owners of these assets are willing to sell them. People's desire to borrow or part with their assets depends upon the general state of confidence and economic activity. When the profits are falling and the business is in a depressed condition the demand for banks credit is at a low level. In spite of large reserves banks find it difficult to lend because there are not many borrowers demanding loans. On the other hand, when there is a rising level of economic activity and the state of optimism prevails, the demand for the bank credit is high. Banks are also prepared to take more risks and can reduce the liquidity of their assets by giving more loans. The volume of banks is also prepared to take more risks and can reduce the liquidity of their assets by giving more loans. The volume of bank deposits therefore increases with rapidity.

Check your progress 6

1. The credit given by commercial bank depends on:

   a. amount of cash reserve

   b. types of cash

   c. arrangement of currency

   d. none of above

2.8 Manner of Arising Deposit

The deposits are raised in the following manner. When a customer goes to his bank for a loan, generally he provides "collateral security". The banker grants a loan and credit to his account with the amount of the loan. The customer is entitled to draw cheques up to the amount of the loan and these cheques can be used to buy goods and to discharge business obligations. In this way additional money comes into existence and the process is virtually equivalent to the creation of additional supplies of money. It should be noted that primary deposits do not create credit and they go to increase the cash reserve of the bank as actual cash is paid into the bank. But the derived deposits decrease the cash ratio of the bank because that are created without, receiving any cash from the customers. Thus, when a loan is granted to a customer a deposit arises.

We can explain the technique of credit creation with the help of the following examples:

Let us assume that (i) there is number of banks existing and operating in the economy. (ii) The banks have to keep 10% of the deposits as cash reserves as per law. (iii) The customer Mr. X deposits the amount of Rs. 10.000 into his bank say ABC Bank.

The existing Balance sheet of ABC Bank appears as follows:

Balance Sheet

Balance Sheet

Liabilities	*Rs.*	*Assets*	*Rs.*
Deposits	10,000	Cash and balances with RBI	10,000
Total	10,000	Total	10,000

The deposit of Rs.10,000 is a liability for the bank and the bank has an obligation to repay it on demand. And at the same time, it is an asset to the bank as it can use the deposit to lend/invest to earn income (interest). As a legal obligation the bank has to keep 10% of the total deposits as reserve with RBI. Thus, it has a surplus of Rs. 9,000 for advancing loans.

Now, the banks lend Rs. 9,000 to Mr. Y. Then the position of the balance sheet will be as follows :

Balance Sheet

Liabilities	*Rs.*	*Assets*	*Rs.*
Deposits	10,000	Cash and balances with RBI	1,000
		Advances	9,000
Total	10,000		10,000

Fig 2.3 Balance Sheet

The receiver of the loan Mr. Y has the option to deposit the money with the ABC itself or into his bank, say XYZ Bank. Let us assume that, Mr. Y gets the money from ABC bank and deposits it into his bank, XYZ Bank.

XYZ Bank has to keep a reserve of 10% of the deposit and is free to lend the balance. Assume that the bank has purchased the bills from Mr. Z for the balance 90%, i.e., Rs. 8,100. Now the balance sheet of XYZ Bank will be as follows:

Balance Sheet of XYZ Bank

Liabilities	*Rs.*	*Assets*	*Rs.*
Deposits	9,000	Cash and balances with RBI	900
		Investments	8,100
Total	9,000		9,000

If we assume that Mr. Z deposits the money R ^ 100 received into his bank Bank of Mysore.

Here, the Bank of Mysore also has to keep a reserve of 10% of the deposits and can lend the balance. If it lends the balance 90% to a customer "S" then the balance of sheet of Bank of Mysore will be as follows :

Balance Sheet of Bank of Mysore

Capital and Liabilities	*Rs*	*Assets*	*Rs.*
Deposits	8,100	Cash and Balance with RBI	810
		Advances	7,290
Tota!	8,100		8,100

Fig 2.4 Balance Sheet

If this process continued till the original deposit of Rs. 10,000 is fully exhausted, the total amount of deposits so made will be calculated as follows:

= 10,000 + 9,000 + 8100 + 6561 .....etc.

Total amount of deposits = Rs. 1,00,000

This is the process of multiplication of deposits through credit creation.

The Formula for Credit Creation

The credit creation depends upon the mandatory per cent of cash reserve to the total -deposits.

Thus, the deposit multiplier is,

K=l/r where K = Deposit multiplier; r = ratio of cash reserve to deposits.

If the cash reserve ratio is 20% or .2, the deposit multiplier will be, ...

K=l/r =1/0.2 = 5

If the percentage of reserves to the total deposits decrease, the multiplier will increase if. The higher the cash reserve ratio, the lower will be the deposit multiplier and vice versa.

If we assume that the total percentage of cash reserve is 20% and the commercial banks get fresh additional cash of Rs. 1000 million, as a result of government spending, they would be able to create deposits through loans and investments to the extent of Rs. 5000 million. This is calculated as follows:

Credit creation = K x 1000 million = 5 x 1000 = 5000 million. Thus, banks are able to create deposits because of the activities of 3 parties.

- The public who are willing to keep its money in the banks as deposits
- The banks, keeping only a fraction of deposits as cash reserves
- The borrowers from the banks

From the above discussion that banks create deposits by granting loans to customers. When a loan is granted and a deposit is created, the liabilities side of the balance sheet of the bank "increases under the heading deposits" while the corresponding increase can be found on the assets side of the balance sheet under the head "advances". Banks voluntarily acquire liabilities when they create deposits because they are able to earn more profit on the loans they grant. This process of creation of deposit is essentially an exchange of claims. Because of this capacity to manufacture money, banks are very important institutions for the economy of a country. They create additional purchasing power and there by influence the price level.

Check your progress 7

1. Which among the following bonds have tangible property as collateral?

   a. collateral security

   b. commercial trust notes

   c. equipment trust certificates

   d. equipment bonds

2.9 Multiple Expansion of Credit

A single bank cannot create huge deposits. If we take several banks together, there is scope for multiple expansions of bank deposits. They lend many times more than the actual cash held by them and it is possible by mere entries in the books of banks. In this way banks can create credit to a large extent and adds to the total money supply in the country. However the ability of banks to create such additional money supply is curtailed by prescribing higher Cash Reserve Ratio for banks.

Let us try to understand credit expansion via an example: - Suppose a bank "A" has a deposit of Rs. 2000 in the name of a person P. Assuming a minimum cash reserve ratio of 10%, the bank will keep Rs. 200 towards this cash reserve requirement and create derivative deposit to the extent of Rs. 1800, which represents the excess reserves with the bank.

It is these excess reserves that the bank uses to give loans and advances to its customers. Let us say the borrower, Mr. M, in repayment of some business obligation gives the Cheque of Rs. 1800 to Mr. N who has a deposit account in a bank "B". Bank B now receives Rs. 1800 and can give Rs. 1620 as loan/advances.

Continuing the process likewise, we can see with the help of the table below, that the original primary deposit of Rs. 2000 results in creating a derivative deposit of Rs. 18,000, which is ten times of the original excess reserves of Rs. 1800.

Table Multiple Expansion of Credit through Banking System

Banks	Primary deposit	Cash reserve	Loans/derivative deposit
A	2000[1]	200	1800[2]
B	1800	180	1620
C	1620	162	1458
D	1458	145	1313
E	1313	131	1182
Eventually	20,000	2000	18,000[3]

1-original deposit
2-Original excess deposit
3-total capital expenditure through credit expansion with original primary deposit of Rs.2000.

A higher cash reserve ratio would lead to a lower Credit multiplier* and vice versa. *Credit Multiplier = Volume of Derivative Deposits / Original Excess Reserve In our example this would be 18000/1800, i.e. 1.

Check your progress 8

1. The ratio of cash reserves which banks are required to keep with RBI is:

   a. Liquidity ratio

   b. Statutory liquidity ratio

   c. Cash Reserve Ratio

   d. None of these

2.10 Technique of Credit Creation

Central bank is the first source of money supply in the form of currency in circulation. The Reserve Bank of Indian is the note issuing authority of the country. The RBI ensures availability of currency to meet the transaction needs of the economy. The Total Volume of money in the economy should be adequate to facilitate the various types of economic activities such as production, distribution and consumption.

The commercial banks are the second most important sources of money supply. The money that commercial banks supply is called credit money

The process of 'Credit Creation' begins with banks' lending money out of primary deposits. Primary deposits are those deposits which are deposited in banks. In fact banks cannot lend the entire primary deposits as they are required to maintain a certain proportion of primary deposits in the form of reserves with the RBI under RBI & Banking Regulation Act. After maintaining the required

reserves, the bank can lend the remaining portion of primary deposits. Here bank's lend the money and the process of credit creation starts.

Suppose there are a number of Commercial Banks in the Banking System – Bank 1, Bank 2 and Bank 3 and so on.

To begin with, let us suppose that an individual "A" makes a deposit of Rs. 100 in bank 1. Bank "1" is required to maintain a Cash Reserve Requirement of 5% (Prevailing Rate) which is decided by the RBI's Monetary Policy from the deposits made by 'A'. Bank "1" is required to maintain a cash reserve of Rs. 5 (5% of 100). The bank has now lendable funds of Rs. 95(100 – 5). Let the Bank "1" lend Rs. 95 to a borrower; say B. the method of lending is the same that is bank 1 opens an account in the name of the borrower cheque for the loan amount. At the end of the process of deposits & lending, the balance sheet of bank reads as given below:-

Balance Sheet of Bank "1"

Liabilities	**Amount**	**Assets**	**Amount**
A's deposits	100	Cash Reserve	5
		Loan to "B"	95
Total	**100**	**Total**	**100**

Now suppose that money that borrowed from bank "1" is paid to individual "C" in settlement of his past debts. The individual "C" deposits the money in his bank say, bank 2. Now bank 2 carries out its banking transaction. It keeps a cash reserve to the extent of 5%, that is Rs. 4.75 (5% of 95) and lend Rs. 90.5 to a borrower D. at the end of the process the balance sheet of Bank 2 will be look like:-

Balance Sheet of Bank "2"

Liabilities	**Amount**	**Assets**	**Amount**
B's deposits	95	Cash Reserve	4.75
		Loan to "C"	90.5
Total	**95**	**Total**	**95**

The amount advanced to D will return ultimately to the banking system, as described in case of B and the process of deposits and credit creation will continue until the reserve with the banks is reduced to zero. The final picture that would emerge at the end of the process of deposit and credit creation by the banking system is presented in the consolidated balance sheet of all banks are as under:- The combined Balance sheet of Banks

Bank	**Liabilities Deposits**	**Assets Credits**	**Reserve**	**Total Assets**
Bank 1	100	95	5	100
Bank 2	95	90.5	4.75	95
Bank 3	90.5	85.98	4.52	90.5
-	-	-	-	-
-	-	-	-	-
Bank n	00	00	00	00
Total	**2,000**	**1,900**	**100**	**2,000**

It can be seen from the combined balance sheet that a primary deposits of Rs. 100 in a bank 1 leads to the creation of the total deposit of Rs. 2,000. The combined balance sheet also shows that the banks have created a total credit of Rs. 2,000. And maintained a total cash reserve of Rs.100.Which equals the primary deposits. The total deposit created by the commercial banks constitutes the money supply by the banks.

Check your progress 9

1. It is found that an immediate effect of credit creation by banks is:

   a. Rise in prices

   b. Increase in money supply

   c. Increase in real national income

   d. Reduction of poverty

2.11 Credit Contraction

Commercial banks are able to multiply creation of credit, when deposits are made with them. If cash is removed from the banking system, it results in multiple contraction of credit.

Let us trace withdrawal of cash with the help of the following example.

The "Bank B" has a cash reserve of 10,000 at 20% of total deposits of Rs, 50,000 and Rs. 40,000 as investments. Now the position of the bank will be as follows:

Balance Sheet of "Bank B"

Capital and Liabilities	Rs.	Assets	Rs.
Deposits Total	50,000	Cash and Balances with RBI Investments	10,000 40,000
	50,000		50,000

Let us assume that a depositor withdraws his deposit of Rs. 5,000 permanently from the bank. Now the balance sheet of the bank will be,

Indian Banking

Balance Sheet of' Bank B'			
Capital and Liabilities	Rs.	Assets	RS.
Deposits Total	45,000	Cash and Balances with RBI Investments	5,000 40,000
	45,000		45,000

From the balance sheet, it could be seen that the cash reserve is below the legal minimum and it should be Rs. 9000, i.e., 20% of Rs. 45,000. Therefore the bank must sell Rs. 4,000 worth of investments. When the bank sells its securities there will be a chain of reaction. The buyer of the security may withdraw Rs. 4,000 from his bank say Vijaya Bank to pay for it. Then the Vijaya Bank will find its cash reserves fallen by Rs. 4,000. It will therefore sell some of its securities. And so it goes on until all the effects are exhausted. And the original withdrawal

of Rs. 5,000 has produced a chain "Killing off" Rs. 25,000 worth of deposits throughout the whole banking system. The process of contraction of bank deposits is the same as that of credit expansion—but in the opposite direction.

Limitations on Credit Creation

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

(i) Total amount of cash in the country

(ii) Cash reserve ratio

(iii) Banking habit of people

(iv) Policy of other banks

(v) The availability of good securities

(vi) Policies of Central Bank

(vii) Initiative of businessmen

(viii) Effects of trade cycles

(ix) Liquidity preference by the people

(x) Leakages

Let us discuss these limitations herein below:

(i) The Total Amount of Cash in the Country: The banks have power to create deposits depending upon the total supply of cash. The Central Bank of a country has the monopoly power to issue currency notes. The quantity of money in circulation increases with the issue of more currency and vice versa. Hence, the increased money supply or circulation enables the banks to create more credit. If the supply decreases the banks capacity to create credit will be decreased.

(ii) Cash Reserve Ratio: The actual cash reserve held by a bank and the cash ratios considered safe in the banking circles, set the limit for creation of credit. Every bank must keep sufficient cash balances to meet the demands of the customers across the counter and settle the inter-bank indebtedness arising out of the clearing house. The need for keeping adequate cash reserves to meet the claims that arise from currency withdrawal sets a limit to the capacity of a bank to create money. Banks have to maintain the required cash ratios either according to the custom prevailing in the market

or as required by law. In India it is decided by the RBI under Reserve Bank of India Act. This is the minimum cash required to be maintained by a bank with RBI. As per Sec. 42 of RBI Act, this ratio can vary from a Commercial Bank and Credit Creation 93 minimum of 3 per cent to a maximum of 15 per cent of net demand and time liabilities (deposits) of a bank. The higher the ratio, lesser is the opportunity for credit creation and vice versa. CRR is an instrument of monetary control.

(iii) 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. determine the amount of cash that the public wishes to hold. The amount of loan given to a customer should again come back to the bank in the form of primary deposits. Then only there can be credit creation. This is possible only when the banking habits among the people are well developed and they keep their money in the banks as deposits and use cheques for the settlement of their claims.

(iv) Policy of other Banks: The credit creation is possible if all the banks in the industry follow the uniform policy regarding maintenance of cash reserves. If certain banks follow the conservative loan policy and keeping high rate of cash reserves while others are freely lending with minimum cash reserves, the creation of credit will not be up to the extent as determined above i.e., the volume of the credit created will not be up to the extent of the credit multiplier.

(v) Availability of Good Securities: The availability of good securities, i.e., 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 assets are not acceptable to banks as securities. They lend only on liquid assets such as gold, bills, raw materials, etc. As Sayers said, the banks do not create credit by lending to everybody "but to those individuals who can offer to the banks the kind of assets which the bank thinks attractive."

(vi) Policies of 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. As the Central Bank can control the supply of cash through various weapons of credit control such as bank rate, open market operations and variation of cash reserves the upper limit of the volume of bank deposits is absolutely

determined. Thus, the Central Bank can control the creation of credit by increasing or reducing the total supply of cash in the economy.

(vii) Initiative of Businessmen: The banks can create credit if only the customers are willing to borrow from them. The capacity of the banks to create credit depends upon the psychology and initiative of businessmen and general market conditions for good business activities.

(viii) Effects of Trade Cycles: 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. Therefore, the volume of bank credit will be low.

(ix) Liquidity Preference by the People: If the general public are highly driven to keep more amounts of cash with them, the banks cannot get adequate deposits to create credit and thus, the liquidity preference by people place a limitation on the creation of credit.

(x) Leakages: The credit creation by the banks is subject to certain conditions. If there is any leakage in this process the credit creation by the banks will be limited. In credit creation it is expected that the banks lend the entire amount of excess deposits over the minimum statutory reserve. And if there is any down fall in such lending, it will affect the creation of credit to that extent. Likewise it is expected that people who borrow money will deposit the same in their respective banks. If, they do not deposit the loan borrowed, the capacity of the banks to create credit will be limited.

Check your progress 10

1. The credit can be created subject to:

   a. Total amount of cash in country

   b. Cash reserve ratio

   c. Policies of Central Bank

   d. all of these

2.12 Criticism of Theory of Credit Creation

The economists like Edwin Cannon and Walter Leaf have criticised the above theory of multiple creation and concluded that banks cannot lend anything more than the deposits received from the customers. Their arguments may be summarised as under:

i. It is not correct to say that the initiative in the credit creation lies with banks. But, it would be more correct to say that the initiative lies with depositors who deposit their money with bankers. A banker is no more than a middleman between "lender and borrowers.

ii. By granting loans the bank credit the account of the customer with the amount of loan granted to him. But the deposit amount, i.e., the loan amount can be withdrawn by the customer at any time. If he withdraws cash from the bank it will reduce the cash reserve of the bank. Thus, it cannot grant loans beyond the cash? Deposited by customers with it.

iii. The bank can lend only because all the customers do not withdraw their money at one time and consequently there are some funds of the depositors left with it. , Prof. Canon compares the bank with a cloakroom. He supports his argument with the following example.

Suppose on a rainy day, 100 people come to a music concert with umbrella. They left these 100 umbrellas with the counter clerk of the concert hall. The clerk knows that only 10 members require umbrellas from him during an hour. Then he may send out the other 90 umbrellas for the duration of the concert and make some money. Does it mean that the clerk has created 90 umbrellas? Obviously no, Carman argues. Similarly the banker, when he knows that all the depositors do not withdraw their money at the same time, may lend a part of deposits. But, it cannot be said to be creating money, just as the clerk at the counter has not created umbrellas.

Check your progress 11

1. Loan is credited in customers:

a. credit card
c. debit card
b. bank account
d. term deposit

2.13 Let Us Sum Up

In this unit we have studied that Window Dressing is a practice which is adopted by some banks for marking their deposits or assets or profits to produce good position. This is done to produce favourable result by manipulating several practices. It is found that Bank issues guarantee on behalf of customers which is important revenue generating services provided by banks. In case of commercial business, customers require to provide with bank guarantee.

It is noted that banks do not keep all cash received by deposits in locker, but lent out part of it by keeping certain cash reserve to meet demand of depositors. This is done by advancing loans on cash credit basis or by purchasing securities and paying for them with its own cheques.

2.14 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-c)

Check your progress 5

Answers: (1-b)

Check your progress 6

Answers: (1-a)

Check your progress 7

Answers: (1-c)

Check your progress 8

Answers: (1-c)

Check your progress 9

Answers: (1-b)

Check your progress 10

Answers: (1-d)

Check your progress 11

Answers: (1-b)

2.15 Glossary

1. **Bank capital -** The difference between the value of a bank's assets and its liabilities.
2. **Market -** A place, where are meeting people for buying and selling goods, usually outside.

2.16 Assignment

Discuss Credit Creation with examples.

2.17 Activities

Is the practice of Window Dressing good for Banks?

2.18 Case Study

Discuss the performance of commercial banks in India after nationalization.

2.19 Further Readings

1. Business Cycles, Hamberg, W.
2. A Contribution to the Theory of the Trade Cycle, Hicks, J. R.
3. The Demand for Money: Some Theoretical and Empi¬rical Results, Friedman, M., Journal of Political Economy, Vol. 67, June 1959.
4. The Demand for Money Theories and Evidences, Laidler, D.
5. Introduction to Macro-Economics, Harney, J. and Johnson, M.
6. Liquidity Functions in the American Economy, Bronfenbrenner and Mayer.
7. Money and Banking, Ran'ett, J. G.
8. Money, Capital and Other Stores of Value, American Economic Review, Vol. 51, No. 2, May 1961, Tobin, James.

Block Summary

In the above block, we have detailed to students regarding the functions of commercial banks and certain information on services which are rendered by such banks along with agency services. The explanation about General Utility Services and Systems of Banking are detailed with features and characteristics. The block gives information about Group banking and Chain banking with several advantages and disadvantages.

After studying this block, students or user will understand correctly about Balance Sheet of Commercial Banks and information on Commercial Bank with Credit Creation. The summary about multiple expansion of credit and criticism theory of Credit Creation shows extra knowledge to student which could of help to them in future. The concepts of Window Dressing will allow students to understand more about banking strategies.

Block Assignment

Short Answer Questions

1. Highlight some demerits of Unit banking?
2. What are the characteristics of Window dressing?
3. What is the benefit of Chain banking system?
4. Write some advantages about Branch Banking?

Long Answer Questions

1. What are the functions of commercial banks?
2. How Investment Banking is superior than Chain Banking?
3. Explain the process of multiple credit creation by commercial banks?

Enrolment No. ☐

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
Ahmedabad-382 481.

BANKING MANAGEMENT

PGDF-201

BLOCK 3:
STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

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BANKING MANAGEMENT

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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included may tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

BANKING MANAGEMENT

Contents

Manner of Arising Deposit, Multiple Expansion of Credit, Technique of Credit Creation, Credit Contraction, Criticism of the Theory of Credit Creation.

BLOCK 3: STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

UNIT 1 MONEY MARKET

Introduction, Meaning and Function of financial system, Functions of Money Market, Components or Structured of Indian Money Market: Organized Sector of Indian Money Market, Unorganized Sector of Indian Money Market, Features (or Defects) of-Indian Money Market, Reforms in Indian Money Market

UNIT 2 CAPITAL MARKET AND RBI

Capital market, Significance (or Role) of Capital Market in Economic Development, Structure of Capital Market in India, Market Capitalisation, Introduction to RBI, Traditional or General Functions of the RBI, Development Function of RBI, RBI'S Monetary Policy, Objectives of RBIs Monetary Policy, Instruments of RBls Monetary Management, Recent Changes in RBI's Monetary Management, Evaluation of RBIs Monetary Policy

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BLOCK 4: SOURCES AND USES OF FUNDS

UNIT 1 SOURCE AND USES OF FUNDS IN BANKS

Introduction, Type of Financing, Repayment Method, Venture Capital, Factoring Services, Banknet, Automated Teller Machine (ATM), Phone Banking, Net Banking or Internet Banking, Gold Deposit Scheme

UNIT 2 MERCHANT AND RETAIL BANKING

Assistance provided by Merchant bankers, Guidelines on Merchant Banking, Meaning and Definition of Credit Card, Other Types of Cards, Operation of the Credit Card, Advantages of Credit Card, Disadvantages of Credit Card, New Scheme of Farmers Credit Card, Debit Cards,

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BANKING MANAGEMENT

BLOCK 3: STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

BLOCK 3: STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

Block Introduction

The financial system consists of Financial Institutions, Financial Markets & Financial Instruments and the Financial Services. Financial Markets and Financial Institutions facilitate the functioning of the Financial System through Financial Instruments. The Indian money market has two segments: organised sector and unorganised sector. A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year. There are various financial instruments categorized under capital market like Equity and preference shares, debentures, etc. The Reserve Bank of India was established as a private sector bank on April 1, 1935 on the terms of the Reserve Bank of India Act, 1934.

In this block, you will get knowledge about working and function of financial system with characteristics about money market. The concept of various components of Indian Money Market and its features along with various explanations related to organised and unorganised Indian Money Market structure are well explained. The block will detail about significance and role about Capital Market in Economic Development along with features of market capitalisation are generalised for future references.

After studying this block, you will be able to understand correctly about RBI and how RBI involves in various reforms building. Various functions, developmental factors and reforms as framed by Reserve Bank of India are explained to student which will help them to know how banking system with the interference of RBI works. The concepts of certain monetary policies of RBI along with its working strategies are explained which will make you to understand more about banking policies and reforms as laid by RBI.

Block Objective

After learning this unit, you will be able to understand:

- The definition of financial system
- Functions of Money Market
- Layout of Indian Money Market
- Comparison among Organized and Unorganized Indian Money Market Sector
- Reforms in Indian Money Market
- Capital Market in India
- Concept theory of Market Capitalisation
- Features of Functions of the RBI
- Objectives behind RBIs Monetary Policy
- Evaluation of RBIs Monetary Policy

Block Structure

Unit 1: Money Market

Unit 2: Capital Market and RBI

UNIT 1: MONEY MARKET

Unit Structure

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Function of financial system
- Functions of Money Market
- Components Indian Money Market
- Reforms in Indian Money Market

1.1 Introduction

The financial system is a very complex system dealing with a vast variety of financial activities. The financial system consists of Financial Institutions, Financial Markets & Financial Instruments and the Financial Services.

Financial Markets and Financial Institutions facilitate the functioning of the Financial System through Financial Instruments. This unit covers introduction to financial services and instruments and its significance and the various types of financial instruments.

A money market is defined as a market for lending and borrowing of short-term funds. It deals in funds up to one-year maturity. It covers money and financial assets that are close substitutes for money. The Reserve Bank of India is the most important constituent of Indian money market. Money market comes within the direct purview of RBI regulation.

The objective of RBI operations in the money market is to ensure that liquidity and short-term interest rates are maintained at levels required for achieving the objectives of monetary policy. The primary objectives of monetary policy are to ensure economic growth and price stability.

1.2 Meaning and Function of Financial System

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. While performing their activities, these units will be placed in a surplus/deficit/balanced budgetary situation.

There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

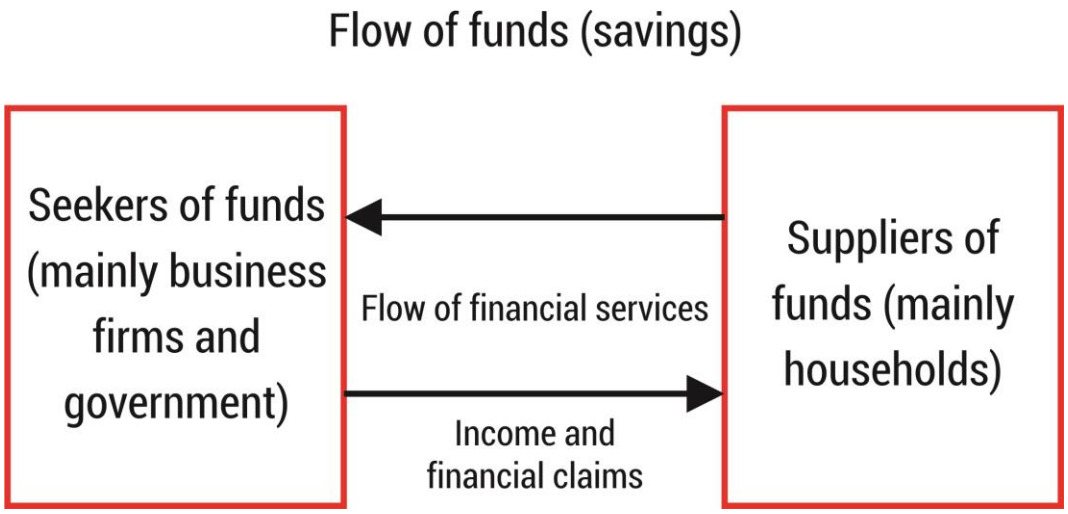

Fig 1.1 Financial System

The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation.

The functions of financial system can be enumerated as follows:

- Financial system works as an effective conduit for optimum allocation of financial resources in an economy.
- It helps in establishing a link between the savers and the investors.
- Financial system allows 'asset-liability transformation'. Banks create claims (liabilities) against themselves when they accept deposits from customers but also create assets when they provide loans to clients.
- Economic resources (i.e., funds) are transferred from one party to another through financial system.
- The financial system ensures the efficient functioning of the payment mechanism in an economy. All transactions between the buyers and sellers of goods and services are effected smoothly because of financial system.
- Financial system helps in risk transformation by diversification, as in case of mutual funds.
- Financial system enhances liquidity of financial claims.

- Financial system helps price discovery of financial assets resulting from the interaction of buyers and sellers. For example, the prices of securities are determined by demand and supply forces in the capital market.
- Financial system helps reducing the cost of transactions.

Check your progress 1

1. A Financial System is a mixture of:

a. institutions
c. money manager
b. markets
d. all of these

1.3 Functions of Money Market

Money markets exist to facilitate efficient transfer of short-term funds between holders and borrowers of cash assets. For the lender/investor it provides a good return on their funds. For the borrower it enables quick and relatively inexpensive attainment of cash to cover short-term liabilities. One of the primary functions of money market is to provide focal point for RBI's involvement for influencing liquidity and general levels of interest rates in the financial system. RBI being the main constituent in the money market aims at ensuring that liquidity and short term interest rates are reliable with the monetary policy objectives.

Money market rates play a main role in controlling the price line. Higher rates in the money markets decrease the liquidity in the economy and have the effect of reducing the economic activity in the system. Reduced rates on the other hand increase the liquidity in the market and bring down the cost of capital considerably, thereby raising the investment. This function also assists the RBI to control the general money supply in the economy.

The following are the main functions of Money Market

a. It provides a forum to financial institutes having surplus short term funds to lend or invest in the market to earn a return on their otherwise idle funds.

b. It provides a forum to financial institutes having temporary shortage of funds to borrow from the market at a reasonable rate of interest.

c. It provides liquidity funding for the financial system

d. It helps in sucking excess liquidity in the market

e. It infuses additional funds in the market in the case of liquidity crisis.

f. It plays an important role in money supply in the market

g. It plays an important role in Inflation Management

h. It provides a forum for buying and selling of short term financial instruments like Commercial Paper, Certificate of Deposit and Treasury Bills.

i. It helps the eligible companies to raise short term finance at cheap rate of interest.

j. It helps Banks to manage their liquidity risk arising out of mismatch between their receipts and payment.

k. It provides a platform to Reserve Bank of India to use its tools of monetary management so as to contract or expand the money supply.

l. It provides a platform to Reserve Bank of India to implement Government policies regarding inflation, credit flow etc.

Check your progress 2

1. Which is not the function of Money Market?

   a. provides forum to financial institutes with extra short term funds to invest in market

   b. provides forum to financial institutes with temporary shortage of funds to borrow from market

   c. stops extra money supply to the market

   d. sucks excess liquidity in market

1.4 Components or Structured of Indian Money Market

The Indian money market consists of two segments, namely organised sector and unorganised sector. The organised money market consists of RBI and commercial banks. The organised sector is within the direct purview of RBI regulation. The unorganised sector comprises of indigenous bankers, money lenders and unregulated non-banking financial institutions.

The components (or structure) of Indian money market are depicted in the chart

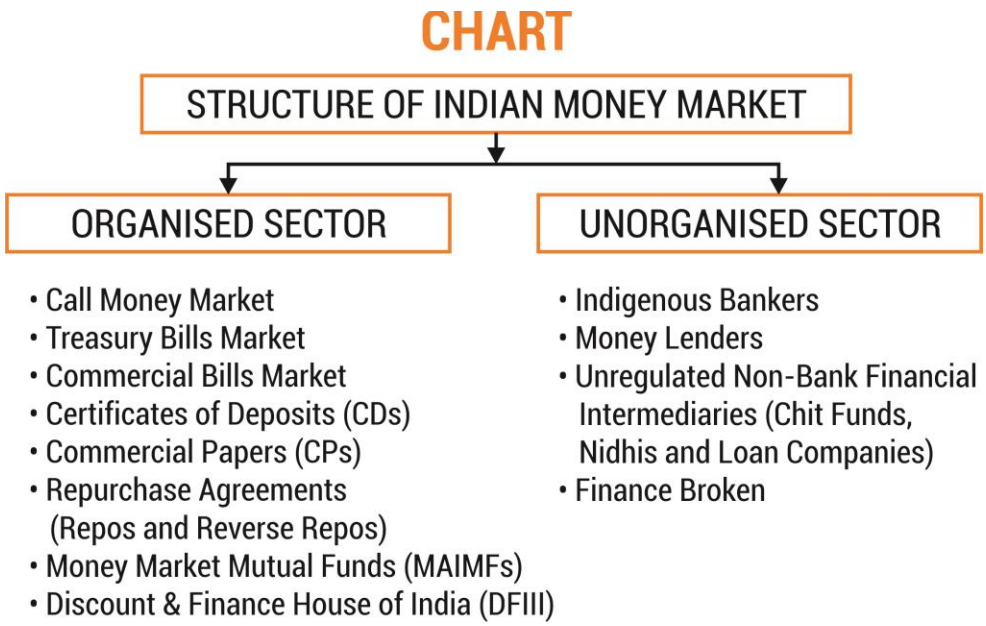

Fig 1.2 Indian money market

Check your progress 3

1. Which among the following is not under organised sector?

   a. Call money Market

   b. Money Lenders

   c. Commercial Papers

   d. Commercial Bill Market

1.5 Organized Sector of Indian Money Market

Organised sector traditionally dealt in call money, treasury bills and commercial bills. In the recent years instruments such as CDs, CPs and repos are added to the Indian money market. The organised sector is further diversified through the addition of MMMFs and DFHI. We have analysed below the components of organised sector:

1. Call Money Market

It is a market for very short term funds. In the call money market day to day surplus funds, mostly of banks, are traded. The loans given in this market are short-term in nature and their maturities vary between one day to 14 days. The loans are repayable on demand and at the option of either the lender or the borrower. The rate at which funds are borrowed and lent this market is called the call money rate. The call money rate is determined by demand and supply of short term funds. The call rate is highly variable from day to day. It also varies from centre to centre.

The main participants in the call money market are commercial banks, co-operative banks and Discount and Finance House of India (DFH1). Nonbanking financial institutions such as LlC, GIC, UTI, NABARD, etc. are allowed to participate in the call money market as lenders. Call money markets are mainly located in big commercial centres like Mumbai, Kolkata, Chennai, Delhi, and Ahmedabad. In adjusting its monetary policy, RBI takes due notice of call money market because it is a highly sensitive market and it is an indicator of liquidity position in the organised money market.

2. Treasury Bills (TBs) Market

Treasury bill market deals in treasury bills. "Treasury bills (T-bills) offer short-term investment opportunities, generally up to one year. They are the main instruments of short term borrowing by the government. They are useful in managing short-term liquidity. At present, the Government of India issues three types of treasury bills through auctions, namely - 91-day, 182-day and 364-day treasury bills. There are no treasury bills issued by state governments. With the introduction of the auction system, interest rates on all types of TBs are being determined by the market forces.

The important features of TBs are: (i) high liquidity, (ii) absence of risk of default, (iii) ready availability, (iv) assured yield, (v) low transaction cost, (vi) eligibility for inclusion in the SLR and (vii) negligible capital depreciation.

T-bills are now available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000. T-bills are issued at a discount and are redeemed at par. T-bills are also issued under the Market Stabilization Scheme (MSS).

91-day T-bills are auctioned every week on Wednesday. On the other hand, 182-day and 364-day T-bills are auctioned every alternative week on Wednesdays. The RBI issues a quarterly circular of T-bills auctions. It also announces the exact dates of auction, the amount to be auctioned and payment dates by issuing press releases prior to every auction.

The TBs are purchased by RBI, commercial banks, state governments and other approved bodies and financial institutions like LIC and UTI. The TBs market in India is narrow and undeveloped. This is due to the fact that they can be easily rediscounted with the RBI, they offer a very low rate of return and banks prefer to invest in government securities to earn higher income.

3. Commercial Bills Market

Bills of exchange are negotiable instruments drawn by a seller on the buyer for the value of goods delivered by him. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. If the seller gives some time for payment, the bill is payable at future date (i.e. usance bill). Generally the maturity period is up to 90 days. During the usance period, if the seller is in need of funds, he may approach his bank for discounting the bill. Commercial banks can provide credit to customers by discounting commercial bills. The banks can rediscount the commercial bills any number of times during the usance period of bill and get money.

Commercial bills are short-term, negotiable and self-liquidating money market instruments. They have the liability to make the payment on a fixed date when goods are bought on credit. They are assets with a high degree of liquidity and a low degree of risk. Commercial bills are very important devices for providing short term credit to trade and commerce.

The commercial bill market in India is underdeveloped. The prevalence of cash credit system, the reluctance of people to accept the payment discipline, lack of uniformity and high stamp duty have been responsible factors for impeding the growth of the bill market in India. Further, the well-established and widespread practice of borrowing against bills is absent. The commercial banks in India do not make much use of the bills of exchange while providing credit.

The eligibility criteria prescribed by the RBI for rediscounting commercial bills are that the bill should arise out of genuine commercial transaction

evidencing sale of goods. Further, the maturity date of the bill should not be more than 90 days from the date of discounting.

4. Derivative Usance Promissory Notes (DPNs):

With a view to eliminating movement of papers and facilitating multiple rediscounting the RBI introduced an innovative instrument known as "Derivative Usance Promissory Notes". They are backed by such eligible commercial bills for required amounts and usance period up to 90 days. They are negotiable instruments issued by a bank. Government has exempted stamp duty on derivative usance promissory notes. This has simplified and streamlined the bill rediscounting by institutions. This has also made commercial bill an active instrument in the secondary money market.

Discount and Finance House of India Ltd. (DFHI) trades in these instruments by rediscounting Derivative Usance Promissory Notes (DPNs) drawn by commercial banks. DPNs sold to investors may also be purchased by DFHI.

RBI has been trying to develop the bill market in our country. It has introduced the Bill Market Scheme in 1952 and a new scheme called the Bill Rediscounting Scheme in November 1970.

Despite various measures taken by the RBI the commercial bills have not yet become, popular in India.

5. Certificates of Deposits (CDs)

CDs are marketable receipts of funds deposited in a bank for a fixed period at a specified rate of interest. They are bearer instruments and are readily marketable. They are attractive to both the bankers and the investors in the sense that the former is hot required to encash the deposit prematurely, while the latter can sell CDs in the secondary market before its maturity. Thus, CDs are highly liquid and riskless money market instruments.

CDs were introduced in India in June 1989. The main purpose of the scheme was to enable commercial banks to raise funds from the market through CDs. According to the original scheme, CDs were issued in multiples of Rs. 25 lakh subject to a minimum size of an issue being Rs. I crore. They had the maturity period of 3 months to one year. They can be issued at a discount to the face value and the discount rate can be freely determined by the issuing bank and the market. They are freely transferable but only after the lock in period of 45 days after the date of issue.

The RBI has modified its original scheme from time to time to widen the market for CDs. The present guidelines are the following:

(i) The minimum size of an issue for a single investor Rs 5 lakh zm'1 the amount can be increased in multiples of Rs. 1 lakh.

(ii) CDs' are issued at a discount to face value and discount rate is determined by the market.

(iii) CDs are freely transferable after lock in period of 15 days after the issue.

(iv) All scheduled banks other than RRBs can issue CDs with a maturity period of 15 days to one year.

(v) All India financial institutions such as, SIDBI, IFCI, EXIM Bank etc. can also issue CDs with u maturity period of one year to 3 years.

(vi) CDs are subject to CRR and SLR requirements and banks have to report CDs as deposits to RBI.

(vii) CDs cannot be bought back by issuing institutions, nor can they lend against CDs.

(viii) CDs can be purchased by any one.

Due to the absence of a well-developed secondary market for CDs, they are still a "take and hold to maturity" instrument. The size of CDs market is quite small in India.

5. Commercial Papers (CPs)

CPs is unsecured, negotiable, short-term usance promissory notes with fixed maturity. They indicate the short-term obligation of an issuer. They are quite safe and highly liquid. They are generally issued by the leading, nationally reputed, highly rated and credit-worthy large manufacturing and finance companies in the public as well as private sector. They are issued on a discount to face value. The issuer promises the buyer a fixed amount at a future date but pledges no assets. His liquidity and earning power are the only guarantee.

CPs was introduced in India in January 1990. CPs was launched in India with a view to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and also to provide an additional instrument to investors. RBI has modified its original scheme in order to widen the market for CPs. The main guidelines which are in force at present are the following:

- A company can issue CPs if its tangible net worth is not less than Rs. 4 crore and its working capital is net less than Rs. 40 million.

- It should have a minimum rating of P^ from CRISIL or such equivalent rating by other credit rating agencies.
- The CPs can be issued for maturities between a minimum of 15 days and a maximum of up to one year from the date of issue. The maturity date cannot go beyond the validity period of its credit rating.
- CPs can be issued in denominations of Rs. 5 lakhs or multiples thereof.
- The company can issue CPs to the extent of 75 per cent of working capital limit.
- There is no need for prior approval of the RBI to make an issue of CPs.
- Investment in CPs can be made by individuals, banks, other corporate bodies, NRIs and Foreign Institutional Investors (FIIs).
- (viii)CPs can be issued only in a dematerialised form through any of the depositories registered with SEBI. CPs can be held only in dematerialised form.
- CPs will be issued at a discount to face value as may be determined by the issuer.
- Banks and All-India financial institutions are prohibited from underrating CPs.

The participants in the CPs market are corporate bodies, banks, mutual funds, the UTI, LIC, GIC and so on. They have surplus funds and are on a lookout for opportunities for short-term investments. The DFHI (Discount and Finance House of India) operates both in the primary and secondary markets for CPs. Even though the CPs markets have become popular now, a secondary market is yet to develop in India.

6. Repos and Reverse Repos (Repurchase Agreements)

A repo or reverse repo is a transaction in which two parties agree to sell and repurchase the same security. Under such an agreement, the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller at an agreed date and

Price, transaction is called a repo when viewed from the perspective of the seller of the securities (that is -borrower) and a reverse repo when viewed from the perspective of the buyer of the securities (that is lender). Thus, whether a

given agreement is termed as a repo or reverse repo depends on the party initiating the transaction.

The repos in government securities were first introduced in India since December 1992. Since November 1996, RBI has introduced "Reverse Repos", i.e. to sell government securities through auction. The terms of contract are in terms of a "repo rate" or "reverse repo rate" representing the money borrowing or lending rate. Repo rate is the rate at which banks borrow from RBI and the reverse repo rate is the rate at which RBI borrows from banks.

There are two types of repos in India: Interbank repos and the RBI repos. All central and state government securities and treasury bills are eligible for repo transactions. Besides, repos have also been permitted in PSU bonds, financial institutions bonds, corporate bonds and private debt securities if they are held in dematerialised form. Besides RBI and banks, PDs (Primary Dealers) are allowed to undertake both repos and reverse repo deals. The financial institutions and other specified parties can participate only in the reverse repo market, i.e., they are allowed to lend money through reverse repos to other eligible participants. The minimum maturity period of repos is one day and the maximum maturity period is 14 days.

Purpose: Repos and reverse repos are used for following purposes:

- To meet shortfall in cash positions.
- To increase returns on funds held.
- To borrow securities to meet SLR requirements.
- RBI uses this instrument for the absorption and injection of liquidity.
- To help equilibrating between demand and supply of short-term funds.

RBI changes repo and reverse repo rates to reflect the policy objectives on short-term interest rate. In the recent credit policy announcements RBI has been increasing repo rates. In April 2007, RBI increased the repo rate from 7.5% to 7.75 per cent and reverse repo rate kept unchanged at 6%.

The repo rate set by the RBI has more recently become a sort of signalling rate. According to Y. V. Reddy, 'The repo rate currently in a way serves the purpose of a floor and the bank rate / refinance rate somewhat as a cap for the money market to operate within an interest rate corridor.

7. Money Market Mutual Funds (MMMFs)

RBI introduced MMMFs in April 1992 to enable small investors to participate in the money market. In order to make the scheme of MMMFs more flexible and attractive to banks and financial institutions certain modifications were introduced into the scheme in December 1995 and in subsequent years. The important features of the scheme are:

(i) MMMFs could be set by scheduled commercial banks and public financial institutions or through their existing mutual funds or subsidiaries engaged in funds management as well as mutual funds set up in the private sector.

(ii) Initially only individual investors could participate in the MMMFs. In order to involve more market participation corporates and others were allowed to invest in MMMFs in 1996-97.

(iii) Resources mobilised by MMMFs could be invested only in money market instrument. With effect from October 1997 MMMFs were permitted to invest in rated corporate bonds and debentures with a maturity period up to one year.

(iv) The minimum lock-in period for investments in MMMFs was 46 days. It was reduced to 30 days in April 1998 and 15 days in October 1998,

(v) The setting up of a MMMF required approval of RBI. Private sector: mutual funds need approval of SEBI and RBI to participate in the money market. Since March 2000 the MMMFs have been brought it under the SEBI regulations.

8. Discount and Finance House of India (DFIII)

It was set up by RBI in April 1988 with the objective of deepening and activating money market. It is jointly owned by RBI, public sector banks arid all India financial institutions which have contributed to its paid up capital. The role of DFHI is both developmental and stabilising. It works as a specialised money market intermediary for stimulating activity in the money market instruments and developing secondary markets in those instruments. It was accredited as a Primary Dealer (PD) in February 1996.

Thereafter, its participation in the primary and secondary markets for government securities has increased. It is playing an important role in developing an active secondary market in money market instruments.

Check your progress 4

1. Which among the following is not a non-banking financial institution?

a. Bank
c. GIC
b. LlC
d. UTI

1.6 Unorganized Sector of Indian Money Market

The unorganised Indian money market is largely made up of indigenous bankers, money lenders and unregulated non-bank financial intermediaries. They do operate in urban centres but their activities are largely confined to the rural sector. This market is not homogeneous and there is no demarcation between short-term and long-term funds and purposes of finance. This market is unorganised because it's activities are not systematically coordinated by the RBI. This sector meets a large part of working capital needs of several segments of the economy. As per All India Debt and Investment Survey of 1991, 36% of rural households depended on finance from these sources.

The main components of unorganised money market are:

1. **Indigenous Bankers:** They are financial intermediaries which operate as banks, receive deposits and give loans and deals in hundies. The hundi is a short term credit instrument. It is the indigenous bill of exchange. The rate of interest differs from one market to another and from one bank to another. They do not depend on deposits entirely; they may use their own funds. Indigenous bankers are confined to certain castes and they are known as Kathawals, Sarafs, Shroffs or Chettis. Their lending operations are generally confined to productive purposes (traders and industrialists). They provide loans directly to trade and industry and to agriculturists through money lenders and traders.

   They are the important source of funds due to inadequate banking facilities, simple and flexible nature of their operations, their informal approach and personal contacts, prompt services and availability of timely funds.

   In spite of such advantages, over the years, indigenous banks have tended to decline in importance because (i) they charge a very high rate of interest (18% or 36%), (ii) they combine banking with trade and (iii) they have been showing more interest in non-banking activities such as general merchants, brokers and so on.

2. **Money Lenders:** They are those whose primary business is money lending. Money lenders predominate in villages. However, they are also found in urban areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The operations of money lenders are prompt, informal and flexible. The borrowers are generally agricultural labourers, marginal and small farmers, artisans, factory workers, small traders, etc.

3. **Unregulated non-bank financial intermediaries:** They consist of Chit funds, Nidhis, Loan companies and others.

   (a) **Chit Funds:** They are saving institutions. The members make regular contribution to the fund. The collected fund is given to some member based on previously agreed criterion (by bids or by draws). Chit Fund is more famous in Kerala and Tamilnadu.

   (b) **Nidhis:** They deal with members and act as mutual benefit funds. The deposits from the members are the major source of funds and they make loans to members at reasonable rate of interest for the purposes like house construction or repairs. They are highly localized and peculiar to South India. Both chit funds and Nidhis are unregulated.

   (c) **Loan Companies:** They are also called finance companies. Their total capital consists of borrowings, deposits and owned funds. They offer a high rate of interest along with other incentives to attract deposits. A part is invested in banks in the form of fixed deposits and the rest is used to grant loans. Their activities are mainly confined to traders, small scale industries and self-employed persons. Loans are given at a very high rate of interest (36 percent to 48 percent per annum).

4. **Finance Brokers:** They are found in all major urban markets specially in cloth markets, grain markets and commodity markets. They are middlemen between lenders and borrowers.

Check your progress 5

1. What are the reasons of downfall of indigenous banks?

a. High rate of interest

b. Use both banking and trade

c. Concern more with non-banking activities

d. all of above

1.7 Features (or Defects) of Indian Money Market

Despite many efforts over the years, Indian money market remains lopsided, thin and extremely volatile. Indian money market is relatively underdeveloped when compared to advanced markets like London and New York money markets. Its main weaknesses (or features) are explained below:

1. **Existence of Unorganised Money Market**: This is one of the major defects of Indian money market. It does not distinguish between short term and long term finance and also between the purposes of finance. Since it is outside the control and supervision of RBI, it limits the RBI's control of over money market.

2. **Lack of Integration**: The Indian money market is broadly divided into two sectors, the organised money market and the unorganised market. The organised market constitutes several institutions such as RBI, State Bank of India, commercial banks, cooperative banks and financial institutions. RBI as an apex body regulates their working. The unregulated sector is not homogeneous in itself. It constitutes indigenous bankers, loan companies, money lenders, etc. There is no uniformity in their practices and there is multiplicity of functionaries.

   Thus there is dichotomy in Indian money market. The several segments are loosely connected with each other. RBI is fully effective in organised money market but unorganised market is out of RBFs control. There are also differences in interest rates in both the markets. Thus there is lack of integration in Indian money market.

3. **Multiplicity in Interest Rates**: There exists too many rates of interest in the Indian money market such as the borrowing rate of government, deposits and lending rates of cooperative and commercial banks, lending rates of financial institutions, etc. This is due to lack of mobility of funds from one section of the money market to another. The rates differ for funds of same durations lent by different institutions. Even though such wide differences are being narrowed down, differences still exist and they hamper the efficiency of the money market.

4. **Inadequate Funds**: Generally there is shortage of funds in Indian money market on account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy, etc. However, the banking development particularly branch expansion, has improved the mobilization of funds to some extent in the recent years.

5. **Seasonal Stringency of Money**: The seasonal stringency of money and high rate of interest during the busy season (November to June) is a striking feature of Indian money market. There are wide fluctuations in the interest rates from one season to another. RBI has been taking various measures to avoid such fluctuations in the money market by adding money into the money market during the busy season and withdrawing the funds during the slack season.

6. **Absence of Bill Market**: A well organised bill market is necessary for linking up various credit agencies effectively to RBI. The bill market is not yet developed on account of many factors such as the practice of banks keeping a large amount of cash for liquidity purposes, preference for borrowing rather than discounting bills, dependence of indigenous bankers on one another, widespread practice of using cash credit, high stamp duty on usance bill etc.

7. **Absence of Well-organised Banking Sector**: Branch expansion was very slow before bank nationalization in 1969. Even now the banks are largely concentrated in large towns and small cities. There is lack of movement of funds. The involvement of the banking system in different seams including the IPO scam of 2005 and the failure of RBI to prevent these abuses of the banking system prove that Indian banking system is not yet a well organised sector..

8. **Inadequate Credit Instruments**: The Indian money market did not have adequate short term paper instruments till 1985-86. There were only call money and bill markets. Moreover there were no specialist dealers and brokers dealing in the money market: After 1985-86, RBI has introduced new credit instruments such as 182-day treasury bills, 364-day treasury bills, CDs and CPs.

The above features or defects of Indian money market clearly indicate that it is relatively less developed and has yet to acquire sufficient depth and width. Thus, it cannot be compared with developed money markets such as London and New York money markets.

Check your progress 6

1. Which is not the reason of Indian Money Markets to be considered as Volatile Market?

   a. Presence of unorganised money flow

   b. Lack of Integration

   c. Varied Interest Rates

   d. Adequate Funds

1.8 Reforms in Indian Money Market

The Committee to Review the Working of Monetary System chaired by S. Chakravarty made several recommendations in 1985 to develop Indian money market. As a follow-up, the RBI set up a Working Group on money market under the chairmanship of N. Vaghul, in 1987. Based on the recommendations of Vaghul Committee, RBI initiated a number of measures to widen and deepen the money market. The main measures are as follows.

Indian Money Market

1. **Deregulation of Interest Rates**: From May 1989, the ceiling on interest rates on the call money, inter-bank short-term deposits, bills rediscounting and inter-bank participation was removed and the rates were permitted to be determined by the market forces. Thus, the system of administered interest rates is being gradually dismantled. Currently, all the money market interest rates are by and large determined by * market forces.

2. **Introduction of New Money Market Instruments**: In order to widen and diversify the Indian money market RBI has introduced many new money market instruments such as 182-day treasury bills, 364-day treasury bills, CDs and CPs. Through these instruments the government, commercial banks, financial institutions and corporates can raise funds-through the money market. They also provide investors additional instruments for investments. In order to expand the investor base for CDs and CPs the minimum amount of investment and the minimum maturity periods are reduced by RBI.

3. **Repurchase Agreements (Repos and Reverse Repos)**: RBI introduced repos in government securities in December 1992 and reverse repos in November 1996. Repos and reverse repos help to even out short-term fluctuations in liquidity in the money market. They also provide a short-term avenue to banks to park their surplus funds. Through changes in repo and reverse repo rates RBI transmits policy objectives to entire money market.

4. **Liquidity Adjustment Facility (LAF**): RBI has introduced LAF from June 2000 as an important tool for adjusting liquidity through repos and reverse repos. Thus, in the recent years RBI is using repos and reverse repos as a policy to adjust liquidity in the money market and therefore, to stabilise the short-term interest rates or call rates. LAF has, therefore, emerged as a major instrument of monetary policy.

5. **Money Market Mutual Funds (MMMF)**: RBI introduced MMMFs in April 1991 to enable the individual investors to participate in money market instruments. To make the scheme flexible and attractive, RBI has brought about many modifications. The important features of this scheme as of now are :

   a. It can be set up by commercial banks, financial institutions and private sector.

   b. Individual investors, corporate and others can invest in MMMF 206 Business Economics - II

   c. Resources mobilised through this scheme can be invested in money market instruments as well as rated corporate bonds and debentures with a maturity period up to one year.

   d. The minimum lock in period is gradually reduced to 15 days, making the scheme more attractive to investors.

6. **Discount and Finance House of India (DFHI)**: In order to impart-liquidity to money market instruments and help the development of secondary market in such instruments, DFHI was set up in 1988 jointly by RBI, public sector banks and financial institutions.

7. **Development of Call and Term Money Market**: The call money market was predominantly an interbank market until 1990, except for UTI and LIC, which were allowed to operate as lenders since 1971. The RBI gradually liberalised the entry into call money market to widen and to provide more liquidity, although Vaghul Committee had recommended that the call money market should be restricted to banks. Thus until 2001 banks and

primary dealers (PDs) were operating as both lenders and borrowers, while a large number of financial institutions and mutual funds were operating only as lenders.

As per the recommendations of Vaghul Committee RBI in 2001-02 has underlined the need for transforming the call money market into a pure inter-bank money market. To achieve this, the borrowing and lending capacities of non-banking institutions in the call money market are being reduced in stages.

In order to develop term money market RBI has gradually removed most of the constraints prevailing in the money market.

8. **Regulation of NBFCs**: The RBI Act was amended in 1997 to provide for a comprehensive regulation for NBFC sector. According to the amendment, no NBFC can carry on any business of a financial institution, including acceptance of public deposit, without obtaining a Certificate of Registration (CoR) from RBI. Companies accepting public deposits are required to comply with all directions on public deposits, prudential norms and liquid assets. They are required to submit periodic returns to the RBI.

9. **The Clearing Corporation of India Limited (CCIL)**: The CCIL was registered on April 30, 2001 under the Companies' Act, 1956, with the State Bank of India as the chief promoter. The CCIL clears all transactions in government securities and repos reported on the Negotiated Dealing System (NDS) of RBI and also rupee/US $ foreign exchange spot and forward deals. All trades in government securities below Rs. 20 crores would be mandatorily settled through CCIL while those above Rs. 20 crore would have the option for settlement through the RBI or the CCIL.

Check your progress 7

1. The Money Market Mutual Fund can be catered by:

   a. Commercial banks

   b. Financial institutions

   c. Private sector

   d. All of above

1.9 Let Us Sum Up

In this unit we have learnt that financial system is a complex system which deals with variety of financial activities which has Financial Institutions, Financial Markets & Financial Instruments and Financial Services. It is noted that the Financial Markets and Institutions facilitate the functioning of Financial System by way of Financial Instruments.

We see that money market is a type of market which deals with lending and borrowing of short term funds which funds money to one year maturity by covering money and financial assets as a substitute. These markets exist to facilitate efficient transfer of short term funds that arises among holders and borrowers of cash assets.

It is seen that the structure of money market consists of two segments that are organised sector and unorganised sector. In case of an organised money market, the RBI and commercial banks plays certain role, while in case of organised sector, the regulations are purview by RBI.

It is found that the committee to review the working of monetary system is chaired by S. Chakravarty which amends several recommendations in 1985 to develop Indian money market. Further, the RBI set up a Working Group on money market under chairmanship of N. Vaghul, in 1987.

1.10 Answer for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-c)

Check your progress 3

Answers: (1-b)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-d)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-d)

1.11 Glossary

1. **Financial System -** It is a mixture system which carries different financial activities.
2. **Money Market -** It is a market where activities such as lending and borrowing of short term funds are done.

1.12 Assignment

What is money market? What are the important functions performed by it in the economy.

1.13 Activities

Discuss the Reforms in Indian Money Market.

1.14 Case Study

Discuss briefly the structure of organised Indian money market.

1.15 Further Readings

1. A Treatise on Money, Keynes, J. M.

UNIT 2: CAPITAL MARKET AND RBI

Unit Structure

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Structure of Capital Market in India
- Traditional Functions of RBI

- Objectives of RBIs Monetary Policy
- Recent Changes in RBI's Monetary Management

2.1 Introduction

Capital market is a place which provides a plat form to the companies to raise the long term capital required by them and to the investors to invest their money in the instruments offered by these companies. For the investors it provides a good return on their funds in the long run. For the companies and business houses it enables a reliable means of raising long term capital needed by them.

2.2 Capital market

A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year. There are various financial instruments categorized under capital market like Equity and preference shares, debentures, etc.

However new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc. The following are the main functions of Capital Market:

a. It provides a forum to small investors to invest in the capital market to earn a return higher than the return on the traditional investments.

b. It provides long term funding for the business world.

c. It provides various modes of raising finance

d. Secondary Market provides liquidity to the investors

e. It provides a forum for buying and selling of short term financial instruments like Equity Shares, Preference Shares, Debentures, Bonds, etc

f. It helps the eligible companies to raise long term finance without obligation of repayment in respect of equity shares.

g. Facilitates pooling of household savings for financing business

h. Facilitates transfer of economic resources for the most productive use in business sector

i. Provides opportunity for risk pooling & risk sharing for both investor & corporate sector

j. Provides complete information to develop healthy capital market.

k. Market for creation & exchange of financial assets

l. Channel of funds transfer between different parties

m. Establishing prices of financial assets

n. Provides liquidity to financial assets

Check your progress 1

1. In Capital market money is provided for:

   a. Short period of time

   b. Longer period of time

   c. Particular period of time

   d. All of above

2.3 Significance (or Role) of Capital Market in Economic Development

Capital market has a crucial significance to capital formation. Adequate capital formation is indispensable for a speedy economic development. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development.

The process of capital formation involves three distinct but interrelated, activities, i.e.

1. Savings
2. Mobilisation of Savings
3. Investments

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. The effective mobilisation of savings, the efficiency of financial organisation and the channelisation of these savings

into the most desirable and productive forms of investment are all interconnected. They have a great bearing on the contribution of capital formation to economic development.

A sound and efficient capital market facilitates the process of capital formation and thus contributes to economic development. The significance of capital market in economic development is explained below.

1. **Mobilisation of Savings**: Capital market is an organised institutional network of financial organisations, which not only mobilizes savings through various instruments but also channelises them into productive avenues. In other words, the resources that would have been normally used for consumption purpose are being released for productive purposes through capital market. By making available various types of financial assets, the capital market encourages savings. By providing liquidity to these financial assets through the secondary markets capital market is able to mobilise large amount of savings from various sections of the people.

2. **Channelisation of Funds into Investments:** Capital market plays a crucial role in the economic development by channelising funds in accordance with developmental priorities. The financial intermediaries in the capital market are better placed than individuals to channel the funds into investments which are more favourable for economic development. It raises efficiency of investment with its specialised knowledge, expertise, information and huge amount of resources. It undertakes this in the following ways:

   a) It allocates resources to the most viable projects, which improves allocation of resources.

   b) It reduces the cost of transferring resources from lenders to borrowers related to contract, risk of default, etc. Thus it provides high returns to savers and reduces the charges to borrowers.

3. **Industrial Development:** Capital market contributes to industrial development in the following ways:

   a) It provides adequate, cheap and diversified finance to the industrial sector for various purposes.

   b) It provides funds for diversified purposes such as for expansion, modernization, up gradation of technology, establishment of new units etc.

c) It provides a variety of services to entrepreneurs such as provision of underwriting facilities, participating in equity capital, credit rating, consultancy services, etc. This helps to stimulate industrial entrepreneurship.

4. **Modernisation and Rehabilitation of Industries:** Capital market can contribute towards modernisation, rationalisation and rehabilitation of industries. For example, the setting up of development financial institutions in India such as 1FCI, ICICI, IDBI and so on has helped the existing industries in the country to adopt modernisation and replacement of obsolete machinery by providing adequate finance. Further, they have also enabled the industrial units to solve the problems of foreign exchange by channelising the funds obtained from international agencies like International Finance Corporation. They also participate in the equity capital of industries.

5. **Technical Assistance:** An important bottleneck faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to the preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in the capital market play an important role in stimulating industrial entrepreneurship. This helps to stimulate industrial investment and thus promotes economic development.

6. **Encourage Investors to invest in Industrial Securities:** Secondary market in securities encourage investors to invest in industrial securities by making them liquid. It provides facilities for continuous, regular and ready buying and selling of securities. Thus, industries are able to raise substantial amount of funds from various segments of the economy.

7. **Reliable Guide to Performance:** The capital market serves as a reliable guide to the performance and financial position of corporates and thereby promotes efficiency. It values companies accurately and toes up manager compensation to stock values. This gives incentives to managers to maximise the value of companies. This stimulates efficient resource allocation and growth.

Check your progress 2

1. By which way the capital market involves in generation of capital?

a. Savings c. Investments

b. Mobilisation of Savings d. All

2.4 Structure of Capital Market in India

The capital market, like any market, is composed of those who demand funds (i.e. borrowers) and those who supply funds (i.e. lenders). Indian capital market is broadly composed of (1)' Gilt-edged market (i.e. government securities market), (2) Industrial securities market, (3) Development financial institutions and (4) Financial intermediaries (see Chart)

Chart

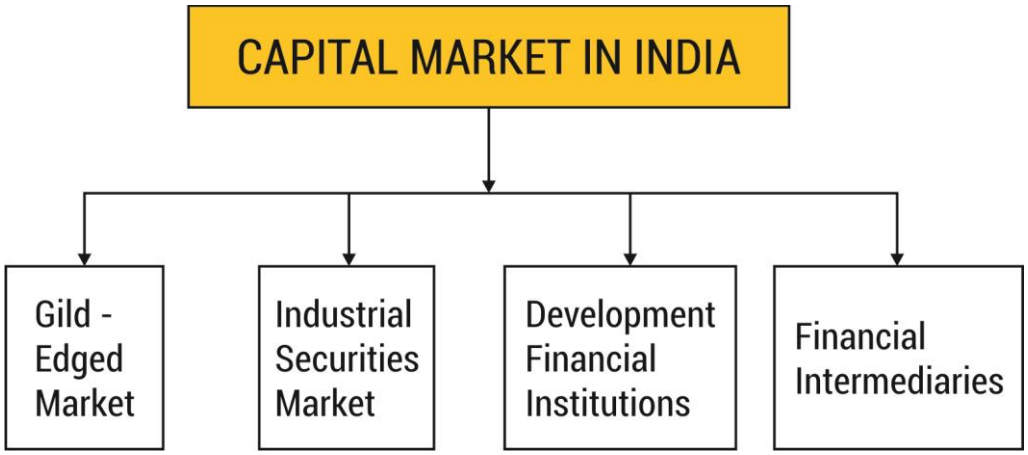

Fig 2.1 Indian Capital Market

1. **Gild-Edged Market**: It deals in government and semi-government securities. These securities carry fixed interest rates. The investors in government securities are mainly financial institutions like commercial banks, LIC, GIC and provident funds. These institutions are often compelled by law to invest a certain percentage of their funds in these, securities. Therefore, they are often referred to as the captive market for government securities. RBI plays a very important role in this market through open market operations.

2. **Industrial Securities Market**: It deals with shares and debentures of old and new companies. This market is further divided into new issues market i.e. primary market and old issues market i.e. secondary market. The

primary market helps to raise new capital through shares and debentures. The secondary market deals with securities already issued by the companies. The secondary market operates through stock exchanges.

3. **Development Financial Institutions (DFIs**): These institutions were set up mainly to provide medium and long term financial assistance to industries in the private sector. Thus, to provide financial assistance to industrial sector government set up the Industrial Finance Corporation of India (IFCI) in 1948, the Industrial Credit and Investment Corporation of India (ICICI) in 1955, the Industrial Development Bank of India (IDBI) in 1964, the Industrial Reconstruction Bank of India (IRBI) in 1971 which was renamed as Industrial Investment Bank of India Ltd. (IIBI) in 1995, the Export and Import Bank of India (EXIM Bank) in 1982 and so on. At the state level government set up State Financial Corporations (SFCs), State Industrial Corporations (SIDCs) and so on. All these institutions have been called public sector financial institutions or term lending institutions. The Narasimham Committee (1991) called them Development Financial institutions.

These institutions have been doing very useful work in subscribing to the shares and debentures of new and old companies, in giving loan assistance, in underwriting new issues and so on. At present, many of them have become powerful shareholders in many prominent companies. LIC and UTI mobilize resources from the public and place them at the disposal of the capital market. On the other hand, the Development Financial Institutions (DFIs) are engaged in providing funds to the private sector enterprises.

Historically, the RBI and the Central Government have played a major role in financing these institutions by subscribing to the share capital, by allowing them to issue Government guaranteed bonds and by extending long-term. Loan at concessional terms. However, with the financial sector reforms in the nineties, concessional lending by the RBI and the Government was phased out, leaving the financial institutions to rely for financing their needs on the equity capital and the debt market. Expansion of their equity base through public offers and public issues of long-term bonds has become an important element of their market-based financing. In order to provide flexibility, the RBI has also allowed FIs to raise resources by way of term deposits, certificate of deposits (CDs) and borrowings. Some of them such as ICICI and IDBI have converted themselves into banks.

4. **Financial Intermediaries:** They consist of merchant banks, mutual funds, leasing companies, venture capital companies and others. They help in mobilising savings and supplying funds to the capital market. Merchant banks in India manage and underwrite new issues and advise corporates clients on fund raising and other financial aspects. Leasing companies provide finance for acquiring plant and machinery specially for small and medium sized enterprises. Mutual funds mobilise the savings of the general public and invest them in stock market.

The venture capital companies provide financial support to new ideas and for the introduction and adaptation of new technologies. There is a high degree of risk involved in venture capital financing.

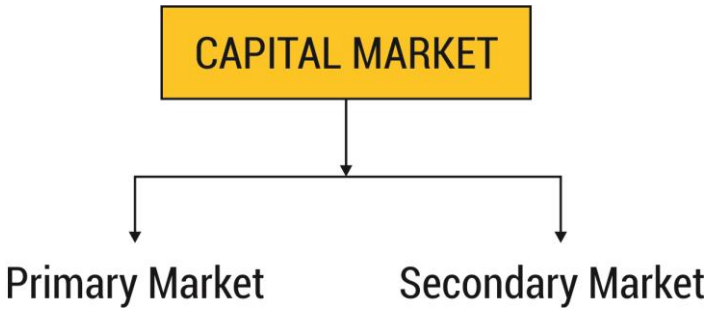

Fig 2.2 Capital market

It is a market for new issues and therefore it is also called the New Issue Market. It deals with the raising of fresh capital in the form of equity shares, preference shares, debentures, bonus, deposits, miscellaneous loans, etc. by companies, government and semi-government bodies, public sector units, etc. It includes all institutions dealing in the issue of fresh claims.

The resources mobilised from the primary market can be broadly classified into two categories i.e. (i) Equity issues and (ii) Debt issues (see Chart).

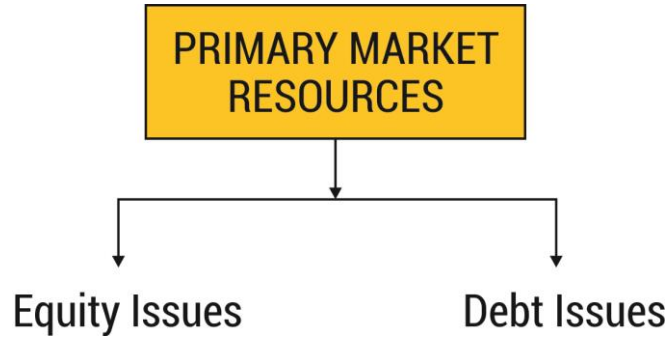

Fig 2.3 Primary market resource

Equity Issues: They include issue of ordinary shares and preference shares of corporates, units of mutual funds and funds mobilised in the form of equity shares from overseas. There is no assurance on the rate of return to the investors in equities.

Debt Issues: They include' fixed deposits, bonds of all types and debentures (both convertible and non-convertible) and funds mobilised in the form of debt from overseas. They involve a fixed interest cost to the corporate and the commitment to repay on maturity.

The funds mobilised in the primary market in the form of equity and debts reveal investor preference.

Change in Primary Market Scenario

The scenario in the primary market changed substantially after the mid-eighties and its organisation underwent a transformation. A significant organisational development in the Indian primary market has been the emergence of number of intermediaries such as lead managers, underwriters, bankers to issue, registers and share transfer agents, debenture trustees and portfolio managers. They plan a very important role in the process of selling new issues. SEBI has prescribed the legal framework for their operations. These guidelines provide the ground rules for the intermediaries.

Resource Mobilisation through Primary Market

The local amount of resources mobilised through primary market increased substantially from Rs. 1,23,991 crore in 2005 to Rs. 1,61,769 crore in 2006. (See Table) Out of this amount mobilised in 2006, 72.5 per cent i.e. Rs. 1.17,407 crore was raised through private placements. There was 75 IPOs in 2006. They raised Rs. 24,779 crore which accounted for 76 per cent of resources raised through equity.

Table Resource Mobilisation through Primary Market in India

Rs. Crore

	Calendar Year	
Mode	2005	2006
1. Debt	66	389
2. Equity	30,325	32,672

Of which. IPO's	9,918	24,779
Number of IPO's	55	75
3. Private Placements	83,812	1,17,407
4. Euro Issues (ADR/GDR)	9,788	11,301
Total (I to 4)	1,23,991	1,61,769

Source: Economic Survey, Government of India, 2006-7, P. 70.

The net mobilisation of resources by manual funds also increased substantially. It increased by more than four times from Rs. 25,454 crore in 2005 to Rs. 1,04,950 crore in 2006. (See Table) The sharp rise in mobilisation by mutual funds is due to buoyant inflows under both incomes/ debt oriented schemes and growth/equity oriented schemes.

Capital Market 2/5 Table: Net Resource Mobilisation by Mutual Funds in India

Rs. Crore

Calendar Year	Total Net Resource Mobilisation
2004	4,775
2005	25,454
2006	1,04,950

Source: Economic Survey, 2006-07, P. 71.

B) Secondary Market in India

It deals in securities already issued or existing or outstanding. The primary, market mobilises savings and supplies fresh or additional capital to business, units. Even though secondary market does not contribute directly to the supply of additional capital, does so indirectly by rendering securities issued on the primary market liquid. This takes place through stock exchanges.

The stock exchanges provide facilities in the form of infrastructure for buying and selling of securities and help to develop a secondary market for them. They help in discovering the price of an underlying asset and in providing liquidity to the investor. Stock exchanges provide the platform for transaction to

large number of buyers and sellers of the securities with the help of brokers and other market intermediaries.

The secondary market in India has shown maturity by registering enormous growth in the recent years in terms of number of listed companies, market capitalisation, market value of listed companies to GNP, number of shareholders and so on. There are 23 recognised stock exchanges in the country. The National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) are the two premier stock exchanges in India. They provide efficient and transparent platform for trading of equities, preference shares, debentures, warrants, etc.

India's capital market is already more competitive, deep and developed according to international markets standards. Business in the country's oldest stock exchange, namely Bombay Stock Exchange (BSE) dating back to 1875, continued to grow. The National Stock Exchange (NSE), which emerged in the mid-1990s and introduced many improvements in trading systems, made sustained progress. The secondary market is overseen by SEBI, an independent statutory regulatory authority.

According to the number of transactions, NSE continued to occupy the third position among the world's biggest exchanges in 2006, as in the previous year. BSE occupied the sixth position in 2006, slipping one position from 2005. In terms of listed companies, the BSE ranks first in the world.

However, the stock exchanges had not been discharging their self-regulatory | role well as a result of which malpractices had crept into trading. This had adversely affected the investors' interests.

SEBI: The SEBI has been set up to ensure that stock exchanges discharge their self-regulatory role properly. To prevent malpractices in trading and to protect the rights of investors, the SEBI has taken up the monitoring function, requiring the brokers to be registered and stock exchanges to report on their activities.

Check your progress 3

1. The Indian capital market composed of:

a. government securities
c. financial institutions
b. Industrial securities
d. all of above

2.5 Market Capitalisation

Market capitalisation is a good indicator of the health of capital markets of an economy. Leading economies of the world have huge market capitalisation in relation to their gross domestic product (GDP).

This indicates not only the investor confidence, domestic and international, but also the strength of their economies. In this article, we try to look at where India is placed.

Market capitalisation, as the name implies, in very simple terms, is the capital of a market. To begin with, market capitalisation of a particular stock is the total number of outstanding shares of the company multiplied by the share price of that stock. Thus, stock market capitalisation would mean the summation of the market capitalisation of all the individual stocks that are listed on the exchange.

On a narrower perspective, stock exchanges have indices based on various parameters e.g. BSE- 30. As the name implies, BSE-30 consists of 30 stocks in the index. These stocks, from various sectors, are representatives or leaders of the sectors they belong to. Every index has a mix of a number of stocks representing various sectors.

Table India: Market capitalisation growth

?	FY96	FY03	CAGR (%)
BSE	5,265	5,722	1%
BSE-30	1,449	2,414	9%
BSE-30 as % of BSE	28%	42%	-

Source: CMIE

The market Capitalisation of BSE has increased at a CAGR of 1% in the last 7 years. It must be noted here that during the same period, the number of listed companies on BSE has increased by 1% from 5,603 to the current 5,687.

It is believed that stock markets tend to reflect a true picture of the economy since companies from various sectors are listed on the exchanges. If the sector or companies perform well, investors tend to reward the company in terms of better valuations. This has a direct impact on the market Capitalisation of the exchange. However, if we compare the GDP growth of our economy with the trend in

market Capitalisation in the last eight years, the relationship is rather weak. This is clearly visible in the chart below.

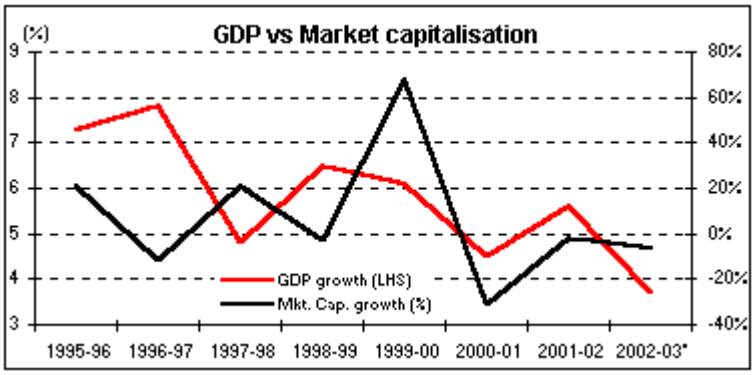

Fig 2.4 GDP vs. market Capitalisation

The broader reason could be due to various factors like East Asian crisis (1997), technology boom (FY00), stock market scams (FY01) and select domestic unrest (like Gujarat riots and Indo-Pak conflict in FY01-02).

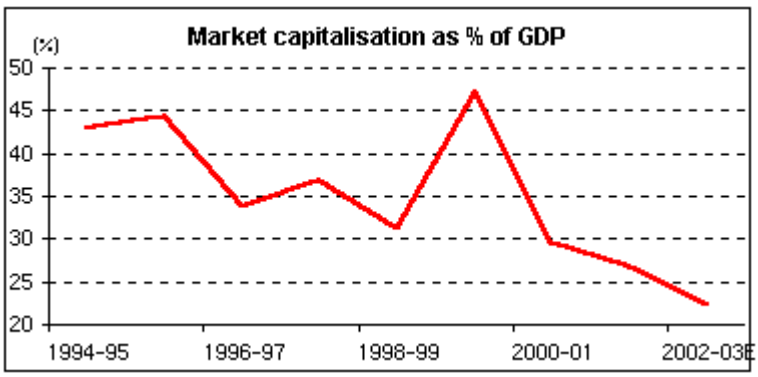

Fig 2.5 Market Capitalisation as % of GDP

Market capitalisation, in absolute terms, does not hold much relevance. However, market capitalisation as a % of GDP could be considered as a decent indicator for any markets. The chart above shows the movement of market capitalisation as a % of GDP for India, which currently rests at about 22% (off from its peak of 47% in FY00 due to the technology boom).

Check your progress 4

1. Market capitalisation involves:

a. Shares

b. Bonds

c. FDs

d. None of above

2.6 Introduction to RBI

The Reserve Bank of India was established as a private sector bank on April 1, 1935 on the terms of the Reserve Bank of India Act, 1934. It was nationalized 1949 when it became the central bank of the country under the Reserve Bank of India Act, 1948.

The RBI performs general central banking functions. It has powers to supervise and control commercial and co-operative banks with the objective of developing a sound and efficient banking system in the country. In addition to the general central banking functions, the RBI also performs some developmental or promotional functions.

Functions of RBI are as under:

1. Monetary Authority:

- Formulates implements and monitors the monetary policy.
- Objective: maintaining price stability and ensuring adequate flow of credit to productive sectors.

2. Regulator and supervisor of the financial system:

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- Objective: maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3. Manager of Foreign Exchange

- Manages the Foreign Exchange Management Act, 1999.
- Objective: to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. Issuer of currency:

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Objective: to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5. Developmental role

- Performs a wide range of promotional functions to support national objectives.

6. Related Functions

- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks: maintains banking accounts of all scheduled banks.

Check your progress 5

1. Which is not a function of RBI?

a. Issue of Credit Card

b. monitors monetary policy

c. manages Foreign Exchange

d. all of above

2.7 Traditional or General Functions of the RBI

The general functions of the RBI include, issue of currency notes, acting as banker to the government, acting as banker's bank and lender of the last resort, credit management and control, exchange management and control and collection and publication and data.

Some of the traditional functions performed by the RBI are:

1. **Monopoly of Note Issue:** The RBI has been given the statutory function of note issue on a monopoly basis. It has the sole right of issuing currency notes other than one rupee notes and coins and coins of smaller denominations.
2. **Banker to the Government**: The RBI acts as a banker to the Central and the state governments. It provides to the governments banking services like acceptance of deposits, withdrawal of funds, making payments, receipts and collection of payments on behalf of the government, transfer of funds and management of public debt. The RBI earns no income for carrying out government's banking transactions but earns commissions for managing

public debt. "Ways and means" advances are extended by the RBI to the government to meet temporary shortfalls in government revenue.

3. **Agent and Advisor to the Government**: As an agent to the government, the RBI manages public debt, issues government bonds and treasury bills. It is also the government's financial advisor.

4. **Bankers' Bank**: Like all central banks, the RBI is a bankers' bank. All scheduled banks in India must keep a certain percentage of their demand and time deposits with the RBI. Banks also maintain current account with the RBI for various banking transactions.

5. **Acts as National Clearing House**: The RBI acts as the clearing house for settlement of banking transactions. This helps commercial and other banks to settle their interbank claims easily.

6. **Lender of the Last Resort**: The RBI is the ultimate source of funds to the banks. It acts as the lender of the last resort to banks, that is, it provides fur ds to the banks when they are not able to procure finance from any other source.

7. **Custodian of Foreign Exchange**: The RBI is the custodian of the country's foreign exchange reserves. One of the important functions of the RBI is to maintain stability of the external value of the rupee. It may buy and sell foreign currencies in order to maintain exchange rate stability.

8. **Publishes Economic Statistics and Other Information**: The RBI periodically publishes data analysis of the entire financial system.

Check your progress 6

1. Which comes under traditional function of RBI?

   a. issue of Credit Card

   b. monitors monetary policy

   c. manages Foreign Exchange

   d. issuing currency notes

2.8 Development Function of RBI

The central bank of a developing country has a much wider role to play than that in a developed country. Besides the general central banking functions, developmental and promotional functions are very important in such countries. In India, the RBI has to perform several functions in order to promote social and economic development.

Some of RBI's developmental functions are as follows:

1. **Promoting Banking Habit**: RBI has played a major role in promoting banking habit among the people, by actively encouraging branch expansion by commercial banks, especially in rural areas.
2. **Mobilization of Savings**: Mobilization of savings is of utmost importance in the process of capital formation in a developing nation. Keeping this in mind, the RBI has promoted mobilization of savings through banks and other financial institutions for productive purposes. This has been achieved through expansion of branches in semi-urban and rural areas.
3. **Lead Bank Scheme**: Soon after nationalization of major commercial banks in 1969, the RBI started the Lead Bank Scheme. Under this scheme the commercial banking system was used to bring about district level area development.
4. **Reduce Importance of Unorganised Sector**: The unorganised sector of the money market consists of indigenous banks and money lenders. This sector is known to exploit poor farmers, traders and small businesses. The RBI is trying to correct the problems arising out of the existence of the unorganised sector in the money market. For this, the RBI has been promoting branch expansion by commercial banks in semi-urban and rural areas. This has helped in reducing people's dependence on the unorganised sector.
5. **Priority Sector Lending**: In a developing economy, capital is scarce, therefore the central bank has to regulate the use of credit and direct it to those sectors that need it the most. The RBI has used selective credit control measures to direct credit to the priority sector which includes agriculture and small scale industries.
6. **Depositor Security**: To protect the interest of depositors in case of bank failures, the RBI has established the Deposit Insurance Corporation in 1962.

7. **Agricultural Credit**: The RBI has helped in the development of short term cooperative credit agencies for agriculture. It has participated it' the establishment of Agriculture Refinance and Development) Corporation (ARDC) in 1963. National Bank for Agriculture and Run Development (NABARD) was set up in 1982. NABARD has sin« taken over ARDC.

8. **Industrial Finance**: To promote the industrial sector, the RBI got involved in the establishment of several specialized institutions of industrial finance, like, the Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Unit Trust of India and State Finance Corporations.

Check your progress 7

1. Which comes under development function of RBI?

   a. acts as clearing house.

   b. solving money problems in unorganised sectors.

   c. maintaining stability of external value of rupee.

   d. issuing currency notes.

2.9 RBI'S Monetary Policy

Money supply is an important factor determining growth and price stability in an economy. It can be controlled and regulated by the central bank. The central bank in most countries has the exclusive power to issue currency notes. It has the power to either expand or contract money supply by using certain measures of credit control. Changes in money supply are brought about according to the need of the situation. Central bank contracts money supply to control inflationary situations and expands it to revive the economy from recession. This is termed as monetary management of the central bank.

In India, the RBI has complete control over the supply of money and credit. It has exclusive power to issue currency notes. RBI's monetary management is done by the use of quantitative and selective credit control measures. Before implementing the credit control measures, the RBI measures the extent of money and credit available in the economy by measuring M_1 and M_3.

The RBI announces its money and credit policy twice a year in April and October. It also brings out a mid-term review of the policy.

Check your progress 8

1. Which comes under monetary policy of RBI?

   a. supply of money

   b. issuing of credit

   c. issuing currency notes

   d. all of above

2.10 Objectives of RBIs Monetary Policy

RBFs monetary policy affects the cost and availability of credit in the economy. Therefore, the policy measures have wide ranging impact on the performance of the economy. The central bank can control price level, promote growth, influence employment generation with the help of its monetary policy. In other words, monetary policy can be used to meet several economic and social objectives.

In India, the main objective of RBFs monetary policy is 'growth with stability'. This refers to the use of credit control measures in such a manner that the inflation rate-is kept in check and at the same time ensuring that sufficient credit is available to promote economic growth. Besides, the RBIs also use its power to ensure that credit flows to the priority sector. Mobilization of savings takes place. Employment is generated through deployment of credit and stability of the external value of the rupee is maintained.

The following are the objectives of RBI's monetary management:

a. **Growth with Stability**: In India, the rate of growth of money supply has always been higher than the rate of growth of real income. This has resulted in inflation. Therefore one of the primary objectives of RBI's monetary policy has been control of inflation through contraction of credit. However, credit contraction has had an adverse effect on economic growth due to high cost and poor availability of credit. Therefore, RBI has now adopted the policy of 'growth with stability' or 'controlled expansion' of credit. This implies that the monetary policy will be such that sufficient credit is available for the growing needs of different sectors of the economy and at

the same time inflation will be controlled within a certain limit. This is a difficult objective to follow as the two objectives of price stability and growth, conflict with each other.

b. **Priority Sector Lending**: This has been one of the developmental objectives of RBI's monetary policy since nationalization of commercial banks in 1969. The priority sector includes agriculture, export and the small scale sector and the weaker section of the population. Through selective measure of credit control, the RBI directs commercial banks to divert adequate funds to these sectors at concessional rates of interest.

c. **Promotion of Equity**: One of the primary objectives of social banking is reduction of inequality of income and wealth. The RBI supports social banking objectives of commercial banks through selective credit control measures and provision of microfinance. Through these measures RBI helps to achieve better income distribution.

d. **Employment Generation**: The RBI's selective credit control measures indirect) help in employment generation. By allocating cheap credit to agriculture and small scale industries the RBI seeks to generate employment as these are the most labour intensive sectors. Provision of micro loans promotes self-employment.

e. **External Stability**: Earlier, the RBI directly controlled the foreign exchange market. The external value of the rupee used to be determined by the RBI. This situation has now changed and RBI now has only indirect control over external stability. Through its selective credit control measures, the RBI directs credit to the export sector. By maintaining price stability within the economy, RBI further helps the export sector. In this way, the RBI indirectly influences external stability.

f. **Encouraging Savings and Investments**: The RBI influences the cost of credit, that is, the interest rate. Attractive interest rates offered by banks encourage people to save. A high saving rate in turn promotes investment. Sector specific investment is encouraged by the RBI through its scheme of differential interest rates.

g. **Regulation of Non-Banking Financial Institutions (NBFIs)**: NBFIs, like the UTI, IDBI, IFCI, play an important role in the deployment of credit and mobilization of savings. The RBI has no direct control over the functioning and policies of such institutions. However, RBI's monetary policy influences

the general interest trends in the entire economy and also indirectly affects the policies and functions of NBFIs.

h. Price stability, growth, equity and social justice and regulating financial institutions are important objectives of the RBI's monetary policy. Some of the objectives conflict with each other making RBI's monetary management difficult. All the objectives need to be evaluated on a continuous basis.

Check your progress 9

1. What are the duties of central bank by considering the monetary policy?

   a. control of price level

   b. promotion of growth

   c. employment generation

   d. all of above

2.11 Instruments of RBIs Monetary Management

Instruments of credit control are of two types:

(a) General or quantitative methods:

- Bank Rate
- Reserve Requirements and
- Open Market Operations.

(b) Selective or qualitative methods:

- Margin Requirements
- Discriminatory Rates of Interest
- Credit Rationing
- Ceiling on Credit
- Direct Action

The RBI Act, 1934 gives RBI the power to use almost all the traditional instruments of credit control, while the Banking Regulation Act, 1949 provides additional powers to use some other direct methods of credit control.

I. General of Quantitative Methods

These methods are used by the RBI to control the total quantity of credit in the economy.

1. Bank Rate:

Bank rate is also referred to as the discount rate. It is the rate at which the central bank is expected to rediscount eligible papers, like approved securities, first class bills of exchange and commercial papers, held by commercial banks. Commercial banks rediscount these papers whenever they are short of funds and need to borrow from the central bank. In other words, bank rate is the rate at which the central bank lends money to the commercial banks.

Bank rate influences the cost of credit. When the bank rate is changed, it changes the cost of commercial banks' borrowings from the central bank. This in turn brings about changes in the Prime Lending Rates (PLR) of banks. PLR is the rate at which commercial banks lend money to businesses and individuals. Changes in PLR affect the short-term demand for funds in the money market and through it long term demand for funds in the capital market. It is very clear that bank rate can have wide ranging effects on business activities. Changes in bank rate are brought about by the RBI to control inflation air! Recession. Bank rate is raised during inflation and lowered during recession. Bank rate will be effective only if commercial banks approach the RBI for funds.

The bank rate has been changed several times by the RRI. It was 10 per cent in J9SOs and was raised to 12 per cent in J£91. It was

Weaknesses of the system, high bank rate could not help to successful control money supply and inflation. Because of this, along with b; rate policy the RBI used the administrative interest rate system control inflation. Under this system, RBI directly controlled lending rates of banks rather than changing the bank rate. This system existed] from 1975-76 to 1994-95. Since 1994, the administrative interest rate system was deregulated in respect of loans above Rs.2 lakhs. The PLR of banks are no longer regulated by the RBI but are determined by commercial banks on the basis of market forces. The RBI has made it compulsory for banks to announce their benchmark PLR.

In 1997, the bank rate was once again activated and made a signalling and reference rate. Since 1997, the bank rate has been continuously reduced. It was 9 per cent in April 1998, 6.5 percent in October2001. Currently it is 6 per cent.

The bank rate as a credit control policy instrument is losing its importance in recent years. It was last changed in 2003. It has been delinked from the refinance rate and is only used for RBI's ways and means assistance to Central and state governments. At present, the repo and the reverse repo rates are becoming important-in determining trends in interest rate structure. Repo or Sale and Repurchase Agreement, is the sale of securities with an agreement to repurchase the same on a future date at a specified price. Thus funds are made, available for a short term. Reverse repo refers to repos deals viewed' from the perspective of the supplier of funds. When RBI pumps in short term liquidity with the system it charges banks the repo rate. Reverse repo rate is the rate at which banks park their short terra excess funds with the RBI. In March 2007, the repo rate was raised from 7.5 per cent to 7.75 per cent, making bank credit costlier. The objective is to fight inflation.

2. **Reserve Requirements**:

Every commercial bank needs to maintain certain proportion of its assets in the form of reserves. Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are the two reserves requirements imposed by the RBI. When the RBI changes reserve: requirements, it influences that capacity of banks to lend and create: credit. During inflation, reserve requirements are raised and during recession they are lowered.

(a) **Cash Reserve Ratio:** CRR is the most powerful tool available to any central bank to influence and control money supply. Under section 42 (1) of RBI act, 1934, every scheduled commercial bank was required to maintain with the RBI every fortnight a minimum average daily cash reserve equivalent to 3% of its Net Demand and Time Liabilities (NDTL) outstanding as on the Friday of the previous week. The RBI is empowered to vary the CRR between 3% and 15%. RBI uses the CRR either to drain out excess liquidity or to release funds needed for the economy from time to time. This technique of credit control was frequently used to control inflation in the 1970s and 1980s. In 1973, CRR was 7 per cent. It was raised to 10 per cent in 1987 and further hiked to 15 per cent in the 1990s.

After the implementation of the Narasimha Committee recommendations, the CRR has been progressively lowered. It was 14 per cent in 1994, H per cent in 2000 and 5 per cent in 2004-05, In March 2007, the RBI announced that CRR will be hiked in two phases

in April 2007, to bring it to 6.5 per cent. This was done to fight rising inflationary trends in the rapidly growing economy.

(b) **Statutory Liquidity Ratio**: Under section 24 (b) of the Banking Regulation Act, 1949, in addition t6 CRR, every bank is required to maintain, at the close of business every day, a minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities. The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR). SLR was introduced in India in 1962. The RBI has the power to fix SLR in the range of 25 per cent and 40 per cent. The SLR was as high as 38.5 per cent between 1990 and 1992. One of the reasons why SLR was maintained at a high level was to make bank funds available to the government at low rate of interest. Under SLR requirements, commercial banks have to maintain a part of their assets in government securities which do not fetch high income to banks. In this way the government made it compulsory for banks to lend their money to finance government's fiscal deficit at a cheap rate. This was considered to be a wasteful use of bank funds and it affected the profitability of banks. The Narasimham Committee strongly advised against high SLR, As a result SLR was progressively lowered and it is now 25 per cent.

3. **Open Market Operations**:

Under open market operations, sale and purchase of government securities take place between the RBI on one hand and the commercial banks and public on the other. The participation in purchase and sale operation is open to all. When the government needs to borrow money from the public, it sells securities (gilt-edged securities). All unsold government securities are purchased and held by the RBI. These securities are used by the RBI in its OMO. Sale of government securities by RBI reduces the deposit resources of the commercial banks. Since payments for the securities are made by cheques, the banking system loses resources. This reduces resources available with hanks for lending. Credit creation capacity of banks is lowered. This policy is followed to control inflation. During recession, RBI purchases securities, the deposit resources of the banks increase and they can lend more.

In India, the OMO as an instrument of credit control was introduced when it was realized that bank rate was not very effective. The RBI has the power to conduct OMO in government securities, treasury bills and other approved

securities. Since government securities are mostly held by banks and institutional investors, the OMO is confined to them. OMO in India has been mainly used to help government to borrow to meet its fiscal deficit. In the past few years, the RBI, apart from outright purchase and sale of securities, has also been involved in 'switch operations'. This refers to purchase of one loan against sale of another. These operations are aimed at preventing unrestricted increase in liquidity.

II. Selective or Qualitative Methods

In India, there are several social objectives the government has to meet. The financial system is used as an instrument to meet these objectives. As part of planned development process, bank funds are diverted to the priority sector at concessional rates to benefit the weaker section. The RBI has the power to direct banks to meet their social obligations through selective methods of credit control. These methods affect particular section of the economy as they influence distribution and direction of credit. They are more effective and important than the quantitative methods in a developing economy.

The following are some of the selective methods followed by the RBI:

1. **Margin Requirements**: A loan is sanctioned against a collateral Security. Margin is that proportion of the value of the security against which loan is not given. Higher the margin, lesser will be the loan sanctioned. In India, bank loans are often used for speculative and unproductive purposes. To prevent this, the RBI has relied on the method of minimum margin requirements. Margin requirements on essential agricultural commodities are often as high as 75 per cent.

2. **Discriminatory Rates of Interest**: Under this method, different rates of interests are charged for different use of credit. RBI has relied on this method to direct resources to priority sector, export promotion and prevent speculative use of bank finance. This method has been used as along with margin requirement in top essential agricultural commodities.

3. **Ceiling on Credit:** Under this scheme, the RBI imposed limit on the amount of credit to different sectors. Credit Authorisation Scheme introduced in 1965 by the RBI regulated not only the amount of credit but also terms on which credit was given to different large borrowers. This scheme has now been withdrawn as a part of financial sector reforms.

4. **Direct Action**: RBI may use strict disciplinary actions against banks that fail to follow its directives. These may be in the form of cancellation of

licenses, refusal of rediscounting facility, imposition of penalty. These methods are very harsh and are therefore rarely carried out by the RBI

Moral Suasion

This is a most actively used technique of monetary control by the RBI since nationalization of banks. Through periodic letters and discussions, RBI addresses the banks about trends in the economy in general and in money, credit and finance in particular. RBI brings out the measures which should be taken by banks from time to time in the light of changing economic trends. Through moral suasion banks are also asked to meet their social obligations. Moral suasion helps RBI to exercise control over commercial bank's lending activities.

Selective measures of credit control are no doubt important in a developing economy like India, as the economy is developing rapidly and progress is taking place in the financial markets, these methods are being slowly phased out. The quantitative methods are becoming more and more significant.

Check your progress 10

1. What are the selective methods used in credit control of instruments?

a. Bank Rate

b. Credit Rationing

c. Reserve Requirements

d. Open Market Operations

2.12 Recent Changes in RBI's Monetary Management

RBI's monetary management has undergone some major changes since 1991 I keeping with the overall reform measures undertaken in the economy. Before 1991, the RBI's monetary policy was closely linked with financing of fiscal deficit. Now the focus is on promoting economic growth and maintaining price stability.

1. **Delinking monetary policy form budget deficit**: In 1994, an agreement has been reached by the Central Government and the RBI to phase out the use of ad hoc treasury bills. This means that RBI will no longer monetize budget deficit. This is a major shift from earlier time, when the government used SLR and OMO to meet its deficit.

2. **Reduction in reserve requirements**: CRR and SLR have been progressively lowered during the post reform period. As a result, more bank funds have been released for lending purpose. This promoted growth of the economy and improved profitability of banks.

3. **Deregulation of administered interest rate system**: PLR of banks used to be determined by the RBI earlier. Since 1990s this system has been changed and PLR of banks are no longer regulated by the RBI but are determined by commercial banks. The RBI has made it compulsory for banks to announce their benchmark PLR.

4. **Provision of micro finance**: The RBI has introduced the scheme of j micro finance to the rural poor by linking the banking system with Self Help Groups and NGOs.

5. **Signalling rate**: Bank rate is now used a signalling and reference rate with effect from 1997. This means that the bank rate will now provide a direction to general level of interest rates. It has become more important after deregulation of administered interest rate system.

6. **Greater market, orientation**: By delinking monetary policy from budget deficit, the RBI has sought to make it more sensitive to the needs of the market. This has also been achieved by giving greater autonomy to the banks.

7. **Selective measures of credit control**: With greater market orientation of monetary policy and rapid progress taking place in the financial markets, these methods are being slowly phased out. The quantitative methods are becoming more and more significant.

8. **External sector**: The monetary policy is now more geared to the process of globalisation. It has become sensitive to changes in the rest of the world as India in increasingly attracting large amount of foreign capital. The export sector is also being supported through various schemes.

Check your progress 11

1. Which term is used in Deregulation of administered interest rate system?

a. PLR c. OMO

b. CRR d. SLR

2.13 Evaluation of RBIs Monetary Policy

The RBI's monetary policy has been successful in terms of distribution of bank funds among different sections of society, but it has failed in achieving the objective of 'controlled expansion'.

1. **Existence of unorganised money market**: Despite all that has been achieved by the banking sector through branch expansion, a large unorganised sector continues to exist especially in rural areas. RBI's monetary policy does not affect the functioning of this sector. It is comprised of indigenous bankers, money lender agents etc. who continue to provide credit to a large number of people at high rate of interest.

2. **Strong link with fiscal policy**: In the past, RBI has not had the freedom to implement monetary policy in according to the need of the situation. . Most of the time the quantitative methods of credit control was used to finance budget deficit of the Central and the state governments. This made the policy instruments by and large ineffective. This link between monetary and fiscal policy is now much weaker.

3. **Limited coverage**: RBI's monetary policy has rather limited coverage. It affects only the commercial banks. The unorganised sector and the non-banking financial intermediaries are not controlled by it. Since banking habits of people are still poor this puts a limit to the RBI’s "monetary policy.

4. **Unable to control inflation**: Till 1990s, the RBI's monetary policy was closely linked with financing government's fiscal deficit. India experience inflation in the 1960s, 1970s and 1980s due to rapid growth in money supply due to deficit financing. Besides, there were shortages in the availability of goods. TO control inflation, RBI raised bank rate, CRR and SLR to very high levels. This proved to be ineffective as money supply continued to rise due to deficit financing and shortages continued to-exist due to excessive government control. The dear money policy followed by RBI restricted growth of the industrial sector. Thus the objective of 'controlled expansion' could not be achieved. Only after 1990s this situation has changed and today CRR, SI.R and hank rates are lower and inflation too is under control.

5. **Black money**: Due to high taxation, India has experienced high incidence of tax evasion and generation of black money. The black economy gives rise to inflation and speculative activities. It cannot be controlled by RBI's monetary policy.

6. **Preference for cash transactions**: A large part of the country is still non-monetized and most transactions are preferred to be done in cash 1 rather than through the banking system. Such cash transactions do not come under the purview of the RBI's monetary policy. However, with rapid growth of the economy, preference for cash transactions is also reducing.

7. **Ineffectiveness of Bank Rate**: Bank rate as a measure of credit control has lost its significance. Changes in bank rate have not helped to control inflation in the past. High bank rate in the past resulted in high interest rate and adverse affected growth.

The Reserve Bank of India occupies a unique and distinctive place in the Indian economy. The Bank has successfully performed its developmental functions and its role as the banker to the government. However, its role as controller of credit and regulator of the financial institutions need improvement.

Check your progress 12

1. In which era, India has not experienced inflation?

a. 1960s c. 1990s

b. 1970s d. 1980s

2.14 Let Us Sum Up

In this unit we have learnt that a capital market is a type of market which carries both debt and equity, where business enterprises and government raises long-term funds. In this market, money is provided for periods longer than a year. This market has various financial instruments such as equity, shares, debentures, etc. It is seen that the new instruments in this market are being introduced such as debentures which are bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

Now the structure of capital market is like any market having demand funds and supply funds. In India, capital market carries government securities, industrial securities, development financial institutions and financial intermediaries. It is seen that the market capitalisation is capital of a market which has particular stock in total among outstanding shares of company which is product of share price of

stock. The stock market capitalisation is summation of market capitalisation of individual stocks which are listed on the exchange.

In India, the Reserve Bank of India was established as a private sector bank on April 1, 1935. It became nationalized in 1949 under central bank of country in Reserve Bank of India Act, 1948. We see that RBI performs central banking functions and has powers to supervise and control commercial and co-operative banks with view of developing sound and efficient banking system in the country. Generally, central banking functions of RBI involve developmental or promotional activities.

2.15 Answers for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-d)

Check your progress 10

Answers: (1-b)

Check your progress 11

Answers: (1-a)

Check your progress 12

Answers: (1-c)

2.16 Glossary

1. **Capital Market -** It is a market which carries both debt and equity for long-term funds.

2.17 Assignment

What is a capital market? Discuss the structure of capital market in India.

2.18 Activities

Explain the role /significance of capital market in the economic development.

2.19 Case Study

Outline the important reforms that have taken place in the Indian capital market.

2.20 Further Readings

1. A Treatise on Money, Keynes, J. M.

Block Summary

In this block, you will get detailed information about functioning of financial system along with certain unique characteristics which concerns with money market. You will be detailed with concept of Indian Money Market System along with its features that will help user or student to understand about organised and unorganised Indian Money Market structure. The block fully explains about significance and role of Indian Capital Market and shows how Economic Development will get affect with market capitalisation.

After studying this block, you will fully understand about RBI and its reforms. The functions, factors and reforms framed by Reserve Bank of India are detailed which can help the user to understanding banking system. The concepts of certain monetary policies of RBI with working strategies are explained which will help you to get information about banking policies and reforms as laid by RBI.

Block Assignment

Short Answer Questions

1. What are Financial Markets?
2. What is a Capital Market?
3. What do you mean by Market Capitalization?
4. When was RBI established?
5. What is the role of reviewing committee of Indian Money Market?

Long Answer Questions

1. Explain the features of Indian Money Market?
2. What are the various functions of RBI?
3. Write and explain the structure of Indian money market?

Enrolment No. ☐

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
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BANKING MANAGEMENT

PGDF-201

BLOCK 4:
SOURCES AND USES OF FUNDS

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BANKING MANAGEMENT

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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included may tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

BANKING MANAGEMENT

Contents

Manner of Arising Deposit, Multiple Expansion of Credit, Technique of Credit Creation, Credit Contraction, Criticism of the Theory of Credit Creation.

BLOCK 3: STRUCTURE AND CHARACTERISTICS OF FINANCIAL SYSTEM

UNIT 1 MONEY MARKET

Introduction, Meaning and Function of financial system, Functions of Money Market, Components or Structured of Indian Money Market: Organized Sector of Indian Money Market, Unorganized Sector of Indian Money Market, Features (or Defects) of-Indian Money Market, Reforms in Indian Money Market

UNIT 2 CAPITAL MARKET AND RBI

Capital market, Significance (or Role) of Capital Market in Economic Development, Structure of Capital Market in India, Market Capitalisation, Introduction to RBI, Traditional or General Functions of the RBI, Development Function of RBI, RBI'S Monetary Policy, Objectives of RBIs Monetary Policy, Instruments of RBls Monetary Management, Recent Changes in RBI's Monetary Management, Evaluation of RBIs Monetary Policy

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BLOCK 4: SOURCES AND USES OF FUNDS

UNIT 1 SOURCE AND USES OF FUNDS IN BANKS

Introduction, Type of Financing, Repayment Method, Venture Capital, Factoring Services, Banknet, Automated Teller Machine (ATM), Phone Banking, Net Banking or Internet Banking, Gold Deposit Scheme

UNIT 2 MERCHANT AND RETAIL BANKING

Assistance provided by Merchant bankers, Guidelines on Merchant Banking, Meaning and Definition of Credit Card, Other Types of Cards, Operation of the Credit Card, Advantages of Credit Card, Disadvantages of Credit Card, New Scheme of Farmers Credit Card, Debit Cards,

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BANKING MANAGEMENT

BLOCK 4: SOURCES AND USES OF FUNDS

BLOCK 4: SOURCES AND USES OF FUNDS

Block Introduction

Commercial Banks gives financial assistance or credit facilities depending upon period of finance, purpose of finance, quantum of balance, etc. There are various forms of financing such as Loan, Syndicated Loan, Bridge Loan, Consortium Finance, Preferred Financing and Non-Fund Based Business. Repayment can be Bullet Payment System and Balloon Payment System. Venture capital is an investment in the form of equity, quasi-equity and sometimes debt straight or conditional, made in new or untried concepts, promoted by a technically or professionally qualified entrepreneur.

In this block, you will get knowledge about financing and its related repayment methods with idea about Venture Capital. The concept of Bank net and ATM machines are well explained with their working features and characteristics.

The block will detail about features and characteristics about Net banking and Internet banking where knowledge on related services. The knowledge about working and use of Debit and Credit Cards are detailed.

After studying this block, you will be able to understand correctly about how an ATM machine will work and what sort of cards are used in this. The concept about farmer credit cards along with its usage will give more knowledge to you.

Block Objective

After learning this block, you will be able understand:

- The features about Financing
- Idea about different types of Repayment Method
- Knowledge about Venture Capital and Bank net
- Studying the working of Automated Teller Machine (ATM)
- Characteristics about Phone and Net Banking
- Detailed about Gold Deposit Scheme
- The Guidelines about Merchant Banking

- Features of Credit Card
- Detailed about Credit Card scheme for Farmers
- Functions of Debit Cards

Block Structure

Unit 1: Source And Uses Of Funds In Banks

Unit 2: Merchant And Retail Banking

UNIT 1: SOURCE AND USES OF FUNDS IN BANKS

Unit Structure

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- The Type of Financing
- Venture Capital
- Automated Teller Machine (ATM)
- Net Banking or Internet Banking

1.1 Introduction

Commercial Banks extend financial assistance or the credit facilities in many ways " Although all Credit facilities are basically a loan, different methods of financing are adopted' depending upon the period of finance, purpose of finance, quantum of balance, etc. Some of these methods of financing introduced in the Indian banking in the recent period have been explained below. Similarly, the repayment of loan is also arranged in specific ways to suit customers/ borrowers requirements. Few such methods of repayment have also been' explained in this chapter.

Indian Banking System developed enormously after independence. Particularly after" nationalisation of banks there has been a multi-dimensional development. Nationalisation of banks provided an impetus to the banking development and the banks started functioning with social responsibility The growth in various banking areas has been discussed in I the latter part of this chapter.

First let us see the types of financing

1. Take out Financing
2. Revolving Credit Facilities
3. Ever greening of Loan
4. Syndicated Loan
5. Bridge Loan
6. Consortium Finance
7. Preferred Financing
8. Non-Fund Based Business.

Types of Repayment System

1. Bullet Payment System
2. Balloon Payment System

Let us discuss these items one by one in depth.

1.2 Type of Financing

1. Take-Out Financing

Take-out financing is a method of providing finance for longer duration projects (say of 15 years) by banks by sanctioning medium term loans (say 5-7 years). It understands that the loan will be taken out of books of the financing bank within pre-fixed period, by another institution thus preventing any possible asset-liability mismatch. After taking out the loans from the banks, the institution could off-load them to another bank or keep it. Under this process, the institutions engaged in long term financing such as IDFC, agree to take out the loan from books of the banks financing such projects after the fixed time period, say of 5 years, when the project reaches certain previously defined milestones. On the basis of such understanding, the bank concerned agrees to provide a medium term loan with phased redemption beginning after, say 5 years. At the end of five years, the bank could sell the loans to the institution and get it off its books.

This ensures that the project gets long-term funding through various participants. The original lender participates in a long term project (say 15-20 years) by granting a medium term loan (of say 5-7). On completion of the pre-decided period, this loan is taken over by another institution subject to fulfilment of the conditions stipulated in the original arrangement Original lender receives the payment from the 2nd lender who has taken over the loan.

2. Revolving Credit Facility:

Under a Revolving Credit Facility a bank fixes up a credit limit to a borrower for certain period, say Rs.100 million for 3 years period. The borrower will get a maximum credit facility of Rs.100 million at any point of time once the loan is repaid. The borrower's facility automatically gets renewed up to Rs.100 million during the 3 year period any number of times. In other words, the credit facility revolves around with a maximum of Rs.100 million outstanding at any point of time over a 3 year period. In principle, under a Revolving Facility there is no formal repayment period. The borrower is allowed to draw, repay and again draw throughout the loan period.

3. Ever greening of Loan:

Sometimes a bank provides a second finance facility to a borrower to help him to pay back the original loan. Why should a bank do it when the bank's exposure to the customer remains same? It is because when a borrower defaults on payment of interest/principal to the bank as per prudential norms, the loan account will become an NPA and the bank has to make provisions. To avoid such an

unpleasant situation and to show a rosy picture of bank's loan portfolio, sometimes banks do resort to ever greening. RBI does not permit this type of replacement credit.

4. Syndicated Loan:

It is a loan facility provided to a single borrower by a group of banks. As the loan is extended by a group of lenders, the size of syndicated loan is normally large and a single lender/ banker may not have been in a position to extend such a facility. It could also be that a single lender may not like to have such a large exposure (credit risk) to a single borrower. Syndicated loans are arranged to finance projects needing large sums of money where the credit risk is also high. These loans are for financing medium to long-term requirements. Since, the bankers involved in providing such loan facility are many; usually co-ordination work is done by a 'lead manager' who acts as an intermediary between the lenders and the borrower. One interesting point in syndicated loan arrangement is that the borrower indicates his requirement of loan sum and the prospective lenders have to offer as to what extent they are prepared to extend the facility.

Also under this arrangement one bank in the syndicate acts as an agent for collecting interest and other payments from borrower and distributes to other banks.

5. Bridge Loan:

Bridge loan is a short-term temporary loan extended by financial institutions to help the borrower to meet the immediate expenditure, pending disposal of requests for long-term funds or regular loans. For example, when a borrower's application for project finance is pending for final sanction, the bank may extend a bridge loan to the borrower to meet urgent expenses. Usually, bridge loans get repaid out of the main loan when sanctioned. During 1980's corporates used to avail of bridge loans from banks against the expected subscription on public issue of debentures, equity, etc. Here, the bridge loan is not against any main loan arrangement but against anticipated cash flow. Again, if an individual is negotiating the sale of his asset, say a house, a bridge loan may be extended by bank to meet the seller's immediate cash requirements. The loan will be paid off when the m borrower realises his sale proceeds.

Bridge loan is relatively risky for the bankers when repayment depends upon an external factor not under the control of lenders.

6. Consortium Finance:

Under consortium finance, a large credit facility may be jointly arranged by a combination of several banks. Usually, one of the banks in the group will act as the leader for the credit. The consortium leader will extend a larger share of the credit as compared to other banks in the consortium. The word consortium here refers to 'a combination of many banks who have agreed to extend the credit facility'. The share of credit agreed to be extended will be decided by the banks in the beginning. The borrower need not deal separately with all the banks in the group. Usually, he deals with the consortium leader who takes care of other banks' credit. In India till two years back, as per RBI guidelines, large credit facility, say Rs.100 million and above, should be granted only under consortium arrangement. The reason for such a condition is that a single bank should not have large credit exposure to a 5 single borrower. RBI has recently liberalised the norms and banks are permitted to fix their own norms for lending. A bank is however not permitted to extend credit beyond 25 per cent of its net owned funds or 25 per cent of borrower's net owned funds (whichever is lower) to a single borrower. This norm is known as single exposure limit. This limit is intended to be lowered to 15 per cent gradually to conform to international standard. As first step, this limit is being reduced to 20 per cent from April 2000.

7. Preferred Financing:

In the highly competitive world of banking today, banks are reaching out to customers, particularly high net worth or wealthy customers. One area of lucrative finance for bankers is consumer finance, more particularly car finance. A preferred financier is a lender or a bank, which provides large consumer loans like car loan under an arrangement with the car manufacturer. Because of the tie-up, the manufacturer agrees to provide some concession in the car price and some additional facilities in the car. Thus, the manufacturer makes this facility available for two reasons. One/purchase price is assured and second it gives some push for the demand of that car.

8. Guarantee Services/Non-fund Based Business:

Non-fund based business is not a credit facility or a financial assistance. However, the banks make sizeable income out of non-fund based business, mainly from guarantee services. This has explained below.

Banks offer 'Guarantee Services' to valued customers. Guarantee service refers to a legal undertaking by the bank to pay a certain sum of money to a third-party or a creditor in the event of the bank's client/customer fails to fulfil his part

of obligation. The obligation may be to pay some money or to perform certain duties like a contract job. The guarantee from bank enhances the certainty of performance or payment. Usually, banks issue guarantees on behalf of their customers in favour of Government Departments like Customs authority saying if the customer does not perform under a contract or does not pay the required sum, the bank will pay the money or damages. This function of issuing a guarantee is done for certain amount of fees. Hence, it is called fee-based services of banks. You will understand, under a guarantee a bank does not provide any credit facility to the customer. Hence, this type of services by banks is called non-fund based business. Other examples are issue of Travellers' Cheques, Demand Drafts, remittance facilities, arrangement of foreign currency loans, etc.

Check your progress 1

1. What is Syndicated Loan?

   a. It is a loan facility provided to a company by group of banks

   b. It is a loan facility provided to a single individual by group of banks

   c. It is a loan facility provided to company by single bank

   d. It is a loan facility provided to single by single bank

1.3 Repayment Method

Following are the repayment methods-

1. **Bullet Payment System:** Under this method of borrowing and lending, the borrower will not be required to pay back the loan and interest payments periodically like every 6 months or so. The full loan amount together with interest payments will be made at a single time on maturity of loan. This system of lending is rare in India as there are no regular cash flows for the bank. This method of payment is adopted in term loans.

2. **Balloon Payment System:** Under this system, the repayment of a term-loan facility will be so arranged that the instalment value will be smaller in the beginning and as the repayment progresses towards maturity value of instalments will be larger and larger. In other words, under Balloon Payment System, the borrower's repayments are higher at end and smaller in the beginning. This type of arrangement will be helpful to borrower who

expects smaller returns in the beginning and higher returns later out of his investments. You will notice that bullet and Balloon payments systems refer to repayment of term loans. These methods are not common in Indian Banking.

Check your progress 2

1. Which is not a part of Balloon Payment System?

a. In this, the instalment value is lower at starting

b. In this the instalment value increases towards maturity

c. In this, the load and interest are paid at end of period

d. It is helpful to borrower

1.4 Venture Capital

A 'venture' is a new risky business. 'Venture Capital' therefore, refers to providing start-up capital to a new and risky business operation.

The venture capital investment helps for the growth of innovative entrepreneurships in India. Venture capital has developed as a result of the need to provide non-conventional, risky finance to new ventures based on innovative entrepreneurship. Venture capital is an investment in the form of equity, quasi-equity and sometimes debt - straight or conditional, made in new or untried concepts, promoted by a technically or professionally qualified entrepreneur. Venture capital means risk capital. It refers to capital investment, both equity and debt, which carries substantial risk and uncertainties. The risk envisaged may be very high may be so high as to result in total loss or very less so as to result in high gains

Definition of Venture Capital:

Venture capital means many things to many people. It is in fact nearly impossible to come across one single definition of the concept.

Jane Koloski Morris, editor of the well-known industry publication, Venture Economics, defines venture capital as 'providing seed, start-up and first stage financing' and also 'funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources.

The European Venture Capital Association describes it as risk finance for entrepreneurial growth oriented companies. It is investment for the medium or long term return seeking to maximize medium or long term for both parties. It is a partnership with the entrepreneur in which the investor can add value to the company because of his knowledge, experience and contact base.

In India, the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. The venture capital funds in India are listed in Annexure I.

Methods of Venture Financing

Venture capital is typically available in three forms in India, they are:

1. **Equity:** All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.
2. **Conditional Loan:** It is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 to 15 percent; actual rate depends on other

factors of the venture such as gestation period, cost-flow patterns, riskiness and other factors of the enterprise.

3. **Income Note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

Other Financing Methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures, introduced by TCFC is an example.

Check your progress 3

1. The forms of Venture capital investment can be:

a. equity
c. debt
b. quasi-equity
d. all of above

1.5 Factoring Services

Factoring services originated from the recommendations of Kalyanasundaram Committee. SBI was the first to start factoring services and Canara Bank has floated Can bank Factors Ltd, which was incorporated on 10th May 1991. Factoring is a portfolio of complementary financial services relating to receivables of a company. The basic components off factoring services are finance up to 80% of the invoice value, sales ledger administration, debt collection services and credit insurance. Current Guidelines on Factoring say that Banks can form subsidiaries for Factoring Services subject to the following guidelines

a. Banks can conduct its business by setting up subsidiaries and invest in factoring companies jointly with other banks.

b. Such concerns should not engage themselves in financing of other companies and; concerns engaged in factoring.

c. Investment of a bank in the business should not exceed 10% of the paid up capital and reserves of the bank.

d. Setting up such ventures requires prior clearance from RBI.

e. (e)The bank should furnish information as required by RBI from time to time.

Check your progress 4

1. Which among the following banks first started the factoring services in India?

   a. Canara Bank

   b. State Bank of India

   c. Allahabad Bank

   d. Punjab and Sind Bank

1.6 Banknet

The collecting, processing and distribution of information is vital to business growth of banks.

Computerisation takes care of only the processing. The gathering and distribution on use of telephone, mail, telegraph and telex which leads to delay and high cost due to handling at several stages. Hence a common communications network called 'Banknet' operated by banks and financial institutions on a co-operative basis within the country is being set up. The Banknet can be put to several uses. Some of the illustrative areas are given here-under:

1. Transfer of funds from one place to another distant place or bank.
2. Exchange of statistical information among banks.
3. Foreign exchange business operations.
4. Inter-Bank applications, like settlement of funds between banks.
5. Others.

The transfer of funds includes that customer can draw cash against their deposit at any branch of the bank as envisaged under 'on-line banking' and can also deposit cash at any branch for credit to an account at some other branch. Advance can be allowed at one branch against deposit at some other branch. This concept is known as 'Banking Anywhere'.

Check your progress 5

1. Banknet is:

a. telephonic system

b. telegraphic system

c. communication network

d. telex system

1.7 Automated Teller Machine (ATM)

An automated teller machine (ATM), also known as automated banking machine (ABM) or Cash Machine and by several other names, is a computerized telecommunications device that provides the clients of a financial institution with access to financial transactions in a public space without the need for a cashier, human clerk or bank teller.

On most modern ATMs, the customer is identified by inserting a plastic ATM card with a magnetic stripe or a plastic smart card with a chip, that contains a unique card number and some security information such as an expiration date or CVVC (CVV). Authentication is provided by the customer entering a personal identification number (PIN).

Using an ATM, customers can access their bank accounts in order to make cash withdrawals, credit card cash advances and check their account balances as well as purchase prepaid cellphone credit. ATMs are known by various other names including automatic banking machine (or automated banking machine particularly in the United States) (ABM), automated transaction machine, An automated teller machine (ATM), also known as automated banking machine (ABM) or Cash Machine and by several other names, is a computerized telecommunications device that provides the clients of a financial institution with access to financial transactions in a public space without the need for a cashier, human clerk or bank teller. On most modern ATMs, the customer is identified by inserting a plastic ATM card with a magnetic stripe or a plastic smart card with a chip that contains a unique card number and some security information such as an expiration date or CVVC (CVV). Authentication is provided by the customer entering a personal identification number (PIN).

Sources and Uses of Funds

Using an ATM, customers can access their bank accounts in order to make cash withdrawals, credit card cash advances and check their account balances as well as purchase prepaid cellphone credit.

ATMs are known by various other names including automatic banking machine (or automated banking machine particularly in the United States) (ABM), automated transaction machine, cashpoint (particularly in the United Kingdom, where it is a trademark of Lloyds TSB), money machine, bank machine, cash machine, hole-in-the-wall, auto teller (after the Bank of Scotland's usage), cash line machine (after the Royal Bank of Scotland's usage), MAC Machine (in the Pittsburgh and Philadelphia areas), Pass Machine in Ireland, Bunkmate (in various countries particularly in Europe and including Russia), Multibanco (after a registered trade mark, in Portugal), Minibank in Norway, Geld Automaat in Belgium and the Netherlands and All Time Money in India. (particularly in the United Kingdom, where it is a trademark of Lloyds TSB), money machine, bank machine, cash machine, hole-in-the-wall, autoteller (after the Bank of Scotland's usage), cashline machine (after the Royal Bank of Scotland's usage), MAC Machine (in the Pittsburgh and Philadelphia areas), Pass Machine in Ireland, Bankomat (in various countries particularly in Europe and including Russia), Multibanco (after a registered trade mark, in Portugal), Minibank in Norway, Geld Automaat in Belgium and the Netherlands and All Time Money in India.

The evolutionary trend from cash economy to cheque economy and onwards to plastic card economy is witnessed in the introduction of ATMs. ATM or Automated Teller Machine outwardly appears like a human weighing machine kept in Railway Platforms. These days, ATMs are securely placed inside the walls of bank's premises. While a weighing machine measures the weight of a person in kilograms, the ATM measures the bank balance of a person in rupees. In the weighing machine you insert a coin and you get a card telling your weight and fortune. In ATM you insert a plastic card and you get brand new currency notes and your bank balance. Can we all get such currency notes from ATM? Is it a lottery? Let us see how ATM works.

The Current and Savings Bank Account holders of a bank having certain minimum balance (say Rs.10,000 in SB A/Cs or Rs.50,000 in Current A/Cs) are issued with an ATM card. It is a plastic card having magnetic strip with the Account number of the person. When the card is inserted in the ATM, the machine's sensing equipment identifies the account holder and asks for his identification code number. Every account holder is given a separate code number through computers and it is not known even to bank staff. This code number is

like the secret code number available in telephone connection for use of STD facility. When the number is asked by the ATM (it comes on the ATM screen), the cardholder identifies himself/herself by pressing relevant number buttons on the machine. The machine verifies the account number on the ATM card with secret code number stored in the ATM. When the numbers tally, the machine shows in the screen as to what he wants? This is done through a Menu Screen, like a Menu Card in hotels or restaurants. You can transact almost all types of bank transactions through ATM. In case, you (as ATM cardholder) want to withdraw cash, you press the number buttons for the amount you decide to withdraw. The machine immediately throws out fresh currency notes. The banks generally restrict the maximum amount one can withdraw. Also you may use the machine only once a day for withdrawals. The amount withdrawn is immediately debited to the concerned account through the entries generated by the machine. Similarly, money can be deposited through ATM for credit to your account. When the Menu screen appears on the ATM, you should indicate you want to deposit money the machine will flash out a cover you deposit the money (no coins) — cash, cheques, - etc., into the envelope close it and put it back into the Machine. The Machine prints the account number on the envelope and stores it. Like the postman collecting letters from Post Box, the bank staffs collects the cover, verify the cash and credit the account.

The ATM also tells you your bank balance, if you ask for it. The ATM facility is avail-1 able round the clock. The main protection in ATM card against wrong use is the secret code number. Like someone knowing your STD secret code can misuse your telephone, similarly someone knowing your ATM secret code can also misuse and draw money from your account.

HSBC bank the first bank in India to offer ATM facility in 1987. Presently, a number of Indian and Foreign Banks are offering ATM facility, but mostly in cities. There is ease and privacy of operation through self-service.

ATMs have many advantages, some of which are given below:

1. In ATM one can draw cash round the clock (for 24 hours a day) and no employee interface is required.
2. ATM provides customer not having credit card facilities an alternative for obtaining cash when required.
3. It eliminates the need for the customers to travel to the branch at which his accounts are maintained if the machines are conveniently located and networked.

4. Automatic and instantaneous accounting is possible.
5. When labour cost is high the technology provides a cost effective solution.
6. Customers can deposit cash/instruments and leave instructions for the requirements of statement of accounts, transfer, etc.
7. As transactions are handled through software, without cash or instruments, scope for fraud, robberies and misappropriation is reduced.

Fig 1.1 Automated Teller Machine

Check your progress 6

1. The maximum withdrawal amount that can be enchased from Saving Account from an ATM will be:

   a. Rs.5,00/-

   b. Rs.10,000/-

   c. Rs.15,000/-

   d. Rs.20,000/-

1.8 Phone Banking

Telephone banking is a service provided by a financial institution, which allows its customers to perform transactions over the telephone.

Fig 1.2 Phone Banking

Most telephone banking services use an automated phone answering system with phone keypad response or voice recognition capability. To guarantee security, the customer must first authenticate through a numeric or verbal password or through security questions asked by a live representative. With the obvious exception of cash withdrawals and deposits, it offers virtually all the features of an automated teller machine: account balance information and list of latest transactions, electronic bill payments, funds transfers between a customer's accounts, etc.

Usually, customers can also speak to a live representative located in a call centre or a branch, although this feature is not always guaranteed to be offered 24/7. In addition to the self-service transactions listed earlier, telephone banking representatives are usually trained to do what was traditionally available only at

the branch: loan applications, investment purchases and redemptions, cheque book orders, debit card replacements, change of address, etc.

Banks which operate mostly or exclusively by telephone are known as phone banks. They also help modernize the user by using special technology.

This makes it possible for a customer of the bank to know account related information over a telephone.

Tele Banker is a state-of-the-art interactive voice response system (IVRS) that facilitates 24-hours-a-day, 365-days-a-year banking from a plain Telephone instrument.

Unique Features of Tele Banking:

- Data input by voice/keypad
- Encryption of input/output data
- Data output by voice/fax/e-mail
- Customer authentication by password/PIN

Services available:

- Balance enquiry
- Issue cheque book/DD
- Enquiry on last few transactions
- Fund transfer
- Inward/outward cheque status
- Telephone/electricity/credit card bill payment

Check your progress 7

1. Which is not a service offered by Phone Banking?

   a. Balance enquiry

   b. Loan approval

   c. Issue of cheque book/DD

   d. Enquiry on last few transactions

1.9 Net Banking or Internet Banking

We are now aware of the nature of banking business. Banking is practically a service-oriented activity. One of the methods of providing service is through the medium of computer network. Net Internet Banking refers to extension of banking services through the network of computers. 'Internet' is a worldwide network of computers connected with telephone lines. Under the internet facility, millions of computers located at banks, offices, hospitals, educator institutions, commercial establishments at different countries are connected to one another.

If you have a Personal Computer (PC), telephone connection and an instrument called modem, with the internet facility, you can have access to various colleges and universities and offices and obtain important information, send and receive messages, etc. Similarly, banking messages can be exchanged between the bank and its customers through the net banking system. Hence in the internet banking a customer can ask for his / her bank balance, give other instructions pertaining to his account, call for his/her statement of account, transfer money from his/her account, pay college fees, call for cheque book and a number of similar functions through net banking without visiting the bank. This system of conducting banking business is known as net or internet banking. ICICI Bank is presently conducting net banking. Other banks are slowly introducing this system in their organisations.

Check your progress 8

1. Which is not a service offered by Tele Banking?

   a. Money Transfer

   b. Cheque Deposit

   c. Request for cheque book

   d. Credit card Payment

1.10 Gold Deposit Scheme

The gold deposit scheme announced by the Indian Finance Minister aims to draw out a part of country's vast gold holding in private hands and thus reducing India's dependence on importation of gold. With approval from the Indian Central Bank, India's largest commercial bank (“SBI”) plans to launch a gold deposit

scheme (GDS) on November 15, 1999, whereby they will issue interest bearing certificates against gold collected from households, temples and trusts.

This is a controversial development and merits an in-depth analysis. A lot can be said both in favour of this scheme and against it. The Indian Finance Minister, backed by the Central Bank, has, obviously, found value in this scheme.

The salient features of the SBI's gold deposit scheme are:

1. Interest bearing certificates will be issued against gold deposits. Interest rate is likely to be about 3.5 % per annum.
2. Certificates will be redeemable in gold or rupee equivalent on maturity, at the discretion of the depositor.
3. Minimum deposit 200 grams of gold.
4. Certificates will be transferable by endorsement and delivery.
5. No capital gains tax, wealth tax or income tax on the deposits.
6. Maturity 3 to 7 years
7. Premature redemption in gold will be permitted after the minimum lock-in of 1 year.
8. SBI will give rupee loans against the certificates.

The State Bank of India (SBI) will sell the gold collected under the scheme in the local market and thereby reduce India's dependence on imported gold. The Central Bank will provide a forward cover to SBI at a cost. This cost plus the interest on the certificate will more or less equal the SBI's rupee borrowing rate. In other words this is an attempt by the government to convert physical gold into paper gold backed by the Indian Central Bank.

Making or accepting a gold deposit is not as simple as it sounds. Nearly all the gold held by Indian households is in the form of jewellery. Jewellery deposited under the GDS would be melted down and refined to pure gold bars. Since jewellery is a value added product, its purchase price is 25% to 100% more than the value of gold content. Under the said scheme this value addition would be lost. At the time of accepting the deposit, the Bank will have to test the purity and issue the certificate based upon the exact gold content. Thereafter, the Bank will have to melt this jewellery and refine it to pure gold bars. In addition to losing the value addition, the depositor of jewellery will have to bear the cost of testing the purity and the cost of refining. This effectively means that only scrap jewellery would be available for deposit. This leads us to an important question, that is,

what is the availability of scrap jewellery? Poor people do not scrap jewellery as they can get it polished very economically. After polishing, the jewellery recovers its lost shine and is as good as new. Very rich people do exchange their old-fashioned jewellery with the latest designs. I am unsure whether they will be willing to exchange their old jewellery for paper. In any case not many households will have 200 grams of scrap jewellery.

Fig 1.3 Gold bars

Temples and religious trusts own a lot of gold in the form of jewellery. The majority Hindu population in India believes in idol worship. The jewellery owned by the temples and religious trusts have been gifted by the believers to decorate the idols of God. Government has a significant influence on the management of these temples and trusts. They may use this influence and persuade the management of these temples and trusts to deposit this gold with the Banks. At the same time there are many diehard believers who would lay down their lives if the "Ornaments meant for God" are deposited with the banks in exchange for paper. History is a witness that a lot of lives have been lost in India because somebody made the mistake of shifting an idol from one place to another. If some religious leader shouts that the necklace of "Lord Rama" has been deposited with SBI and they have melted it down, then the Government could fall in New Delhi. In India or, for that matter anywhere else in the world, one cannot play with the religious sentiments of the people. I believe that unless the deposits are made secretly, there is no chance of this gold finding its way to the Bank.

The government has announced that there will be no capital gains tax or income tax or wealth tax on these deposits. What they have not announced is whether the depositor will be asked to account for the gold. Most of the gold held privately in India is unaccounted. This means that it has been purchased with the money on which no income tax was paid. To make the scheme successful the government may amend the terms to "no questions asked". If that happens, a lot

of gold will be deposited under this scheme. What will then happen is that people will buy gold with their unaccounted money and deposit it with the Bank. The stated purpose of the scheme would then be defeated as the quantity of gold deposited will more or less equal the increased demand.

Check your progress 9

1. Which bank launches the Gold deposit scheme first?

   a. Canara Bank

   b. State Bank of India

   c. Allahabad Bank

   d. Punjab and Sind Bank

1.11 Let Us Sum Up

In this unit we have learnt that Commercial Banks gives financial assistance or credit facilities depending upon period of finance, purpose of finance, quantum of balance, etc. It is found that the repayment loan is arranged in specific ways to suit customers/ borrowers requirements. As seen there are various forms of financing like Loan, Syndicated Loan, Bridge Loan, Consortium Finance, Preferred Financing and Non-Fund Based Business.

Repayment can be through Bullet Payment System or Balloon Payment System. Venture capital is an investment in the form of equity, quasi-equity and sometimes debt straight or conditional, made in new or untried concepts, promoted by a technically or professionally qualified entrepreneur.

1.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-c)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-c)

Check your progress 6

Answers: (1-b)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-b)

Check your progress 9

Answers: (1-b)

1.13 Glossary

1. **Automated Teller Machine (ATM) -** It is a machine, activated by magnetically encoded card which processes variety of banking transactions.
2. **Loan -** It is an agreement between a borrower and a lender where terms and conditions of the loan are set.
3. **Online Banking -** It is a service which allows account holder to get account information and manage certain banking transactions by personal computer.
4. **Mobile Banking -** It is a banking which is done using mobile phone or other mobile devices.

1.14 Assignment

What are the types of repayment methods?

1.15 Activities

Discuss on Gold deposit scheme.

1.16 Case Study

Write a note of 1501 words on contribution of ATM in banking services and economic transaction in human life.

1.17 Further Readings

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UNIT 2: MERCHANT AND RETAIL BANKING

Unit Structure

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Merchant Banking
- Credit Card
- features of Credit Card
- Farmers Credit Card Scheme

2.1 Introduction

Merchant Banks are financial intermediaries. They act as intermediaries for transfer of capital from those who own it to those who use it.

Merchant Bankers provide assistance to the corporate houses for setting up industries. While banks assist industrial development by providing term loans and guarantees for setting up units and working capital, merchant bankers play a different role by assisting Industrial houses in the very formation of the unit and their horizontal and vertical expansion. The steps involved in the formation of a company, setting up the plant, meeting unforeseen situation—legal and other provisions, rising of capital require expert assistance in various fields. Merchant bankers assist in this process of co-ordinating various opportunities and financial options.

Although merchant banking services no longer a part of commercial banking operations in India a brief account of these activities are provided in this chapter. These services do not come under the control of RBI, but are regulated by Securities and Exchange Board of India (SEBI). However, banks are forming subsidiaries to undertake merchant banking activity and RBI may be interested in verifying the books of banks' subsidiaries. SBI was the first Indian Bank to set up a merchant banking subsidiary, followed by Canara Bank. A number of banks have set up subsidiaries or separate departments for this business.

2.2 Assistance Provided by Merchant Bankers

The merchant bankers provide assistance to corporate houses on the following lines.

Project Counselling

Project counselling is an important merchant banking service which includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project, appraising the project report with the financial institutions/banks.

Project reports are prepared to obtain government approval of the project, for procuring financial assistance from financial institutions and banks, for ensuring market for the proposed product, for planning public issues, etc.

Financing the project cost is an important aspect of project counselling. The two sources of funds available to finance the project cost are internal sources of

funds (or owners' funds) which includes promoter's contribution and retained earnings; and external sources of funds which refers to the borrowed funds in the form of loans from banks, private investors and financial institutions and in the form of debentures from the public.

Merchant banker has to decide the financing mix of the internal and external sources of funds keeping in view the rules, regulations and norms prescribed by the government or followed by the term lending financial institutions.

While rendering project counselling services, the merchant banker has to ensure that the application forms for obtaining the funds from financial institutions are filled in with relevant and appropriate information and before submitting the application, the merchant banker has to appraise the project considering the various aspects as to the type of the project, location, technical, commercial and financial viability of the project.

Loan Syndication

The division would help in drawing a financial plan setting out the means of financing the project to conform to the requirements of financial institutions/banks, government agencies as also stock exchange authorities after studying/finalising the project assistance preparing detailed applications for term loans from financial institutions/banks.

The detailed project report and term loan applications would thereafter be submitted to financial institutions/banks to secure their participation in term loans and necessary follow-up action would be initiated.

It includes the following assistance

a. Assist promoters to raise finance from Financial Institutions/banks for modernisation/expansion.

b. Arrange consortium meetings.

c. Prepare necessary documents.

d. Execution of necessary documents, registration of charges, etc.

e. (e) Arrange Syndication of Euro-currency Loans/guarantees whenever require i (Euro currency loans are foreign currency loans raised outside the country of the currency).

Issue Management

The term 'issue management' refers to the work involved in issuing shares and other securities to the public. Merchant banks play a vital role in assisting companies in raising capital by issue of securities. Specifically, issue management service includes:

a) Advising the company regarding the issue

b) Preparation of prospectus and other related information

c) Advising the management on the company's financing structure

d) Tying-up of financiers

e) Selecting brokers, bankers and advertisers for the issue

f) Coordinating with the stock exchanges

g) Preparing plan and budget for total expenses of the issue.

h) Drafting prospectus.

i) Selecting underwriters

j) Selecting advertising agency for pre-issue and post-issue publicity.

The merchant Banking Division would render the following:

a. Public Issue

b. Rights Issue

c. Debenture Issue

d. Advisors to Non-Resident Issues

e. Private placement deals

A) Public issue

(a) Advising the company on planning and timing of the issue.

(b) Obtaining the consent of the SEBI including their approval for reservation of shares for non-residents (on repatriation basis) employees and business associates

(c) Making necessary arrangements for underwriting the issue by financial intuitions, banks and/or brokers.

(d) Selection and appointment of a principal broker, brokers and bankers to the issue.

(e) Selection and appointment of an issue house and fixing their remuneration.

(f) Selection and appointment of advertising consultants agencies for organising the necessary publicity campaign including press and brokers/investors' conferences at important centres.

(g) Preparing the draft prospectus, where necessary, 'having it approved by solicitors.

(h) Obtaining the clearance of financial institutions, bankers, other underwriters and stock exchanges for the draft prospectus.

(i) Arranging for designing and printing of draft prospectus as well as despatch of the final prospectus.

(j) Filing a copy of the prospectus along with the other necessary documents under Section 60 of the Companies Act, with the Registrar of Companies. (xi) Making an application to stock exchanges(s) to have the shares listed and comply with all the listing requirements.

(k) Obtaining written consents from auditors, solicitors and advocates bankers to the company, bankers and brokers to the issue, etc. to act in their respective capacities.

(l) Obtaining permission from Reserve Bank of India for offering shares lo non-residents and opening Foreign Currency Collection Accounts at our overseas branches.

(m) Monitoring the progress and furnishing information to the company on the response to the issue.

(B) Rights Issue

(a) Advising the company on planning and timing of the issue,

(b) Obtaining consent of the SEBI.

(c) Assisting in underwriting/making standby arrangement with financial institutions, banks brokers.

(d) Drafting and finalising the letter of offer and getting the same approved by the stock exchanges wherever the shares are listed.

(e) Selection and appointment of principal broker, broker and banker to the issue.

(f) Selection and appointment of an issue house and advertising consultant / agency.

(g) Designing, printing and mailing of letters of offers, application forms, etc.

(h) Where the shares are held by non-residents of Indian Nationality/origin, assisting the company in obtaining necessary permission from Reserve Bank of India where required.

(C) Debenture Issue

(a) Computation of amount of debentures that can be raised as per the prevailing Government guidelines.

(b) All other services mentioned above for public and right issues as applicable.

(D) Advisors to Non-Resident Issues

(a) Obtaining approval of the Securities and Exchange Board of India (SEBI) for reservation of a part of the issue for non-residents of Indian Nationality/origin.

(b) Obtaining permission from the Reserve Bank of India for offering shares/debentures to non-residents and for opening Foreign Currency Collection Accounts at overseas branches, if applicable.

(c) Advising the strategy of marketing the issue amongst non-residents.

(d) Arranging investors' conferences and publicity campaigns abroad.

(e) Arranging Collection of application moneys at overseas branches and monitoring the day-to-day progress of the issue.

Management of Fixed Deposits of Joint Stock Companies

(a) Computation of amount that a company can raise by way of deposits from public and deposits/loans from shareholders.

(b) Advising the company on terms and conditions for acceptance of fixed deposits and the rate of interest to be paid thereon keeping in view the prevailing conditions in capital and money markets.

(c) Drafting of an advertisement to be issued inviting deposits from public. Filing a copy of the advertisement with the Registrar of companies for registrant

(d) Arranging for issue of advertisement in newspapers as required under Companies Act.

(e) Drafting of application form and arranging printing thereof.

(f) Arranging for collection of deposits at various branches of the Bank.

(g) Submitting periodical statements to the company.

(h) Arranging the company for payment of interest warrants.

(i) Assisting the company in observing all the rules and regulations in this connection!

(j) Maintaining of records /registers for the purpose. ;

Portfolio Management

Portfolio Management includes the following

(a) Advise on right mix of securities for maximum returns with minimum risk.

(b) Undertake to sell / buy securities on authorisation.

Corporate Counselling

It includes identifying the cause of problems like tight liquidity, over/under capacity utilization, product mix, etc.

Bought out Deals

Under the scheme, a portion of equity to be offered to the investing public is taken up the first instance by the merchant banker. At an appropriate later time these shares are laced with the public at a price which will fetch reasonable and adequate return to them.

Venture Capital

Providing long-term start-up funds for high risk ventures promoted by unknown entrepreneurs, which suffer from capital deficiencies but have a high profit genital.

Funding an emerging high risk, hi-tech project based purely on Research and Development efforts is termed as venture capital financing. It is a long-term financial arrangement d oriented towards capital gains. It is a source of financing for hi-tech industries which e new technology to produce new products.

Venture capital supports the early stages of a company's life cycle.

Check your progress 1

1. Issue management is related to:

   a. issuing of shares to public

   b. issuing of securities to public

   c. both a and b

   d. neither a nor b

2.3 Guidelines on Merchant Banking

Followings are the guidelines on merchant banking-

(1) Those with minimum net worth of Rs.1 crore are authorised to act as Lead Managers, Managers to the issue, with minimum net worth of Rs.50 lakh as co-managers to the issue and with minimum net worth of Rs.25 lakh as consultant advisers to the issue

(2) The number of Lead Managers to the issue is restricted to 2 for issues less than Rs.50 crore, 3 for less than Rs.100 crore and 4 for above 100 crore.

(3) Prior permission from SEBI is needed for carrying out Merchant Banking activities.

Merchant banking facilities provide various benefits to the business houses. It also provides the bankers additional income by way of fees, commission and brokerage. It makes available a large float of funds and provides better corporate image to the bankers. The expertise and advice on the lines of Merchant Banking need to be extended to small scale industries. It is also essential to try to develop 'cultivators Market' on par with the capital market. There is also a further need for trained personnel to handle new challenges in the field of innovative banking in this country".

Merchant Banking activities are now being controlled by SEBI because it pertains to Capital Market Function. Accordingly SEBI license is required to undertake merchant banking activity. Banks cannot act as Merchant Bankers now. They can carry on such activity only through a subsidiary.

Check your progress 2

1. Merchant banking gives benefits:

   a. business houses

   b. to bankers by extra fees

   c. in terms of commission and brokerage

   d. all of these

2.4 Meaning and Definition of Credit Card

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.

Fig 2.1 Credit card

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 and are the shape and size specified by the ISO/IEC 7810 standard as ID-1.This is defined as 85.60 × 53.98 mm (3.370 × 2.125 in) (33/8× 21/8 in) in size.

Benefits to customers

The main benefit to each customer is convenience. Compared to debit cards and cheques, a credit card allows small short-term loans to be quickly made to a customer who need not calculate a balance remaining before every transaction,

provided the total charges do not exceed the maximum credit line for the card. Credit cards also provide more fraud protection than debit cards.

Many credit cards offer rewards and benefits packages, such as offering enhanced product warranties at no cost, free loss/damage coverage on new purchases and points which may be redeemed for cash, products or airline tickets. Additionally, carrying a credit card may be a convenience to some customers as it eliminates the need to carry any cash for most purposes. As well as convenient, accessible credit, credit cards offer consumers an easy way to track expenses, which is necessary for both monitoring personal expenditures and the tracking of work-related expenses for taxation and reimbursement purposes. Credit cards are accepted worldwide and are available with a large variety of credit limits, repayment arrangement and other perks (such as rewards schemes in which points earned by purchasing goods with the card can be redeemed for further goods and services or credit card cash back).

Check your progress 3

1. A credit card is made of:

a. paper
b. plastic
c. steel
d. glass

2.5 Other Types of Cards

Cash Cards

A special plastic card used for getting currency notes from a machine installed generally near a bank. The Machine is known as Automated Teller Machine.

Fig 2.2 Cash card

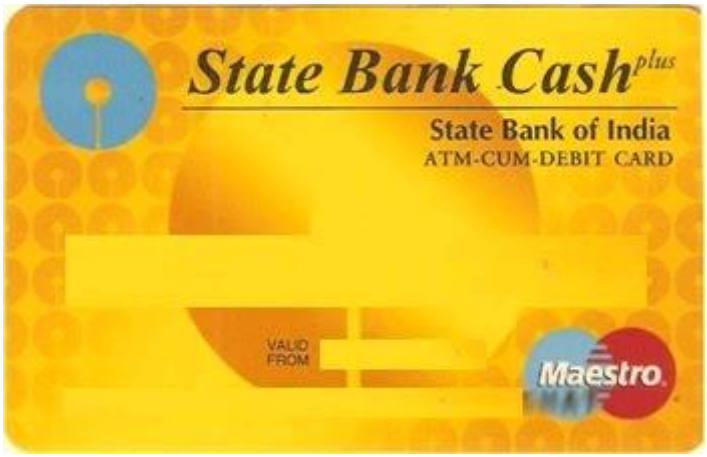

Fig 2.3 Debt card

Cheque Card

It is a card given to the customer by the bank that he must show when he writes a cheque which promises that the bank will pay out the money written on the cheque. Under' Cheque cards' system, the card-holder is given a card and a cheque book. He has to use the cheques, while purchases are made and the trader gets guaranteed payment. The customer does not get free credit, he has to keep sufficient balance in his account or the bank will provide overdraft up to a specified limit, of course on interest payment basis.

Fig 2.4 Cheque card

Charge Card

A small usually plastic card provided by an organisation with which one may buy goods from various shops, etc. The full amount owed must then be paid on demand. In credit cards, the card holders get credit or loan for payment of periodical bills when sufficient balance is not available in their accounts. In a charge card such credit facility is not available. The periodical bill amount should

be paid off by charging it to customers' account. A fee is also payable by the card holder to the card issuing institution.

Fig 2.5 Charge card

Smart Card

With the use of credit cards, we may avail of credit facility on our purchase of goods/services from approved sales outlets. A smart card however, enables the card holder to perform various other banking functions apart from credit purchases. For example, with smart cards, we can draw cash from ATMs, we can verify entries in our accounts, seek information pertaining to our accounts, etc. This is possible because the card has an integrated circuit with microprocessor chip embedded in the card for identification purposes. The card can also perform calculations and maintain records.

Fig 2.6 Smart card

Convenience Users

We can see that under credit card customers are extended an unsecured credit at least usually up to 30 days. Beyond the period, the bank charges interest on outstanding bills. However, some card holders may prefer to pay off their full dues before the free credit period. Such card holders are called Convenience Users.

Check your progress 4

1. Which card is used to obtain money from ATM?

   a. Cash Card

   b. Cheque Card

   c. Smart Card

   d. Charge Card

2.6 Operation of Credit Card

Credit cards operate quite differently from cheque cards. A cheque card guarantees payment of a cheque, whereas a credit card guarantees payment against a sales voucher signed by the Credit Card Holder.

Each credit card bears a specimen signature of its holder and is embossed by the issuing bank with the holder's name and number. When goods or services are supplied, the holder gives his card to the supplier who has agreed to join the scheme. The supplier places the card in a special imprinter machine, which records the holders name and number on a sales voucher. The particulars of the transaction are added on the voucher. The holder signs the voucher and the supplier compares the signature with that on the card.

He then sends the voucher to the issuing bank which pays the amount claimed less a service charge (normally between 3% to 7%). At the end of the month, the bank sends a fully item-wised statement to its card holder who must remit his cheque for the total amount. The customer is not required to pay any interest upon the sum due, provided that he makes payment within a specified time, usually about three weeks.

Fig 2.7 Card swipe machine with voucher

Credit cards may also be used for the purpose of obtaining cash from the branches of issuing bank or branches of certain other banks with whom arrangements have been made. Some institutions make a specific annual charge to their cardholders.

The mechanism of operation of the credit card can be explained with the help of the following diagram:

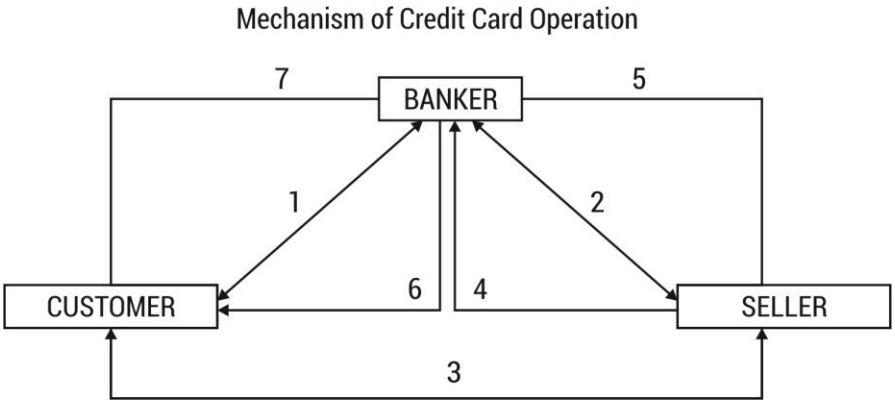

Fig 2.8 Mechanism of credit card operation

1. Customer applied and got the Credit card.
2. Arrangements are completed between the banker and seller.
3. The customer makes the actual purchases and signs on the sales vouchers.
4. The seller sends the detailed vouchers to the bank.
5. The bank settles the claims of the seller.

6. The customer receives the intimation from the bank in this regard.

Check your progress 5

1. Which card guarantees payment against sales voucher signed by Card Holder?

a. Cash Card c. Credit Card

b. Cheque Card d. Charge Card

2.7 Advantages of Credit Card

The benefits of the credit card can be grouped as follows:

1. Benefits to the bank .
2 Benefits to the customer (Cardholder)
3. Benefits to the retailer.

1. Benefits to the Bank

A credit card is an integral part of bank's major services these days. The credit card provides the following advantages to the Bank:

(a) The system provides an opportunity to the bank to attract new potential customers.

(b) To get new customers the bank has to employ special trained staff. This gives the bank an opportunity to find the latent talent from among existing staff that would have been otherwise wasted.

(c) The more important function of a credit card, however, is simply to yield direct profit for the bank. There is scope and potential for better profitability out of income/commission earned from the traders' turnover.

(d) This also provides additional customer services to the existing clients. It enhances the customer satisfaction.

(e) More use by the card holders and consequently increased turnover improves national business growth and consequently the growth of banking habits general.

(f) Better network of card holders and increased use of cards means higher popularity and image for the banks.

(g) Savings of expense on cash holdings, i.e., stationery, printing and manpower to handle clearing transactions will considerably be reduced. –

(h) It increases customer-base of the bank.

(i) It brings into bank's fold high net worth customers by introducing various types of Credit Cards like Gold Card, Executive Card

(j) It brings in new customers from various merchants outlet which accepts credit card against sale of their goods/services.

(k) It creates a brand name and popular image for the bank.

(l) Large scale uses of credit cards and shops, etc., accepting them help to increase deposit base of the bank.

(m) It increases interest income of the bank when card users avail of loan facility to settle the bills.

(n) It minimises credit risk of the bank as most of the card holders availing of credit facility must have been financially screened by the bank.

(o) This may increase the chances of relationship banking and thereby retaining the customers.

2. Benefits to the Cardholder

The principal benefits to a cardholder are-

(a) He can purchase goods and services at a large number of outlets without cash or cheque. The card is useful in emergency, can save embarrassment. The risk factor of carrying and storing cash is avoided. It is convenient for him to carry a credit card and he has trouble free travel and makes purchases without carrying cash or cheques.

(b) A month's purchases can be settled with a single remittance, thus, tending to reduce bank and handling charges.

(c) The cardholder has a period of free credit usually between 30-50 days of purchase.

(d) Cash can usually be obtained with the card, either on card account or by using it as identification when encashing a cheque at a bank.

(e) Availing credit with minimum formality.

(f) The credit card saves trouble and paper work to travelling businessmen.

(g) The cardholder has the option of taking extended credit up to a pre-arranged limit without reference to anyone, in addition to an initial credit and interest free period. Further, revolving credit becomes automatically available as the outstanding balance is reduced.

(h) It also induces a sense of financial discipline in a cardholder by allowing him to analyse the statement of expenses incurred which are supplied by card organisations. Cash expenses are often without record and can therefore result in unplanned spending.

(i) It provides a proof of spending through banking channels to strengthen his position in case of disputes with sellers.

(j) It also gives him exposures to banking operations since systematic accounting for spending and payments are routed through banking channels. (xii) He has the convenience for making a single payment for the purchases made during the month rather than many payments by various means. (xiii) It also allows him to delegate spending power to add on members (with additional cards).

(k) It also extends additional facilities like free insurance coverage, discount on purchases, free travel booking.

(l) Credit card is considered as a status symbol.

(m) It provides preferential rates on hotel stay, etc., depending upon the arrangement of the card issuing bank/agency.

Thus, the credit card is a pivotal instrument to the card holder for his convenience, social image and for financial credibility.

3. Benefits to the Merchant Establishments

The principal benefits of a credit card to the retailer are

(a) This will carry prestigious weight to the outlets.

(b) Increase in sales because of increased purchasing power of the cardholder due to unbilled credit available to the cardholder.

(c) The retailers gain from the impulse buying and 'trading up' the tendency to buy the bigger or better article. This argument has little appeal to service establishments but much to sellers of goods.

(d) He can offer credit without the botheration of cost or book-keeping and bad debts.

(e) Credit card ensures timely and certainties of payments, (of) Suppliers/ Sellers no longer have to send reminders of outstanding debts.

(f) Systematic accounting since sales receipts are routed through banking channels.

(g) Advertising and promotional support on national scale.

(h) Development of prestigious clientele base.

(i) Avoids all the cost and security problems involved in handling cash.

(j) Less need for merchant establishments to provide customers with extended credit facility, which is likely to be costly burdens on them.

(k) The losses through bad debts are reduced and additional liquidity is achieved.

(l) As customers are well educated and understanding, less customer problems.

Profitability

Profitability of the banks depends principally on the following factors:

a. Value of the average transaction.

b. Rate of merchant discount.

c. Cost of the bank money.

d. Cost of processing.

e. Rate of cardholder service charge.

f. Average pattern of repayment.

g. Loss from bad debts and fraud.

Check your progress 6

1. Which is not a feature of Credit Card?

   a. It increases customer-base of the bank

   b. It creates a brand name and popular image for the bank

   c. It helps in availing credit with minimum formality

   d. It help in issuing of cheques from the bank

2.8 Disadvantages of Credit Card

The following are the common disadvantages of the credit card.

(a) Only a few outlets accept the card. It is the duty of the bank to set up or seek many outlets to service the customers in order to ease out the difficulties.

(b) Some credit card transactions take longer time than cash transactions because various formalities.

(c) The customer tends to overspend out of immense happiness.

(d) Discounts and rebates can rarely be obtained.

(e) The cardholder is responsible for charges due to loss or theft of the card and .the bank may not be a party for loss due to fraud or collusion of staff, etc.

(f) Customers may be denied cash discount for payment through card.

(g) It might lead to spending habits and cardholders may end up in big debts. It should, however, be clearly told that the benefits of credit cards far outweigh its disadvantages. But acceptability of a product mainly comes from its usefulness. It will become more popular in India if a large number of service providers accepts payment through credit cards.

Check your progress 7

1. Which is not an advantage of Credit Card?

   a. It increases customer-base of the bank

   b. It increase sales as of increased purchasing power

   c. It helps in spending more money

   d. It help in avoiding cost and security problems related to handling cash

2.9 New Scheme of Farmers Credit Card

Kisan Credit Cards Scheme (KCC Scheme)

Union Finance Minister in his budget speech for the year 1998-99 had desired that the banks should issue Kisan Credit Cards to farmers on the basis of their land holdings so that the farmers may use for ready purchase of agricultural inputs such as seeds, fertilisers, pesticides, etc. and draw cash for their production

needs NABARD was asked to formulate a model scheme in this regard for uniform adoption by banks.

Fig 2.9 Kisan credit card

Accordingly, NABARD has since formulated a model Kisan Credit Card Scheme in consultation with major banks. The Scheme has been recommended to banks for adoption. The salient features of the scheme are as under:

(a) Kisan Credit Card Scheme aims at adequate and timely support from the banking system to the farmers for their cultivation needs including purchase of inputs in a flexible and cost effective manner. The scheme is to be implemented by commercial banks, RRBs and Co-operative Banks.

(b) The scheme would primarily cater to the short term requirements of the farmers. Under the scheme banks may provide the Kisan Credit Card to farmers who are eligible for production credit of Rs.5,000/- and above. The credit is extended under the KCC Scheme would be in the nature of a revolving cash credit and| provide for any number of withdrawals and repayments within the limit;

(c) While fixing the limit, the bank may take into account the entire production credit requirements of the farmer for the full year including the credit requirements of the farmer for the ancillary activities related to crop production such as maintenance of agricultural machinery/implements, electricity charges, etc.

(d) The Credit Card should normally be valid for 3 years subject to an annual review. The credit limit under the card will be fixed on the basis of the operational land holding, cropping pattern and scales of finance as recommended by the District Level Technical Committee (DLTQ/State Level Technical Committee (SLTC).

(e) Banks may apply the same rates of interest as are applicable to crop loans and the security/margin norms, etc. should be in conformity with the instructions issued by RBI/NABARD from time to time.

(f) The KCC facility being in the nature of cash credit accommodation for agricultural purposes, the prudential norms as applicable to such facilities would apply to KCC accounts.

Repayment

The amount drawn or utilised against the card should be repaid to the bank by the farmers within 12 months of withdrawal of money.

Progress of the Scheme

As in March 1999, a total of 7,83,000 KCC cards with credit facility covering a sum of Rs.2310 crore have been insured by all banks to farmers throughout India. The banks are fast popularising the scheme among farmers.

Credit card scheme is still in its infancy, in India. It is now for the bank managements to seize the opportunities offered by the huge populace and growing number of working class/fixed income earners. The Bank cards are, however, becoming popular in India. Various banks have introduced credit cards either jointly with other banks or independently. For example, Bank of Baroda has introduced its credit card known as "BOBCARD". Similarly Central Bank of India has introduced "Central Card" and State Bank of India, the 'SBI Card'. It may also be told that as per current income tax regulations all persons holding credit cards must file their annual income tax returns.

Check your progress 8

1. With Kisan Credit Cards, which among the following item is not used by farmers to purchase?

   a. seeds

   b. tractor

   c. fertilisers

   d. pesticides

2.10 Debit Cards

A Debit card is a card that has direct access to our bank account. The card is issued by our bank. Whenever we use our debit card, our bank account is debited immediately. Unlike credit cards, we don't enjoy any credit period and therefore the debit card does not have minimum income eligibility criteria. There are two types of debit cards and two types of debit card transactions:

1. 'Direct' debit cards allow only "on-line" transactions. An immediate electronic transfer of money from our bank account to the merchant's account. This requires us to enter our PIN or Personal Identification Number at the store's terminal. The system then checks our account for sufficient funds to cover the purchase. These are typically the cards that come with the "Maestro" logo, from MasterCard. An example is the Suvidha debit card issued by Citibank in select cities.
2. A 'Deferred' debit card looks similar to a credit card, but is not a credit card. It bears a Visa or MasterCard logo and can be used wherever our card's brand name is displayed. This card allows "off-line" and "on-line" transactions. Off line purchases are where the shopkeeper's terminal scans our card and create a debit against our account. We are not required to enter our PIN at the store's terminal. Most off-line transactions are verified immediately to see whether there is enough money in our account. Off-line debit cards usually carry the logo, from Visa. HDFC Bank issues Electron debit cards in more than 15 cities around the country.

Check your progress 9

1. Which among the following card has direct access with bank account?

   a. Credit Card

   b. Debit Card

   c. Cheque Card

   d. Charge Card

2.11 Let Us Sum Up

In this unit we have learnt that Merchant Banking is financial intermediaries which transfer capital from those who own it to those who use it. The merchant bankers show assistance to corporate houses for setting industries. It is found that banks help industrial development by giving term loans which guarantees for setting up of units and working capital. It is seen that the merchant bankers gives assistance to corporate houses such as Project counselling, Loan Syndication, Issue Management, Management of fixed deposits of Joint Stock Companies, Portfolio Management, Corporate Counselling, Bought out Deals and Venture Capital.

It is studied that credit card is made of plastic which is issued to users as system of payment by allowing its holder to buy goods and services based on holder's which promises to pay for goods and services. As seen, the issuer of card shows revolving account and grants a line of credit to consumer from which user borrows money for payment to merchant. A Debit card is a card which has direct access to bank account. This card is issued by bank. On using debit card, bank account gets debited immediately. In this there is no credit period and therefore the debit card does not have minimum income eligibility criteria.

2.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-c)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-b)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-c)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-c)

Check your progress 8

Answers: (1-b)

Check your progress 9

Answers: (1-b)

2.13 Glossary

1. **Merchant Bank -** These are financial intermediaries which transfer capital from owner to user.
2. **Merchant Bankers -** People working in establishment which finalises loans, deposits, projects and anything to banking.
3. **Credit card -** It is a plastic case which is given to users for taking payment on credit.
4. **Debit card -** It is a card that is linked with bank account which shows details about bank transaction.

2.14 Assignment

Compare the working of Debit card with Credit card.

2.15 Activities

Explain the role and importance of merchant banking in providing assistance to corporate houses.

2.16 Case Study

Find out the merits and demerits of credit and debit card of ICICI, SBI, HDFC banks and comment on it.

2.17 Further Readings

1. An Appraisal of Recent Monetary Policy," The Journal of the Indian Institute of Bankers.
2. Monetary System in India: A Survey in India's Economic Problems, Gupta, G. S.
3. RBI Bulletin, June 1960.

Block Summary

In this block, you have given detailed idea about various financial methods and repaying methods. You will be detailed with concept of net banking and internet banking facilities which will help them in future use. The idea about working and functions of bank net along with its usage in today's banking industry will really help you and user to know about the real working. This block allows you to gain extra knowledge on different types of financial cards used today.

After completing this block, you will be able to discuss and practical implement the benefits of using debit and credit cards. The concepts of virtual capital management will help to gather information about various tools.

Block Assignment

Short Answer Questions

1. What is the function of Credit cards?
2. What do you understand by Financing?
3. Explain the role of Merchant Banks?
4. Define Venture Capital with example?
5. What activities are performed by Merchant Banker?

Long Answer Questions

1. How account information is affected by transacting through Debit card?
2. List few characteristics about Phone and Net Banking?
3. Give detail information about Gold Deposit Scheme?

Enrolment No. ☐

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
Ahmedabad-382 481.