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IMPACT OF RESERVE BANK OF INDIA'S POLICY ON INDIAN FINANCIAL SYSTEM

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Introduction

Financial system connected or inter mixed institutions, agents, practices, markets, transactions, claims and liabilities in the economy. The financial system is concerned about credit, money and fiancé—the terms intimately related yet somewhat different from each other. Money refers to the current medium of exchange or means of payment. Credit or loan is a sum of money to be returned normally with interest; it refers to a debt of economic unit. RBI has regulate financial system such a way that Indian rupee will not be destabilised against foreign currencies.

Banking and Non-banking Institutions

The banking institutions have quite a few things in common with the non-banking ones, but their distinguishing character lies in the fact that, unlike other institutions, 1. They participate in the economy's payments mechanism. i.e., they provide transactions services. 2. Their deposit liabilities constitute a major part of the national money supply and 3. They can create deposits or credit, which is money. banks, subject to legal reserve requirements, can advance credit by creating claims against themselves, while other institutions can lend only out of resources put at their disposal by the savers. The difference between the two has been highlighted by sayers by characterizing the former as "creators" of credit and the latter as mere "purveyors" of credit. In India, banks examples is the commercial banks and co-operative banks, the examples of non banking financial institutions are Life Insurance Corporation (LIC), Unit Trust of India (UTI) and NABARD.

Financial System

A financial system means the structure that is available in an economy to mobilize the capital from various surplus sectors of the economy and allocate and distribute the same to the various needy sectors. the transformation of 'Savings' into 'Investments and

Consumption' s facilitated by the active role played by the financial system. the process of transformation is aided by various types of financial assets suiting the individual needs and demands of both the 'investors and spenders. the offering of these diverse types of financial assets is supported by the role of 'financial intermediaries' which invariably intermediate between these two segments of investors and spenders. for example Banks, Financial institutions, Mutual funds etc. The place where these activities take place could be taken to connote the financial market. the financial system comprises a mixture of intermediaries, markets and instruments that are related to each other. it provides a system by which savings are transformed into investments. RBI perform Monetary control including controlling inflation and bank supervision.

It is observed that the banking system in India is regulated by the Reserve Bank of India as the central banking authority in the country. Banking regulation is not peculiar to India, as the banking system of every country is regulated by some authority in terms of the laws of the country concerned. Even in the United Kingdom, where banking has not been defined under any statute book, the banking system is regulated by the Bank of England as the central banking authority in terms of an enactment. In India too the banking system is regulated by the Reserve Bank of India, in terms of the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.

A reasonable- regulation of the banking system is essential to check the imprudence of the players, which can erode the confidence of the public in the banking system. Recently Nirav Modi cheated Punjab National Bank with the help of fake bank account and letter of understanding. The financial system deals with the people's money and it is necessary to generate, maintain and promote the confidence and trust of the people in the banking system at all times and with great care by preventing and curbing all possibilities of misuse and even imprudence by any of the players of the financial system. Thus, the rationale behind regulation of the financial/banking system is:

• To generate, maintain and promote confidence and trust of the public in the banking system.

• To protect investor's interests by adequate/timely disclosure by the institutions and access to information by the investors.

• To ensure that the financial markets are both fair and efficient.

• To ensure that the participants follow the rules of the market place.

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In India, as a developing country, the role of the banking regulator (RBI), as also of the securities market regulator (Securities and Exchange Board of India — SEBI), is more crucial in achieving the aforesaid objectives of a stable banking as well as financial system. RBI has the added responsibility to smoothen and aid the process of economic development of the country via the banking system in tune with the national economic policies.

The foregoing objectives of the banking system with reference to the RBI would be discussed in this Unit. The RBI's statutory objectives and regulatory functions and tools would be explained in this Unit to enable you to better understand the various facets of banking that would be dealt with in the subsequent units.

RBI's CONSTITUTION AND OBJECTIVES

The Reserve Bank of India (RBI) was constituted under the Reserve Bank of India Act, 1934 and started functioning with effect from 1 April, 1935. RBI is the oldest among the central banks operating in developing countries, though it is much younger than the Bank of England and the Federal Reserve Board operating as the central banks in UK and USA respectively, being developed countries. RBI is a state owned institution under the Reserve Bank (Transfer of Public Ownership) of India Act, 1948. This Act empowers the Union Government, in consultation with the Governor of the RBI, to issue such directions to RBI as considered necessary in public interest. The Governor and four Deputy Governors of RBI are appointed by the Union Government. The control of the RBI vests in the Central Board of Directors, that comprises the Governor, four Deputy Governors and 15 Directors nominated by the Union Government. The RBI's internal management is based on functional specialization and coordination amongst about 20 departments, with headquarters at Mumbai.

The main objectives of the RBI are contained in the preamble of the RBI Act, 1934. It reads 'Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'. The main objectives of REI may be stated as follows in specific terms:

(i) To maintain monetary stability such that the business and economic life of the country can deliver the welfare gains of a mixed economy.

(ii) To maintain financial stability and ensure sound financial institutions so that economic units can conduct their business with confidence.

(iii) To maintain stable payment systems, so that financial transactions can be safely and efficiently executed.

(iv) To ensure that credit allocation by the financial system broadly reflects the national economic priorities and social concerns.

(v) To regulate the overall volume of money and credit in the economy to ensure a reasonable degree of price stability

(vi) To promote the development of financial markets and systems to enable itself to operate and regulate efficiently.

Central Banks Functions

We will now discuss the essential functions of RBI that help it to achieve the objectives mentioned above. These are
as follows:

Notes Issuance

RBI has the sole authority for the issuance of currency notes and putting them into circulation, withdrawing them or exchanging them. RBI has issued and put in circulation notes in the denomination of Rs. 2, 5, 10, 20, 50, 100,200, 500 and 2000, except Re. 1 notes and all coins, which are issued by the Government of India, but put into circulation by RBI. The RBI has about gen Issue Offices and above 4,000 currency chests where new and reissuable notes are stored. The currency chests are kept by various banking groups as agents of RBI. The RBI Group has over 2,800 currency chests, Nationalised banks have about 800, Treasuries about 420 and private sector banks have about 20 currency chests. As a cover for the notes issue, RBI keeps a minimum value of gold coin, bullion and foreign securities as a part of the total approved assets.

Government's Banker

RBI acts as the banker to the Central and State Governments. As such, it provides them banking services of deposits, withdrawal of funds, making payments and receipts, collection and transfer of funds and management of public debt. Government deposits are received free of interest and RBI does not receive any remuneration for the routine banking business of the government. RBI makes 'ways and means advance' to central and state governments, subject to certain rules and limits on the amount of overdrafts with a view to contain the fiscal deficit as decided by the central government. RBI charges a commission for managing the public debt and interest on overdrafts from the governments.

Bankers' Bank

Every central bank acts as a bankers' bank and so does RET. The commercial banks and state cooperative banks which are scheduled banks (appearing in the second schedule of the RBI Act) have to keep stipulated reserves in cash and in approved securities as a percentage of their Demand and Time Liabilities (DTL).These reserves, as discussed in a later section of this Unit, regulate the banks' ability to create 'credit and affect money supply in the economy. RBI changes its Bank Rate to regulate the cost of bank credit and thereby its volume indirectly. RBI also acts as a 'lender of the last resort' for banks by rediscounting bills and by refinance mechanism for certain kinds of credit, subject to the conditions laid down in its Credit Policy announced by annually. RBI had pumped huge money to ICICI bank when rumor spread to it's wind up in 2003 and saved private sector bank.

Bank's Supervision

From November 1993, RBI's banking supervisory function has been separated from its .traditional central banking functions. The Board of Financial Supervision (BFS) was set up in 1994 to oversee the Indian Financial System, comprising not only commercial. banks, state cooperative banks, but also All India Financial Institutions (AIFIs) the and Non-Banking Finance Companies (NBFCs). The BFS has a full time vice-chairman and six other members, apart from the RBI Governor as its chairman. RBI's supervisory powers over commercial banks are quite wide as mentioned below and their objective is to develop a sound banking system in the country:

(i) To issue licenses for new banks and new branches for the existing banks.

(ii) To prescribe the minimum requirement for the paid-up capital and reserves, maintenance of cash reserve and other liquid assets.

(iii) To inspect the working of the scheduled banks in India and abroad from all relevant angles to ensure their sound working.

(iv) To conduct Ad hoc investigations into complaints, irregularities and frauds pertaining to the banks.

(v) To control appointments, reappointments, termination of Chairmen and CEO of private banks.

(vi) To approve or force amalgamation or merger o two banks. The recent example is the merger of Global Trust Bank with Oriental Bank of Commerce, after the RBI's moratorium of the former in early 2004.

Development of the Financial System

This represents RBI's developmental role as against its regulatory and supervisory role over banks as mentioned above. RBI has created specialized financial institutions for:

(i) Industrial finance: Industrial Development Bank of India (JDBI) in 1964, Small Industries " Development Bank of India (SIDBI) in 1989.

(H) Agricultural credit: National Bank for Agriculture and Rural Development NABARD) in 1981. (iii) Export-import finance: Export-Import Bank of India (EXIM Bank) in 1981.

(iv) Deposits Insurance Corporation of India in 1961, which later became Deposit Insurance and Credit Guarantee Corporation of India (DICGC).

RBI has also initiated several schemes connected with various facets of banking which have significantly impacted the banking development in the country over the last five decades. Some of these are as follows:

(i) Bill Market Scheme of 1952 and 1970.
(ii) Lead Bank Scheme for backward districts development (1970s).
(iii) P.L. Tondon Committee on Inventory norms for Bank Credit, 1974. *
(iv) Credit Authorization Scheme (l960s)
(v) Consortium Financing Scheme (1970s)
(vi) Priority Sector Advances Scheme

Note: The schemes marked with an asterisk (*) have been discontinued after the liberalization since1991.

RBI has also tried to integrate the large unorganised financial sector (indigenous bankers, various kinds of non-banking finance companies etc.) into the organised financial system by regulating them to some extent. However, the task is so enormous and complex that it will take longer for RBI to have the desired integration of the two sectors, so as to work as a single financial system in the country.

Exchange Control

RBI is entrusted with the duty of maintaining the stability of the external value of the national currency

— Indian Rupee. It used to regulate the foreign exchange market in the country in terms of the Foreign Exchange Regulation Act (FERA), 1947 (amended and enlarged in 1973). The FERA,1973- has been replaced by the Foreign Exchange Management Act, 1999 (FEMA) and RBI is now guided by the provisions of the new Act. The RBI performs the following tasks:

(i) It administers foreign exchange control through its Exchange-Control Department. It authorises the bank's specified branches and other dealers, called Authorised Dealers (ADs) to deal in the prescribed kinds of foreign exchange transactions and issues the AD series of circulars for regulating such transactions.

(ii) It manages the exchange rate between the Indian Rupee and foreign currencies, by selling and buying foreign exchange to/from the Authorised Dealers and by other means.

(iii) It manages the foreign exchange reserves of the country and maintains reserves in gold and foreign securities issued by foreign governments and international financial institutions.

Monetary Control

The RBI controls the money supply, volume of bank credit and also cost of bank credit (via the Bank Rate) and thereby the overall money supply in the economy. Money supply change is a technique of controlling inflationary or deflationary situations in the economy. The RBI issues monetary policy for the country as the Ministry of Finance issues fiscal policy and the Ministry of Commerce issues th7' .'- EXIM policy of the country from time to time. All these policies are among the important macroeconomic policies that influence various businesses in the country. RBI issues monetary and credit policies annually.

TOOLS OF MONETARY CONTROL

RBI uses its monetary policy for controlling inflationary or deflationary situations in the economy by using one or more of the following tools of monetary control. These are discussed below.

Cash Reserve Ratio (CRR)

It refers to the cash that all banks (scheduled and non-scheduled) are required to maintain with RBI as a certain percentage of their demand and time liabilities (DTL). As you know, demand liabilities of a bank represent its deposits which are payable on demand of the depositors (viz., current and savings deposit) and time liabilities refer to its time deposits which In order to meet these liabilities in time (i.e. to keep liquidity), a bank has to keep a regulatory cash reserve with RBI (currently, it is 6.5 per cent for scheduled commercial banks). If a bank fails to maintain the prescribed CRR at prescribed intervals, it has to pay penal interest on the shortfall by adjustment from the interest receivable on the balances with RBI. A cut in the CRR enhances loanable funds with banks and reduces their dependence on the call and term money market. This will bring down the call rates. An increase in CRR will squeeze the liquidity in the banking system and reduce their lending operations and the call rate will tend to increase.

Statutory Liquidity Ratio (SLR)

It refers to the supplementary liquid reserve requirements of banks, in addition to CRR. SLR is maintained by all banks (scheduled and non-scheduled) in the form of cash in hand (exclusive of the minimum CRR), current account balances with SBI and other public sector commercial banks, unencumbered approved securities and gold. RBI can prescribe SLR from 0 per cent to 40 percent of bank's DTL (presently it is 25 percent). SLR has three objectives:

- To restrict expansion of banks' credit,
- To increase banks' investment in approved securities and
- To ensure solvency of banks.

The effect of an increase in SLR by RBI is the reduction in the lending capacity of banks by preempting a certain portion of their DTL for government or other approved securities. It has therefore a deflationary impact on the economy, not only by reducing the supply of loanable funds of banks, but also by increasing the lending rates in the face of an increasing demand for bank credit. The reverse phenomena happens in case of a cut in SLR.

Bank Rate

Bank Rate is the standard rate at which RBI is prepared to buy or rediscount bills of exchange or other eligible commercial papers from bank. It is the basic cost of rediscounting from RBI. The Bank Rate is therefore used by RBI to affect the cost and availability of refinance and to change the loanable resources of banks and other financial institutions. Change in the Bank Rate by RBI affects the interest rates on loans and deposits in the banking system across the board in the same direction, if not to the same extent. After deregulation and banking reforms since 1991, RBI has gradually loosened its direct regulation of deposit and lending rates and these are left to banks to decide through their boards, with only a few exceptions. However, RBI can still affect the interest rates via changes in its Bank Rate, whenever the situation of the economy warrants it.

Open Market Operations (OMOs)

This refers to sale or purchase or government securities (of Central or State governments or: bothh) by RBI in the open market with a view to increase or decrease the liquidity in the banking system and there by affect the loanable funds with banks. RBI can also alter the interest rate structure through its pricing policy for open market sale/purchase.

Selective Credit Control (SCC)

The RBI issues directives, under Sections 21 and 35A of the Banking Regulation Act, stipulating certain restrictions on bank advances against specified sensitive commodities as follows:

Pulses, other food grains (viz., coarse grains), oilseeds, oils including vanaspati, all imported oil seeds and oils, sugar including imported sugar (excepting buffer stocks and unreleased stock of sugar with sugar mills), Gur and Khandsari, Cotton and Kapas, PaddyIRice and Wheat.

RBI's objective in issuing selective credit control (SCC) directives is to prevent speculative holding of essential commodities and the resultant rise in their prices. RBI's general guidelines on SCC are:

(i) Banks should not allow customers dealing in SCC commodities any credit facilities (incleduing against book debts/receivables or even collateral securities like insurance policies, shares, stocks and real estate) that would directly or indirectly defeat the purpose of the SCC directives.

(ii) Credit limits against each commodity covered by SCC directives should be segregated and the SCC restrictions be applied to each of such segregated limits.

Presently, only buffer stocks of sugar, unreleased stocks of sugar with sugar mills representing free sale sugar and levy sugar are covered by SCC directives.

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OTHER TOOLS

a) RBI has used other tools of regulation in the past. However, after the liberalisation policy of 1991, most of these tools have since been discontinued and are no longer used by RBI. These tools are:

- Credit Rationing/Allocation
- Credit Authorisation Scheme
- Credit Planning .
- Inventory and Credit Norms

REGULATORY RESTRICTIONS ON LENDING

There are certain regulatory restrictions on lending by banks in terms of RBI directives or Regulation Act, 1949 (BRA) as follows:

(i) No advance or loan can be granted against the secutity of the_bank's own shares or partly paid share of company

(ii) No bank can hold share in a company:

(a) As pledge or mortgagee in excess of the limit of 30 per cent of the Paid-up capital of that company or 30 per cent of the Bank's Paid-up capital and Reserves, whichever is less (Sec. 19(u) of BRA).

(b) in the management of which Managing Director or Manager of the Bank is interested (Sec. 19(iii) of BRA).

(iii) Bank's aggregate investment in shares, Certificate of Deposits (CDs), bonds, etc., should not exceed the limit of 40 per cent of Bank's net owned funds as at the end of the previous year.

(iv) No bank should grant loans against:

(a) CDs

(b) FDs issued by other banks

(c) Money Market Mutual Funds

(v) Bank should adhere to the RBI guidelines relating to the level of credit, margin and interest rate etc. for loans against the security of commodities covered by the Selective Credit Control Directives of RBI. No loan should be granted by banks to

- The Bank's directors or firms in which a director is interested as a partner/manager/employee/ guarantor (certain exemptions allowed).
- Relatives of other bank's directors ('relatives' defined by RBI) — Such loans can be sanctioned by higher authorities or the Bank's Board as per RBI guidelines.

(vi) Banks should not sanction a new or additional facility to borrowers appearing in RBI's list of "Willful Defaulters" for a period of 5 years from the date of publication of the list by RBI.

Conclusion

Reserve Bank of India is the central banking authority and regulator of the Indian Banking System, like the Federal Reserve Board in USA and Bank of England in UK. RBI was constituted under the Reserve Bank of India Act, 1934 and it draws its regulatory powers from this Act and also the Banking Regulation Act. RB1's main objectives are to maintain financial solvency and liquidity in the banking system,stability in the exchange rate and internal value of the Rupee, to regulate the volume and flow of bank credit in tune with the national priorities and to develop financial institutions on sound lines.RBI performs multifarious functions to achieve the above said objectives. Its main functions include Notes Issuance, Government's Banker, Bankers' Bank, Banks' Supervision, Development of the Financial System, Exchange Control, and Monetary Control.

RBI's main tools of Monetary Control are Cash Reserve Ratio, Statutory Liquidity Ratio, Open Market Operations, Bank Rate and Selective Credit Control. RBI uses these tools singly or in combination to control and rectify specific monetary situations in the economy or banking system from time to time. These measures affect the volume and cost of bank credit, besides maintaining the stability of the financial system.

In accordance with the government policy of poverty alleviation and improving the economic condition of the disadvantaged sections of the society, RBI has directed banks to lend to the specified Priority Sector with a minimum target of 40 per cent of their Net bank credit, with specified sub-targets for agriculture, weaker sections and the very poor sections of the society. Certain concessions in the lending terms and operations have also been prescribed by RBI for Priority Sector Advances.

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