

# Monetary Theory and Policy

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DEECO528

Edited by:

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**L**OVELY  
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# **Monetary Theory and Policy**

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Dr. Pooja Kansra**

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## Unit 01: Financial System

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super

economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it is mobilization of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

Meaning of Financial System:

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as “a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions.”
2. Prof.S.B.Gupta defines the financial system as “a set of institutional arrangements through which financial surpluses available in the economy are mobilized”.
3. Van Horne has defined the financial system as “the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption”.
4. According to Robinson, the primary function of the system is “to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth”.

Features/Characteristics/Role of Financial System:

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.

13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.
19. It includes financial institutions, markets, instruments, services, practices and transactions.
20. The main objective is to formulate capital, investment and profit generation.

### **1.1 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of financial system in an economy. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

### **1.2 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares.

It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.

**3. Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.

**4. Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.

**5. Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.

**6. Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.

**7. Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.

**8. Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.

**9. Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.

**10. Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

**11. Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.

**12. Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

### **1.3 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

*Formal (organized) financial system:* This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

Financial Institutions.

Financial Markets.

Financial Instruments.

Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

## 1.4 Money:

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

Meaning and Definitions of Money:

The word "money" is believed to originate from a temple of 'Juno', located on Capitoline, one of Rome's seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn or instruct) or the Greek word "moneres" (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

## 1.5 Definitions of Money:

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of



economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, "Money is what money does". It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability. Looking from this criterion, we find Crowther's definition to be the most suitable.

"Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value." – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

### **1.6 Legal Tender Money and fiduciary Money:**

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

**Legal tender money is of two kinds:**

- (a) Limited legal tender, and
- (b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

Stages in the Evolution of Money:

#### **(i) Animal Money:**

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.

#### **(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

#### **(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

**(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

**(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

Characteristics of Money:

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

**6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

**7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

Classification of Money:

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

**(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

**(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

**(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

**(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

- (a) Standard Money, and
- (b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

- (a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

**(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

Modern Forms of Money:

**1. Currency:**

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

**(a) Metallic Money:**

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

**(b) Paper Money:**

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

**2. Deposit Money or Bank Money:**

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

**3. Legal Tender Money (Force Tender):**

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.

**4. Near Money:**

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

**5. Electronic Money:**

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money. The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

**6. Fiat Money:**

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country. The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

Importance of Money:

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

**1. Money and Production:**

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

**2. Money and Consumption:**

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

**3. Money and Distribution:**

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

**4. Removal of the Difficulties of Barter:**

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

**5. Money and Capital Formation:**

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

#### **6. Money and Public Finance:**

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

#### **7. External Trade:**

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

#### **8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

### **1.7 Value of Money:**

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

#### **The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value

can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

**(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

**(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

**(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

### **1.8 Evils of Money:**

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:**

**(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

### **1.9 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct



finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

**Process of Intermediation:**

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

Roles of Financial Intermediaries:

1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

**(i) Reduce Hoarding:**

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the “mattress”, as is commonly said.

**(ii) Help the Household Sector:**

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

**(iii) Help the Business Sector:**

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

**(iv) Help the State and Local Government:**

FIs help the state and local bodies financially by purchasing their bonds.

**(v) Help the Central Government:**

Similarly, they buy and sell central government securities and thus they help the central government.

**(vi) Lenders and FIs both Earn:**

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

**(vii) Spread of Risks:**

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

**(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency

and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the

country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

Functions of the Financial Sector

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:

**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### 1.10 Value exchange

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.

**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

Intermediation

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

### **1.11 Risk transfer**

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall

in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

### **1.12 Liquidity**

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

### **1.13 The Characteristics of Finance**

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

### Summary

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

### Keywords

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

### **Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups."  
Comment.
5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

### **Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. — — — — represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset



d. none of these

3. Financial derivatives include

- a. Stocks
- b. Bonds
- c. Futures
- d. None of the above

4. Which of the following is the regulator of Money market?

- a) Reserve Bank of India
- b) Government of India
- c) Telecom Regularity Authority
- d) Insurance Regularity Department

5. What is Call Money?

- a) It is an overnight loan in the Money Market
- b) It is loan of above 1 day to 14 days in the money market
- c) It is loan of above 14 day to 364 days in the money market
- d) It is an amount charged on ISD

6. What is Notice Money?

- a) It is an overnight loan in the Money Market
- b) It is loan of above 1 day to 14 days in the money market
- c) It is loan of above 14 day to 364 days in the money market
- d) It is an amount charged on ISD

7. What is Term Money?

- a) It is an overnight loan in the Money Market
- b) It is loan of above 1 day to 14 days in the money market
- c) It is loan of above 14 day to 364 days in the money market
- d) It is a loan provided on certain terms and conditions by Bank to its customer

8. Which of the following is not related with Money Market?

- a) Treasury Bills
- b) Commercial Bills
- c) Certificates of Deposit
- d) Shares

9. Which of the following is related with Money Market?
- a) Treasury Bills
  - b) Commercial money
  - c) Cheque
  - d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:
- a) Shorter term Markets
  - b) Capital Markets
  - c) Counter Markets
  - d) Long-term Markets
11. What is the main function of financial intermediaries?
- a) Connecting savers and borrowers.
  - b) Regulating the finance industry.
  - c) Acting as a fail-safe during financial crises, such as the Great Recession.
  - d) Facilitating investment in major corporations.
12. Which of the following is not an example of a common financial intermediary?
- a) A commercial bank.
  - b) The Federal Reserve
  - c) The stock market
  - d) The bond market
13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?
- a) The federal government is indirectly involved because it regulates financial intermediaries.
  - b) Financial intermediaries do not deal directly with borrower-spenders.
  - c) Financial intermediaries do not deal directly with saver-lenders.
  - d) Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
14. Which of the following statements about financial markets is not true?
- a) Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.
  - b) Sometimes intermediaries invest in the financial markets.
  - c) Financial markets are associated with "direct" finance.
  - d) When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.

15. Which one of the following is not a financial intermediary?

- a) A money market mutual fund
- b) A steel manufacturing plant
- c) A property and casualty insurance company
- d) A commercial bank

### **Answers for Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

### **Further Readings**

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## Unit 02: Financial System And Economic Development

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the

future and whether it is mobilization of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

## **2.1 Meaning of Financial System:**

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as “a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions.”
2. Prof.S.B.Gupta defines the financial system as “a set of institutional arrangements through which financial surpluses available in the economy are mobilized”.
3. Van Horne has defined the financial system as “the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption”.
4. According to Robinson, the primary function of the system is “to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth”.

## **2.2 Features/Characteristics/Role of Financial System:**

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.
13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.
19. It includes financial institutions, markets, instruments, services, practices and transactions.
20. The main objective is to formulate capital, investment and profit generation.

## **2.3 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of

financial system in an economy. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

## **2.4 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares. It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.
3. **Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.
4. **Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.
5. **Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.
6. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.
7. **Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.
8. **Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.
9. **Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.
10. **Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.
11. **Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.
12. **Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

## **2.5 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

**Formal (organized) financial system:** This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

- Financial Institutions.
- Financial Markets.
- Financial Instruments.
- Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

## **2.6 Money:**

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

## **2.7 Meaning and Definitions of Money:**

The word "money" is believed to originate from a temple of 'Juno', located on Capitoline, one of Rome's seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn or instruct) or the Greek word "moneres" (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

### **Definitions of Money:**

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various



economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, "Money is what money does". It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability. Looking from this criterion, we find Crowther's definition to be the most suitable.

"Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value." – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

#### **Legal Tender Money and fiduciary Money:**

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

#### **Legal tender money is of two kinds:**

(a) Limited legal tender, and

(b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

## **2.8 Stages in the Evolution of Money:**

### **(i) Animal Money:**

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.

### **(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

### **(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

### **(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

### **(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

**Characteristics of Money:**

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

**6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

**7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

**Classification of Money:**

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

**(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

**(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

**(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

**(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

(a) Standard Money, and

(b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

(a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

**(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

## 2.9 Modern Forms of Money:

### 1. Currency:

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

**(a) Metallic Money:**

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

**(b) Paper Money:**

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

### 2. Deposit Money or Bank Money:

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

### 3. Legal Tender Money (Force Tender):

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.

### 4. Near Money:

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

### 5. Electronic Money:

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money.

The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

#### **6. Fiat Money:**

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country.

The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

## **2.10 Importance of Money:**

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

#### **1. Money and Production:**

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

#### **2. Money and Consumption:**

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

#### **3. Money and Distribution:**

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

#### **4. Removal of the Difficulties of Barter:**

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

#### **5. Money and Capital Formation:**

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

#### **6. Money and Public Finance:**

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

#### **7. External Trade:**

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

#### **8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

#### **Value of Money:**

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

**The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

**(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

**(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

**(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

**Evils of Money:**

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:**

**(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

**2.11 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

**Process of Intermediation:**

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a

reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

## 2.12 Roles of Financial Intermediaries:

### 1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

#### (i) Reduce Hoarding:

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

#### (ii) Help the Household Sector:

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

#### (iii) Help the Business Sector:

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

#### (iv) Help the State and Local Government:

FIs help the state and local bodies financially by purchasing their bonds.

#### (v) Help the Central Government:

Similarly, they buy and sell central government securities and thus they help the central government.

#### (vi) Lenders and FIs both Earn:

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

#### (vii) Spread of Risks:

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

**(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

**2.13 Functions of the Financial Sector**

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:



**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### **Value exchange**

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.

**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

### **Intermediation**

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

#### **Risk transfer**

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

#### **Liquidity**

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

#### **The Characteristics of Finance**

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the

## Unit 02: Financial System and Economic Development

assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

### Summary

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets,

instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

### Keywords

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

**Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups." Comment.
5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

**Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. — — — — represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset
  - d. none of these
3. Financial derivatives include
  - a. Stocks
  - b. Bonds
  - c. Futures
  - d. None of the above
4. Which of the following is the regulator of Money market?
  - a) Reserve Bank of India
  - b) Government of India
  - c) Telecom Regularity Authority
  - d) Insurance Regularity Department
5. What is Call Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
6. What is Notice Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
7. What is Term Money?
  - a) It is an overnight loan in the Money Market

- b) It is loan of above 1 day to 14 days in the money market  
 c) It is loan of above 14 day to 364 days in the money market  
 d) It is a loan provided on certain terms and conditions by Bank to its customer
8. Which of the following is not related with Money Market?  
 a) Treasury Bills  
 b) Commercial Bills  
 c) Certificates of Deposit  
 d) Shares
9. Which of the following is related with Money Market?  
 a) Treasury Bills  
 b) Commercial money  
 c) Cheque  
 d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:  
 a) Shorter term Markets  
 b) Capital Markets  
 c) Counter Markets  
 d) Long-term Markets
11. What is the main function of financial intermediaries?  
 a. Connecting savers and borrowers.  
 b. Regulating the finance industry.  
 c. Acting as a fail-safe during financial crises, such as the Great Recession.  
 d. Facilitating investment in major corporations.
12. Which of the following is not an example of a common financial intermediary?  
 a. A commercial bank.  
 b. The Federal Reserve  
 c. The stock market  
 d. The bond market
13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?  
 a. The federal government is indirectly involved because it regulates financial intermediaries.  
 b. Financial intermediaries do not deal directly with borrower-spenders.  
 c. Financial intermediaries do not deal directly with saver-lenders.  
 d. Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
14. Which of the following statements about financial markets is not true?  
 a. Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.  
 b. Sometimes intermediaries invest in the financial markets.  
 c. Financial markets are associated with "direct" finance.  
 d. When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.
15. Which one of the following is not a financial intermediary?  
 a. A money market mutual fund  
 b. A steel manufacturing plant  
 c. A property and casualty insurance company  
 d. A commercial bank

### **Answers: Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

### **Further Readings**

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## Unit 03: Commercial Banking India

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions. Banks provide packages of financial services which individuals find too costly to search out, produce and monitor by them. Commercial banking offers a wide variety of services to small, medium and large-scale business units. The role of banking is more prominent in the open economy.

*“A bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits.” – Benhams*

A central bank is the essential wellspring of cash supply in an economy through the flow of currency. It guarantees the accessibility of cash for meeting the exchange needs of an economy and encouraging different financial exercises, for example, creation, dissemination, and utilization.

Notwithstanding, for this reason, the central bank needs to rely on the reserves of commercial banks. These reserves of commercial banks are the optional wellspring of money supply in an economy. The main function of a commercial bank is the creation of credit.

Credit creation isolates a bank from other monetary establishments. In basic terms, credit creation is the development of reserves. Furthermore, banks can extend their demand deposits as numerous of their money holds since demand deposits fill in as the important medium of trade.

### **3.1 Commercial Banks**

The Indian financial sector has considerably widened and deepened, thereby lending strong support to capital accumulation and overall economic growth. The commercial banks in India constitute the single-most important component of the Indian financial system in bringing about the bulk of financial intermediation process in the country. A significant part of this impressive record of financial development in India is attributable to the crucial role played by banks in the financial intermediation process. In India the financial sector comprises the banking system (i.e. commercial and cooperative banks), financial institutions (which include term lending institutions, i.e. IDBI, NABARD, ICICI, IRBI, IFCI, EXIM Bank and NHB at the all-India level and SFCs and SIDCs at the state level, besides investment institutions, i.e. UTI, LIC and GIC and other institutions including DICGC and ECGC), non-banking financial intermediaries and the capital market.

#### **Evolution of Commercial Banking**

The evolution of banking which lasted for centuries until two types of modern banking developed in the industrially advanced economies in the late nineteenth century was an integral part of the expansion of capitalism. The techniques of banking developed in the 17th century facilitated the industrial and territorial expansion that began about the same time. Banking systems evolved to meet the demands of the constituents, vested interests are regulations governing their establishment. The British system evolved around the central banking system with a central bank and clearing banks with a large network of offices regulated by the central bank while the German one evolved out of an identification of interests of finance, industry and government to

provide multiple services to the constituents. The US system however was set apart by the dominance of the unit banks, the role played by an active interbank market in deposits and reserves and the cooperative lending practices. It also features wholesale banking, which was the source of several innovative practices such as rollover credit or flexi rate lending.

#### **Structure of Indian Commercial Banks**

Having established the pivotal role performed by the banking system in the Indian financial sector and by implication, in the overall financial intermediation process, thus supporting the real sector of the economy. The strong points of the financial system are its ability to mobilize savings, its vast geographical and functional reach and institutional diversity.

The commercial banking structure in India consists of: Scheduled Commercial Banks and Unscheduled Banks. Scheduled commercial banks constitute those banks, which have been

included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI includes only those banks in this schedule, which satisfy the criteria laid down vide section 42 (6) (a) of the Act. Indian banks can be broadly classified into nationalized banks/ public sector banks, private banks and foreign banks. The Indian banks include 27 public sector banks excluding 196 Regional Rural Banks (RRBs).

#### **Asset Structure of Commercial Banks**

Assets structure will reflect the deployment of sources of funds of commercial banks. The main source of funds of commercial banks is deposits. The other sources of funds are borrowings from other banks, capital, reserves and surplus. The deposits of commercial banks are from savings



deposits, current account deposits and term deposits. These deposits constitute 80 per cent of the total sources of funds. Out of the total deposits, term deposits constitute 50 per cent. Borrowings are around 5 per cent of the total liabilities of the commercial banks. These sources are deployed by the commercial banks mainly on its financial assets i.e, loans and advances which constitute 48.6 per cent of the total assets of the banks. The investments is another important component of the assets of commercial banks which is around 40 per cent of the total assets of the banks during the year 2005. This is because of pre-emptions like SLR and CRR requirements in the banking sector. The investments in commercial banks have increased also because of surplus liquidity in Indian banks during this period due to reduction of SLR and CRR to 25 and 4.5 respectively during that period and less demand for loans and advances from credit-worthy customers. This scenario is changing in India due to increasing demand in credit from industrial, agriculture sector and also the growth of FMCG market.

The assets structure of the banks is governed by certain principles, like liquidity, profitability, shiftability and risklessness. The other factors which influence the assets structure of commercial banks are nature of money market, economic growth of the country, policies and vision of the governments. In the countries like India, China, Russia, North Korea and Brazil there is a boom in the growth of the economy hence naturally there will be heavy demand for the credit. Now let us examine each of the important assets of the commercial bank.

**1. Cash in hand and balances with RBI.** From the point of the liquidity in the commercial banks cash in hand is a very important asset but it is idle and it will not fetch any earnings to the banks. Cash in commercial banks depends upon various factors like uncertainty in the economy due to wars, famine, internal disturbance, the growth of banking system, network of branches, networking of banks, automation in banks and so on. The cash reserve requirements in the commercial banks was more during pre-reform period it was 15 per cent during the year 1994-95. Gradually RBI reduced it to 4 per cent based on the requirements of credit and it is now 5 per cent on Net Demand and Time Liabilities.

**2. Money at Call and Short Notice.** It is second line of defense of the commercial banks in cases of emergencies. If the call money market is well developed the commercial banks can lend their surplus funds in the call market for a day or up to 14 days it is called call market or overnight market without keeping their surplus money idle. It can also lend for short period, where the borrower has to return the money borrowed from the banks when short notice is given by the banks. This is becoming a good business in the money market and constitutes around 4 per cent of the total assets of the commercial banks. The banks instead of keeping the money idle lend their surplus funds for short periods in the call market.

**3. Investments.** Investments constitute one of the important assets of the bank next to loans and advances. A bank makes investments for the purpose of earning profits. First, it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject

to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity.

**4. Loans and Advances.** The commercial banking industry in India has been playing a very important role in intermediating between the economic units, which have surpluses and deficits in their current budgets. By mobilizing financial surpluses in the economy and by channeling these resources into various sectors and segments of the economy, they are guiding the pattern of utilisation of a large proportion of the economy. The Government of India which owns a large segment of the industry, and the RBI, which is the central banking authority of the country, have been persuading the commercial banks to deploy larger and larger volumes of financial resources into certain identified priority sectors, for the purpose of accelerating the growth of these sectors. The total advances of commercial banks include bills purchased and discounted, cash credits, overdrafts, loans, unsecured loans, and priority sector advances. The component of loans and advances in the total assets of commercial banks is 48 to 50 per cent – in fact still growing in India. The management of this asset is a very important aspect in the banking sector. The non-performing assets in banks is increasing. In addition to this banks are exposed to various risks such as credit risk, liquidity risk, market risk and operational risk.

**5. Fixed Assets and other assets.** The component of fixed assets and other assets do not form an important aspect in the funds of commercial banks since deals are more in financial assets than real assets.

### **Factors affecting Banking Systems Growth**

While provision of payment services involving the transfer of ownership of bank deposits from one account to another, provision of deposit facilities and advance credit by means of overdrafts and loans, by the discounting of bills and by trade finance constitutes the ordinary business of banking, there has been a sea change in the business of banking in the last forty years as exemplified by the rise of wholesale banking, liability management, international banking, multiple currency loans, rollover credits, securities lending collateralised mortgages note issuance facilities, interest rate and currency options and financial futures.

*Example:*

Credit cards

Debit cards

Automated teller machines

E-cash and on-line banking

Banks globally have undergone fundamental changes because of the ongoing revolution in information technology and communications. The winds of change are reshaping the nature of banking and financial markets. The demand for new types of services as well as the need to step up earnings through fee income is the major factor. On the other hand, technological advances by reducing costs give individuals and business firms direct access to markets reducing the need for banks to offer certain services. Technological advances and subsequent innovations have also led to the creation of new markets in terms of future options, secondary mortgage markets expanding the range of portfolio strategies open to financial intermediaries.

The changes in competitive conditions since 1990s with banks as a leading partner of financial services industry have transformed banks (especially large international ones) into new financial firms. Among the important factors behind changes in competitive conditions are the internationalization of banking and financial markets. The opening up of financial markets, the supply of cross-border financial services and the impact of the entry of foreign commercial and investment banks are the important features of the process. Other factors are the continuous process of deregulation, partly as a consequence of the globalization of the markets and partly as a middle through process. The sources of change of banking industry, mergers and amalgamations of banks, integration of markets by exchanges, growth of financial information business and internet.

### **3.2 Functions of Commercial Banks**

Prof. Syers, defined banks as “institutions whose debt – usually referred to as ‘bank deposits’ – are commonly accepted in final settlement of other people’s debts”. According to Banking Regulation Act of 1949, “Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise”. From the above definitions we can analyze that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

**1. Receiving deposits from the public.** The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity.

**2. Giving loans and advances.** The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and silver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and foreign banks, the other commercial banks also started giving loans and advances not only to their

traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.

**3. Use of cheque system and credit cards.** The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

**4. Credit creation.** Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

**5. Financing foreign trade.** The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

**6. Transfer of funds.** Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transferring funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.

**7. Agency functions.** The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers.

**8. Miscellaneous functions.** The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc. advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. The Ghosh Committee recommended that "a bank's investment portfolio should be bifurcated into two parts, namely, 'permanent investment' and 'current investment'. The committee recommended that banks should make necessary provision for the depreciation in the value of current investment and there is no need to provide for permanent investment. RBI has also advised the banks to classify the existing investment in approved securities into two categories. Initially from the accounting year 1992-93, banks should not keep more than 70% of their investment in permanent category, and 30% of the portfolio as current investments to facilitate valuing all the investments on fully 'marked to market' basis. Guidelines were laid down for transfer of approved securities from 'current' to 'permanent' and 'vice versa' in 1992. These guidelines ensure that latent losses are provided for at the time of such transfer. In 1993 the entire investment portfolio of banks other than investments classified as 'permanent' has to be classified into six categories for the purpose of valuation. The valuation will be done for each category of investments. While net depreciation has to be provided by debit to the profit and loss account, net gains have to be ignored. Permanent investments can be carried at book value. Premium will have to be amortized over the life of the investment but discount cannot be recognized as income.

## Transformation Services

Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process. Firstly, liability, asset and size transformation consist of mobilization funds and their allocation (provision of large loans on the basis of numerous small deposits). Secondly, maturity transformation by offering the savers, the relatively short-term claim on liquid deposits they prefer and providing borrowers long-term

loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. Commercial banks by effectively appraising credit requests can channel funds into productive uses.

### **Transformation Services and Risks**

Banks incur risks while undertaking transformation services. In the past three decades, banks abroad assumed new roles and accepted new forms of financial intermediation by undertaking currency and interest rate swaps and of dealing in financial futures, options and forward agreements. These new instruments reflect considerable flexibility in responding to market situations and adjusting continually assets and liabilities both on and off-balance sheet, while enhancing profitability.

### **3.3 Risk Management**

Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management. In the words of Alan Greenspan, former Chairman of the Federal Reserve Board of US (Conference at Federal Reserve Bank of Chicago, May 12, 1994), "traditional banking can be viewed at an elemental level as simply the measurement, management and acceptance of risk" and banking involves understanding, processing and using massive amounts of information regarding the credit risks, market risks and other risks inherent in a vast array of products and services, many of which do not involve traditional lending, deposit taking and payment services. Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks. To some extent, these risks could be managed through sound business practices and the others through a combination of product design and pricing. In the past banks concentrated on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that for given liquidity level, the return was the maximum.

**Overall Risk of a Bank:** A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.

**Types of Risk:** Banks have to manage four types of risk to earn profits for maximizing shareholder wealth. These are credit risk, interest rate risk, liquidity risk and operational risk. In addition there is a systematic risk arising due to various disruptions in the working of a major bank, which in notime could spread to other banks or the whole financial system. Credit risk arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by an increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of the borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally, operational risk arises out of an inability to control operating expenses, especially non-interest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardize the banks prospects to survive. Empirical analysis reveals that banks risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks maturity gaps, the duration and interest elasticity of its assets and liabilities and the ability of the management to measure and control the exposure.

**Interest Sensitive Assets Notes:** These risks are a part of either assets or liabilities or both of a bank them. Assets are managed through money market instruments such as interbank lending, treasury bills and repos. Shortening the maturity of these assets makes them interest sensitive. Shifting liabilities such as interbank borrowing, issue of CDs while shortening the maturity of the liability side of the balance sheet makes liabilities more interest-sensitive and increases the risk of the bank's portfolio.

**Credit Risk:** The assets of a bank whether a loan or investment carries credit risk. Credit risk is the risk of losing money when loans default. Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans. Banks can raise their credit standards to avoid high risk loans. Guarantees and collaterals can reduce risk. After the loan is made, compliance can be ensured by monitoring the behaviour of the borrower which reduces risk. Credit risk can be transferred by selling standardized loans. Loans portfolio can be

diversified by making loans to a variety of firms whose returns are not perfectly and positively correlated.

**RBI Guidelines:** RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk. Banks are also expected to evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

**Interest Rate Risk:** Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both. On-balance sheet adjustment involves changes in banks portfolio of assets and liabilities, as interest rates change. When medium or long-term loans are funded by short-term deposits, a rise in the rate of interest will increase the cost of funds but the earnings on the assets will not, thereby reducing the margin or spread on the assets. The problem could be resolved by adopting adjustable interest rate on loans on the asset side of the balance sheet and increasing the maturity pattern of deposits on the liability side of balance sheet. These decisions relating to banks portfolio of assets and liabilities represent balance sheet adjustments. The interest rate risk position can also be adjusted by the bank by making off-balance sheet adjustments which involve the use of various non-traditional financial instruments referred to as derivatives such as futures, options, swaps or creation of synthetic loans through use of futures.

**Liquidity Risk:** Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank. The mismatch between short-term liabilities and long-term assets creates a severe funding problem as the liabilities mature. Again, if the duration of assets exceeds the duration of liabilities, the ability to realize liquidity from the assets of the bank is reduced. Liquidity needs are increasingly met by deposit and non-deposit sources of funds paying market rates of interest.

Banks have decreased the quantity of liquid assets they hold for the purpose of deposits withdrawal and loan demand. Liability management has replaced asset management as a method to fund liquidity needs. The effect of replacement of asset management by liability management would be enhancement of credit risk since liquid assets have been replaced by loans. The replacement of short-term assets by long-term assets would also require an increase in gross rates of return, since upward sloping yield curves require higher rate of return on long-term assets than on short-term assets.

**Foreign Exchange Risk:** Foreign exchange risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur. An open foreign exchange position implies a foreign exchange risk. When a bank owns an uncovered claim in foreign currency, it is said to be long and when it has uncovered liability in foreign currency, it is said to be short. There are several techniques available to hedge or cover exposure to foreign exchange risk. These techniques help in minimize the impact of unfavourable potential outcomes. Forward contracts, money market alternative, foreign currency futures, currency swaps and foreign currency options are used to cover exposure to foreign exchange risk.

**Treasury Functions:** To take advantage of the opportunities provided by development of new financial markets and the internationalization of banking while managing risk has led to the growth of treasury function within bank. The role of new treasury department is to manage a wide range of short-term assets and liabilities. The dealers employed in treasury department are constantly trading in wholesale deposits, interbank deposits, certificates of deposit, foreign exchange, repurchase agreements, securities, financial futures and options. Apart from trading in short-term assets and liabilities, the treasury department monitors the bank's position with respect to earnings and risks due to maturity gaps and interest rate or foreign currency exposures. The treasury department usually reports to a high-level treasury or asset and liability management committee. The committee after considering the entire balance sheet of the bank as well as off-balance sheet liabilities decides the treasury policy.

**Monitoring Risks:** To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed. A maturity profile shows all assets and all liabilities by maturities to enable the calculation of mismatches within each period. Rate-of-interest ladder classifies all assets and liabilities by repricing dates and allows the calculation of rate of interest risk for each period. Duration presents the interest exposure.

### **3.4 Asset and Liability Management**

Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals. Frozen lending was offset by increasing flexibility by making new loans against the provision of tradable assets which could be sold before expiry, in case of need. Against a background of rapid growth in the banking business, integrated approach to managing all assets and all liabilities evolved as balance sheets became more complex and as the volatility of interest rates and exchange rates increased. In the eighties, the rescheduling of debt of developing countries on account of their serious payments difficulties involved conversion of short-term and medium term assets into long-term and became frozen.

Banks abroad met the problem by raising long-term funds including capital liabilities. In the process, banks could meet the rise in capital adequacy norms stipulated by bank supervisors. Banks shifted their focus from growth to profitability and asset quality. Banks also started lending against negotiable assets and to the packaging for resale of conventional bank loans. Borrowers were encouraged to raise funds directly through issue of negotiable short-term paper by providing guarantees, standbys and backup facilities. Banks benefited from fee income without expanding balance sheet which would worsen capital ratios. Of course, off-balance sheet contingent liabilities went up.

There was a deliberate attempt to extend asset liability management beyond the range of on-balance sheet assets and liabilities which arises from the bank acting as principal in direct transactions with borrowers and lenders of money. Asset and liability management has helped to bring about securitisation of banking blurring the distinction between commercial banking and investment banking.

### **3.5 RBI Guidelines for Risk Management**

Consequent to the liberalization of domestic market in India, the volatility in interest/exchange rates would be transmitted to the financial sector as a whole. To address these risks, banks have to undertake a comprehensive Asset Liability Management (ALM) strategy. The objectives of ALM are to control volatility of net interest income and net economic value of a bank. RBI issued guidelines on 21.10.1999 for risk management in banks which broadly cover credit, market and operational risks. Earlier, guidelines were issued on 10.2.1999 on asset-liability management system which covered management of liquidity and interest rate risks. Together they are purported to serve as benchmark to banks.

**Notes Credit Risk:** Banks should put in place the loan policy covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive credit ratings system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions. Proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. Portfolio quality should be evaluated on an ongoing basis rather than near about balance sheet date. Risk evaluation should be on the basis of total exposure, credit and investment decisions combined. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. A suitable framework to provide a centralized overview of the aggregate exposure on other banks is to be evolved. The banks should also develop an internal matrix that reckons the counter party and country risk.

**Liquidity Risk:** Banks should put in place prudential limits on interbank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments and swapped funds. Liquidity profile should be evaluated under bank specific and market crisis scenarios. Contingency plans should be prepared to measure the ability to withstand sudden adverse swings in liquidity conditions.

**Interest Rate Risk:** A time-frame should be fixed for moving over to value at risk (VAR) and duration approaches for measurement of interest rate risk.

**Market Risk:** Explicit capital cushion based on international standards should be provided for the market risks to which banks are exposed.

**Operational Risk:** In view of the phenomenal increase in the volume of financial transactions, proper systems for measurement, monitoring and control of operational risk should be set up. Suitable methodologies for estimating and maintaining economic capital should be developed.

The design of the risk management should be oriented towards the banks own requirements dictated by the size and complexity of business risk philosophy, market perception and the existing level of

capital. Banks can evolve their own systems compatible with the type and size of operations as well as risk perception. It is neither possible nor necessary to adopt uniform risk management system in all banks on account of the diversity and varying size of balance sheet items. The success of ALM depends on the effective existence of (1) information and policies, and (2) risk management system. There should be asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimize the volatility in its earnings, liquidity and equity to changes in market conditions. The successful pursuit of the objective would manifest in stable net interest margins, optimal earnings, adequate liquidity and effective control of financial risk. For this purpose the strong ALCO must be aware of policies which would address asset liability management goals and risk limits and by information that relates directly to its asset liability position.

### **3.6 Risk Management Systems**

Measurement, control and monitoring of risk will help banks to attain the objective. Techniques such as gap, duration and value at risk are suggested to analyse risk. Strengthening of information technology in commercial banks is a prerequisite to implement effectively A.I.M system. The role of a broad-based ALCO in advising boards of banks is of significance.

**Financial Services:** Commercial banks provide securities related services. Commercial banks in India have set up subsidiaries to provide capital market related services, advice on portfolio management or investment counseling. In US, the Glass-Steagall Act of 1933 restricts the nature of services provided by commercial banks. In US, they may offer discount brokerage services but not general-purpose brokerage services. US banks facilitate mergers and acquisitions and in trading in currencies and US Government securities.

The Glass-Steagall Banking Act prohibits commercial banks from owning a firm dealing in securities. The Act has been challenged by banks offering money market mutual funds and other investment services. US Federal Reserve Board in January, 1997 issued a proposal that would allow bank holding companies and their securities industry affiliates to offer one stop shopping for their customers. Commercial banks in US in 1990s have become very active in the management and distribution of mutual funds, managing more than 10 per cent of the assets of all mutual funds. In India, several commercial banks such as Bank of India, Canara Bank, Indian Bank and State Bank of India have set up subsidiaries under the guidelines issued by the Reserve Bank in 1987, followed by guidelines laid down by the Ministry of Finance in 1991.

**Fiduciary Services:** In US, banks manage employee pension and profit-sharing programs that do not show up on banks balance sheet. In US, banks operate separate trust departments which manage the funds of others for a fee under the guidance of a trust agreement. The assets held in trust do not show up on banks balance sheet because they do not own the assets held in trust.

### **3.7 Nature of Primary Reserve in Commercial Banks**

The term primary reserve is an analytical term used commonly in banking to refer to absolutely non-earning liquid assets held by a commercial bank. The aggregate of cash holdings by bank with itself and with the central bank and other commercial banks is designated as the primary reserve. It consists of cash in hand, the balance with RBI and demand deposits with other banks. A major function of primary reserve is to maintain liquidity in the bank with a view to protecting

it against illiquidity crises. It enables the bank to satisfy the depositors' claims immediately to perform its expected crisis. The primary reserve plays the role of first day-to-day business needs but to comply with the obligation imposed on it by law. The primary reserve may be divided into:

1. Legal Reserve
2. Working Reserve

**The legal reserve** represents that portion of the primary reserve, which the law requires a bank to maintain. The reserves are computed on the basis of the average deposits outstanding on the bank's books over a short period (one or two weeks). Since the bank is a dealer in public money and attracts public deposits on the premise that the deposits on the premises that the depositors will get back their money on demand, the government has the responsibility to ensure sufficient liquidity in the banking system so that the depositors' claims are met in full as promised. The law prescribes the minimum percentage of deposits, which a commercial bank has to carry with the central bank. By changing the reserve requirements, the central bank can regulate the magnitude of credit. In order to curb inflationary trends, banks may raise the reserve requirements and restrict the lending and investment activities of banks. Similarly the legal reserve weapon may be used along with

other control techniques to take out economy from the possibility of depression, which is another undesired situation to keep the nation on growth track.

The regulatory function of legal reserve involves three steps by the government of the central banking authority:

1. Defines those particular types of assets which can be counted towards the legal reserve requirements. According to RBI the two types of assets- Cash in hand and balance with RBI are considered eligible for legal reserve purpose.
2. Regulates the rupee volume of the legal reserve maintainable by banks. In India, this is the main function of the RBI.
3. Requires banks to hold legal reserves equal to at least some stated fraction of their deposit liabilities.

**Statutory Provisions Regarding Cash Holdings:** The RBI Act, 1934 empowered RBI to require scheduled banks to keep with it not less than 5 percent of their demand liabilities and 2 percent of their time liabilities. RBI announces its CRR policy for the year such that the banks can cope up with the maintaining of adequate Cash Reserve Ratios to prevent illiquidity.

### **Working Reserve - Nature and Functions**

Commercial Banks have to carry cash reserves in excess of the legal minimum reserve to meet the depositors' claims, satisfy the credit needs of the community and provide protection against unforeseen withdrawals. This excess cash reserves held by the commercial banks to fulfill day today business requirements is designated as working reserve. This consists of:

1. Cash in their own vaults.
2. Demand deposits with other banks
3. Excess reserve with the central bank.

The principal function of the working reserve is to take care of both regular and exceptional requirements. Since they have to meet the obligatory demands of human, predicting about their requirements is very difficult and that's why determining working reserve determining is complicated. How much of total deposit liabilities should be held in the form of working reserves is a basic problem which confronts a commercial bank. A commercial bank has to trade off between liquidity and profit. In order to determine the proper size of the working reserve a banker should consider all those variables, which affect the quantum and nature of money inflows, and cheques are collected. The various factors, which generally affect are:

1. Banking habit of the people
2. Nature of Business conditions
3. Seasonal factors
4. Existence of clearing house arrangements
5. Cash reserves held by other Banks
6. Structure of Deposits
7. Size of Deposit Accounts
8. Ownership of deposit accounts
9. Size of secondary Reserve
10. Location of Bank
11. availability and cost of borrowings
12. Ownership of deposit account
13. Banks inclination and ability to adjust working reserve position.

### **3.8 Cash Management in a Commercial Bank**

An efficient utilization of cash is essential for the successful survival of a bank. A bank receives money from customers in various deposit accounts and pays cash to depositors and demand cheques or demand drafts or bank orders etc. The basic issues involved in cash management in a bank are:

1. The management has to keep the cash balance at the lowest possible level in order to avoid the loss of opportunity income.
2. A low cash level will mean a greater risk of running out of cash and higher cost of replenishment.

Prudence in the management of cash lies in striking a balance between the two factors. The banks have to compile data weekly about:

1. Cash receipts from the customers
2. Cash receipts by way of remittances
3. Routine cash payments to customers.



4. Payments in the form of remittances to the head office
5. The amount of cash receipts utilized for the purpose of making everyday.

Cash Management system should be effective to increase profitability and liquidity of any bank. The bank managers should compile periodically information relating to cash receipts, cash payments and similar other information (weekly) and submit to the head office. The head office should analyze the data and determine the optimal cash levels for huge withdrawals and determine cash inventory levels by scientific inventory management techniques. They can be applied to determine optimal cash levels for each bank and if followed that would improve the profitability of a bank.

### **3.9 Nature of Secondary Reserve in Commercial Banks**

A commercial bank generally relies on highly liquid earning assets to meet its expected and unexpected financial needs because it can't afford to hold a larger proportion of funds in the vault for the reasons stated earlier. The aggregate of highly liquid earning assets is designated as the secondary reserve in banking circles. The principal objective of holding the secondary reserve is to impart adequate liquidity to funds without adversely affecting the profitability of a bank. The bank must have such assets which are highly liquid and at the same time generate some yield on them. Call loans to brokers or bankers which may be terminated at any time at a very short notice may be regarded as highly liquid assets. Keeping above requirements of high liquidity, yield and shiftability, the following types of assets may be grouped in the category of secondary reserve:

1. Call loans to stock brokers and commercial banks.
2. Short term loans to commercial banks.
3. Short term loans secured against self liquidating assets or blue chips.
4. Investment in treasury bills.
5. Promissory notes of short period maturity.
6. Discounting of usance bills eligible for rediscounting from the RBI.
7. Short period debentures of companies.

### **3.10 Functions of Secondary Reserve in Commercial Banks**

The principal function of the secondary reserve is to replenish the primary reserve, while its subsidiary function is to earn a moderate income. Since it is very difficult to estimate correctly the working reserve requirements because the bank deals with human beings who are motivated by a variety of factors, a banker would like to keep a little more cash in the vault than is absolutely necessary to avoid an illiquid crisis. Secondary reserve helps a banker to trade off successfully between liquidity and profitability. Where a bank has a surplus in the primary reserve because of heavy cash inflows, it is invested in secondary reserve assets so that it may be drawn conveniently. Moreover the bank can earn some yield rather than earning nothing or a less yield.

### **Factors Influencing the Level of Secondary Reserve in Commercial Banks**

The factors can be classified into External factors and Local factors:

#### ***External Factors***

1. **General state of Economy:** If the level of business activity is expected to increase, which means more demand for business loans the banker can keep large proportion of loans in secondary reserve to meet the requirements.
2. **Political conditions:** When there are uncertain political conditions in the country, banks generally lose public confidence and consequently there is a run on the banks. In such conditions to meet the heavy customers banks have to invest in secondary reserves more and release conveniently.
3. **Taxation policy** of the government may affect the size and composition of the secondary reserve. A bank may be tempted to invest more in government securities if the government decides to exempt them from the levy of tax because this investment will not only strengthen the liquidity position of the bank and also profitability.
4. **Monetary policy:** A banker has to understand the monetary policies announced by the central bank and expected to be followed at the same time liquidity and profitability are also balanced.

#### **Local Factors**

Character of the local economy- A banker must be familiar with the characteristics of the economy in which he is operating because the character and magnitude of deposits and loans is affected by them. Indian economy is dominated by agriculture and its requirements are highly vulnerable therefore because banks receive large deposits after the harvest season, while withdrawals take place throughout the year. Similarly the banks in industrial locality must familiarize with the industrial requirements pattern and accordingly invest the surplus in secondary reserves. A large number of internal factors such as deposit structures, ownership of

deposit accounts, average size of bank accounts, access to money market, nature of bank loan, maturities and diversification of investment portfolio are such other factors influence regarding the size of secondary reserves of a bank. Banks can apply statistical methods to analyse the various demand supply requirements of money and accordingly determine the structure its secondary reserve portfolio to maintain liquidity and profitability.

### **3.11 Management of Loans in a Commercial Bank**

Lending is the most important function commercial banks. At they aim at lending results in maximum return and their survival depends on high they can do it with in the frame work of central bank regulations and guidelines along with the social responsibility for the economy development as expected by the society. The important characteristics of commercial bank loans are:

1. The bulk of the loans in India are provided to trade and industries.
2. As the banks look at liquidity they give maximum proportion of loans of less than year type which are short term nature.
3. Commercial banks in India demand sound security like goods, financial assets, gold, and hypothecation. Unsecured credit loans are given to firms with a sound financial position and stable earning records.

Lending is the most profitable business of a commercial bank but at the same time it is highly risky. A banker is supposed to do the lending business on the sound principles of safety, liquidity and profitability. Banks should diversify their risk of lending by evolving to a right portfolio. It should not be merely defensive but provide for earning for increasing average rate of return on fund. The principle of maturity diversification allows the loan portfolio is staggered over different maturity periods so that a certain amount of loans mature at regular intervals of timeperiods so that the realizations can be utilized to meet the investors obligations. The funds can be invested in securities of diversified nature to earn reasonable returns.

Banks should check well into the purpose of loan an applicant seeks and track whether the loan is applied. This is important for productive purpose and the banks social obligations are also satisfied. An advance made to for non productive and speculative purposes is subject to high risk of recovery. A banker should avoid making loans against wasteful expenditure on social functions. The banker should examine whether the credit granted is not for a purpose other than that is sought. A bank has the social obligation of meeting the diverse credit needs of the society ranging from personal needs to small businesses to large industrial business needs. It can not afford to lend the funds of its depositors indiscriminately and incur losses. The loan policy should be carefully structured to maintain uniformity and standardization of lending policies. There is always a risk of misunderstanding and misinterpretation of the policy. In general, the loan policy in a bank largely influenced by the following factors:

1. **Capital position:** A bank having strong capital base can follow a liberal lending policy.
2. **Earning Requirements:** Profit making and required rate of return becomes the basis while structuring lending policy.
3. **Deposit variability:** Large variation is found between the urban banks and rural banks regarding demand and of supply of money. Banks expecting a rising tendency can go for liberal credit policy.
4. **State of local economy and National economy:** Banks have to understand the local needs and national needs due to variation in seasonality, commercial activity or agricultural needs.
5. **Monetary policy of the Central bank:** RBI announces the lending policy of term loans and interest rates range focusing on sectoral growth for prosperity and to put a check on inflationary movements affecting the common man and welfare of the economy. Fiscal disciplinary measures are to be followed by the banks and need to follow the directives of the central banks.
6. Term lending policy of a commercial bank is usually based on industrial activity and sectoral growth needs. Banks have to commit large funds to long term loans to industry. Commercial banks generally seek the assistance of banks like NABARD, IDBI etc. while granting collaborative lending to commercial purposes with respect to term loans. The commercial banks thus play an important role in the growth of an economy by mobilizing funds from small investors to business and play a critical role in the transformation of the nation to a greater and powerful economy. *Task* Prepare a project feasibility proposal as per the guidelines of a merchant Banker by selecting an entrepreneurial activity.

## Summary

The importance of Commercial banks and their contribution are discussed. An attempt is made to provide the effect of RBI banking regulations, demand supply theory of money, interest and profitability of banks are explained. The risk management practices observed by banks are discussed. The management of primary and secondary reserves, loan policy formulation and issues involved are discussed. There is also discussion on the financial institutions, which offer a variety of specialized to traditional services to the business and act as mediators and agents of transfer of funds to create wealth to the society at some charge for the service, which would be their source of revenue. They have the obligation of creating a qualitative Financial System and should cooperate with the regulatory bodies engaged with various measures to discipline the economic system.

## Keywords

**Credit or loan:** Credit or loan refers to sum of money along with interest payable.

**Finance:** Finance is monetary resources comprising debt and ownership funds of the state, company or person.

**Financial Institutions:** Financial Institutions are business organizations that act as mobilizers and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the society.

**Financial System:** Financial System is concerned about money, credit and finance.

**Money:** Money refers to the current medium of exchange or means of payment.

## Review Questions

1. What is the role of commercial banking in developing the economy?
2. Explain about the functions of commercial banks.
3. Write about the regulating policies RBI with respect to commercial banks.
4. What are the various factors influencing the level of secondary reserve in commercial banks?

## Self Assessment

1. In a market-oriented financial system, specialized .....including banks, financial markets and market intermediaries cater to the different financial needs.
2. In a .....financial system, savings are largely transferred directly from those who generate them to those wishing to use them by the intermediation of banks.
3. ....consists of provision of banking services by a single institution.
4. A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the .....of the value.
5. ....arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise.
6. Liquidity risk refers to the bank's ability to meet its .....obligations to depositors and borrowers.
7. ....risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.
8. ....is the link between financial markets and bank's profitability.
9. A capital shortage of a bank indicates that it should change, among others, its .....policies.
10. .... indicates how well a bank's programmes can be sustained and the capital sum serves as a cushion against temporary losses.
11. Market discipline according to .....is a lever to strengthen the safety and soundness of the banking system.
12. ....is the most profitable business of a commercial bank but at the same time it is highly risky.

13. Term lending policy of a commercial bank is usually based on industrial activity and .....needs.
14. A bank has the social obligation of meeting the diverse ..... needs of the society ranging from personal needs to small businesses to large industrial business needs.
15. .... reserve helps a banker to trade off successfully between liquidity and profitability.

### **Answers for Self-Assessment**

1. financial institutions
2. bank-oriented
3. Unit banking
4. standard deviation
5. Credit risk
6. cash
7. Foreign exchange
8. Bank capital
9. Operating
10. Return on bank capital
11. BCBS
12. Lending
13. sectoral growth
14. credit
15. Secondary

### **Further Readings**

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## Unit 04: Central banking

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### objectives

After this lecture, you would be able to

- To explore the structure of a central bank in an economy.
- To evaluate the functions of central bank in an economy.
- To explore the process of credit control by central bank
- To evaluate the methods of credit control by central bank
- To explore the central banks and monetary policy of India.
- To evaluate the central banks and monetary policy of India.

### Introduction

The origins of the Reserve Bank of India can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton-Young Commission – recommended the creation of a central bank for India to separate the control of currency and credit from the Government and to augment banking facilities throughout the country. The Reserve Bank of India Act of 1934 established the Reserve Bank and set in motion a series of actions culminating in the start of operations in 1935. Since then, the Reserve Bank's role and functions have undergone numerous changes, as the nature of the Indian economy and financial sector changed. Starting as a private shareholders' bank, the Reserve Bank was nationalized in 1949. It then assumed the responsibility to meet the aspirations of a newly independent country and its people. The Reserve Bank's nationalisation aimed at achieving coordination between the policies of the government and those of the central bank.

## **4.1 Central Bank**

A central bank has been defined in terms of its functions. According to Vera Smith, "The primary definition of central banking is a banking system in which a single bank has either complete control or a residuary monopoly of note issue." W.A. Shaw defines a central bank as a bank which control credit. To Hawtrey, a central bank is that which is the lender of the last resort. According to A.C.L. Day, a central bank is "to help control and stabilise the monetary and banking system."

According to Sayers, the central bank "is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behaviour of financial institutions so as to support the economic policy of the Government." Sayers refers only to the nature of the central bank as the government's bank. All these definitions are narrow because they refer only to one particular function of a central bank.

On the other hand, Samuelson's definition is wide. According to him, a central bank "is a bank of bankers. Its duty is to control the monetary base.... and through control of this 'high-powered money' to control the community's supply of money." But the broadest definition has been given by De Kock.

Reserve Bank of India being an apex court of the center enjoys enormous power and functions under banking system in India. It has monopoly over the issue of bank-notes and monetary system of the country. These power and functions as to issue of bank notes and currency system are governed by the Reserve Bank of India Act, 1934. Besides it the Banking Regulation Act, 1949 also empowers certain power and Function of the Reserve Bank.

### **Main Functions of CENTRAL BANK**

A central bank is "a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions:

i) The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof,

(ii) The performance of general banking and agency for the state,

(iii) The custody of the cash reserves of the commercial banks,

(iv) The custody and management of the nation's reserves of international currency,

(v) The granting of accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions and the general acceptance of the responsibility of lender of the last resort,

(vi) The settlement of clearance balances between the banks,

(vii) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state." De Kock's definition is too long to be called a definition. For, a definition must be brief.

Main functions are those functions which every central bank of each nation performs all over the world. Basically, these functions are in line with the objectives with which the bank is set up. It includes fundamental functions of the Central Bank. They comprise the following tasks.

**1. Issue of Currency Notes:** The central bank is the bank of issue. It has the monopoly of note issue. Notes issued by it circulate as legal tender money. It has its issue department which issues notes and coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank.

Central banks have been following different methods of note issue in different countries. The centred bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued.

In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank. This system is operative in India whereby the Reserve Bank of India is required to keep Rs115crores in gold and Rs85crores in foreign securities. There is no limit to the issue of notes after keeping this minimum amount of Rs200crores in gold and foreign securities.

The monopoly of issuing notes vested in the central bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public.

The central bank can restrict or expand the supply of cash according to the requirements of the economy. Thus it provides elasticity to the monetary system. By having a monopoly of note issue, the central bank also controls the banking system by being the ultimate source of cash. Last but not the least, by entrusting the monopoly of note issue to the central bank, the government is able to earn profits from printing notes whose cost is very low as compared with their face value.

**2. Banker to other Banks:** Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on governments deposits. It buys and sells foreign currencies on behalf of the government., It keeps the stock of gold of the government.

Thus it is the custodian of government money and wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt.

The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc. As pointed out by De Kock, "Central banks everywhere operate as bankers to the state not only because it may be more convenient and economical to the state, but also because of the intimate connection between public finance and monetary affairs."

**3. Banker to the Government:** The CENTRAL BANK being the apex monetary body has to work as an agent of the central and state governments. It performs various banking function such as to accept deposits, taxes and make payments on behalf of the government. It works as a representative of the government even at the international level. It maintains government accounts, provides financial advice to the government. It manages government public debts and maintains foreign exchange reserves on behalf of the government. It provides overdraft facility to the government when it faces financial crunch.

**4. Custodian of cash reserves of commercial banks:** Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions.

- There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock.
- In the first place, the centralisation of cash reserves in the central bank is a source of great strength to the banking system of a country.
- Secondly, centralised cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks.
- Thirdly, centralised cash reserves can be utilised fully and most effectively during periods of seasonal strains and in financial crises or emergencies.
- Fourthly, by varying these cash reserves the central bank can control the credit creation by commercial banks. Lastly, the central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

**5. Exchange Rate Management:** It is an essential function of the CENTRAL BANK. In order to maintain stability in the external value of rupee, it has to prepare domestic policies in that direction. Also, it needs to prepare and implement the foreign exchange rate policy which will help in attaining the exchange rate stability. In order to maintain the exchange rate stability, it has to bring demand and supply of the foreign currency (U.S Dollar) close to each other.

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed prices to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the exchange rates of the domestic currency in terms of foreign currencies.

It holds these rates within narrow limits in keeping with its obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons

visiting foreign countries on business, studies, etc. in keeping with the rules laid down by the government.

**5. Lender of the last resort:** De Kock regards this function as a sine qua non of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse.

It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at "the front door". The other method is to give temporary accommodation to the commercial banks or discount houses directly through the "back door". The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

**6. Clearing house for transfer and settlement:** As bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques.

This is done by making transfer entries in their accounts on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centres. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and convenient for the commercial banks to settle their claims at one place. It also economises the use of money. "It is not only a means of economising cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining."

**7. Credit Control Function:** The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods.

Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilise economic activity in the country.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce. Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks.

They are the issuing of licences; the regulation of branch expansion; to see that every bank maintains the minimum paid up capital and reserves as provided by law; inspecting or auditing the accounts of banks; to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; to control and recommend merger of weak banks in order to avoid their failures and to protect the interest of depositors; to recommend nationalisation of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc. Commercial bank in the country creates credit according to the demand in the economy. But if this credit creation is unchecked or unregulated then it leads the economy into inflationary cycles. On the other credit creation is below the required limit then it harms the growth of the economy. As a central bank of the nation the CENTRAL BANK has to look for growth with price stability. Thus, it regulates the credit creation capacity of commercial banks by using various credit control tools.

**6. Supervisory Function:** The CENTRAL BANK has been endowed with vast powers for supervising the banking system in the country. It has powers to issue license for setting up new banks, to open new branches, to decide minimum reserves, to inspect functioning of commercial banks in India and abroad, and to guide and direct the commercial banks in India. It can have periodical inspections an audit of the commercial banks in India.



## **4.2 Objectives of Credit Control by the Central Bank:**

Credit control is the means to control the lending policy of commercial banks by the central bank.

The central bank controls credit to achieve the following objectives:

**1. To stabilise the internal price level:** One of the objective of controlling credit is to stabilise the price level in the country. Frequent changes in prices adversely affect the economy. Inflationary or deflationary trends need to be prevented. This can be achieved by adopting a judicious policy of credit control.

**2. To stabilise the rate of foreign exchange:** With the change in the internal prices level, exports and imports of the country are affected. When prices fall, exports increase and imports decline. Consequently, the demand for domestic currency increases in the foreign market and its exchange rate rises. On the contrary, a rise in domestic prices leads to a decline in exports and an increase in imports.

As a result, the demand for foreign currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilise the rate of foreign exchange by controlling bank credit.

**3. To protect the outflow of gold:** The central bank holds the gold reserves of the country in its vaults. Expansion of bank credit leads to rise in prices which reduce exports and increase imports, thereby creating an unfavourable balance of payments. This necessitates the export of gold to other countries. The central bank has to control credit in order to prevent such outflows of gold to other countries.

**4. To control business cycles:** Business cycles are a common phenomenon of capitalist countries which lead to periodic fluctuations in production, employment and prices. They are characterised by alternating periods of prosperity and depression. During prosperity, there is large expansion in the volume of credit, and production, employment and prices rise.

During depression, credit contracts, and production, employment and prices fall. The central bank can counteract such cyclical fluctuations through contraction of bank credit during boom periods, and expansion of bank credit during depression.

**5. To meet business needs:** According to Burgess, one of the important objectives of credit control is the "adjustment of the volume of credit to the volume of business." Credit is needed to meet the requirements of trade and industry. As business expands, larger quantity of credit is needed, and when business contracts less credit is needed. Therefore, it is the central bank which can meet the requirements of business by controlling credit.

**6. To have growth with stability:** In recent years, the principal objective of credit control is to have growth with stability. The other objectives, such as price stability, foreign exchange rate stability, etc., are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of payments deficits.

## **4.3 Role of Central Bank in a Developing Economy:**

The central bank in a developing economy performs both traditional and non-traditional functions. The principal traditional functions performed by it are the monopoly of note issue, banker to the government, bankers' bank, lender of the last resort, controller of credit and maintaining stable exchange rate. But all these functions are related to the foremost function of helping in the economic development of the country.

The central bank in a developing country aims at the promotion and maintenance of a rising level of production, employment and real income in the country. The central banks in the majority of underdeveloped countries have been given wide powers to promote the growth of such economies.

### **Creation and expansion of financial institutions:**

One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are

localised in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses.

In order to remedy this, the central bank should extend branch banking to rural areas to make credit available to peasants, small businessmen and traders. In underdeveloped countries, the commercial banks provide only short-term loans. Credit facilities in rural areas are mostly non-existent.

The only source is the village moneylender who charges exorbitant interest rates. The hold of the village moneylender in rural areas can be slackened if new institutional arrangements are made by the central bank in providing short-term, medium term and long-term credit at lower interest rates to the cultivators.

A network of co-operative credit societies with apex banks financed by the central bank can help solve the problem. Similarly, it can help the establishment of lead banks and through them regional rural banks for providing credit facilities to marginal farmers, landless agricultural workers and other weaker sections.

With the vast resources at its command, the central bank can also help in establishing industrial banks and financial corporations in order to finance large and small industries.

#### **Proper adjustment between demand for and supply of money:**

The central bank plays an important role in bringing about a proper adjustment between demand for and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops, the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agricultural and industrial production and prices.

The demand for money for transactions and speculative motives will also rise. So the increase in money supply will have to be more than proportionate to the increase in the demand for money in order to avoid inflation. There is, however, the likelihood of increased money supply being used for speculative purposes, thereby inhibiting growth and causing inflation.

The central bank controls the uses of money and credit by an appropriate monetary policy. Thus in an underdeveloped economy, the central bank should control the supply of money in such a way that the price level is prevented from rising without affecting investment and production adversely.

#### **A suitable interest rate policy:**

In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates and between interest rates in different sectors of the economy. The existence of high interest rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy. A low interest rate is, therefore, essential for encouraging private investment in agriculture and industry.

Since in an underdeveloped country businessmen have little savings out of undistributed profits, they have to borrow from the banks or from the capital market for purposes of investment and they would borrow only if the interest rate is low.

A low interest rate policy is also essential for encouraging public investment. A low interest rate policy is a cheap money policy. It makes public borrowing cheap, keeps the cost of servicing public debt low, and thus helps in financing economic development.

In order to discourage the flow of resources into speculative borrowing and investment, the central bank should follow a policy of discriminatory interest rates, charging high rates for non-essential and unproductive loans and low rates for productive loans.

But this does not imply that savings are interest-elastic in an underdeveloped economy. Since the level of income is low in such economies, a high rate of interest is not likely to raise the propensity to save.

In the context of economic growth, as the economy develops, a progressive rise in the price level is inevitable. The value of money falls and the propensity to save declines further. Money conditions become tight and there is a tendency for the rate of interest to rise automatically. This would result in inflation. In such a situation any effort to control inflation by raising the rate of interest would be disastrous. A stable price level is, therefore, essential for the success of a low interest rate policy which can be maintained by following a judicious monetary policy by the central bank.

**Debt management:**

Debt management is one of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing public debt. It is the central bank which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt.

In order to strengthen and stabilize the market for government bonds, the policy of low interest rates is essential. For, a low rate of interest raises the price of government bonds, thereby making them more attractive to the public and giving an impetus to the public borrowing programmes of the government.

The maintenance of structure of low interest rates is also called for minimizing the cost of servicing the national debt. Further, it encourages funding of debt by private firms. However, the success of debt management would depend upon the existence of well-developed money and capital markets in which wide range of securities exist both for short and long periods. It is the central bank which can help in the development of these markets.

**Credit control:**

Central Bank should also aim at controlling credit in order to influence the patterns of investment and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control.

Open market operations are not successful in controlling inflation in underdeveloped countries because the bill market is small and undeveloped. Commercial banks keep an elastic cash-deposit ratio because the central bank's control over them is not complete. They are also reluctant to invest in government securities due to their relatively low interest rates.

Moreover, instead of investing in government securities, they prefer to keep their reserves in liquid form such as gold, foreign exchange and cash. Commercial banks are also not in the habit of rediscounting or borrowing from the central bank.

**The bank rate policy is also not so effective in controlling credit in LDCs due to:**

- (a) The lack of bills of discount;
- (b) The narrow size of the bill market;
- (c) A large non-monetized sector where barter transactions take place;
- (d) The existence of a large unorganised money market;
- (e) The existence of indigenous banks which do not discount bills with the central banks;
- (f) The habit of commercial banks to keep large cash reserves.

The use of variable reserve ratio as method of credit control is more effective than open market operations and bank rate policy in LDCs. Since the market for securities is very small, open market operations are not successful. But a rise or fall in the reserve ratio by the central bank reduces or increases the cash available with the commercial banks without affecting adversely the prices of securities. Again, the commercial banks keep large cash reserves which cannot be reduced by a raise in the bank rate or sale of securities by the central bank.

But raising the cash-reserve ratio reduces liquidity with the banks. However, the use of variable reserve ratio has certain limitations in LDCs. First, the non-banking financial intermediaries do not keep deposits with the central bank so they are not affected by it. Second, banks which do not maintain excess liquidity are not affected than those who maintain it.

The qualitative credit control measures are, however, more effective than the quantitative measures in influencing the allocation of credit, and thereby the pattern of investment. In underdeveloped countries, there is a strong tendency to invest in gold, jewellery, inventories, real estate, etc., instead of in alternative productive channels available in agriculture, mining, plantations and industry.

The selective credit controls are more appropriate for controlling and limiting credit facilitates for such unproductive purposes. They are beneficial in controlling speculative activities in food grains and raw materials. They prove more useful in controlling 'sectional inflations' in the economy. They curtail the demand for imports by making it obligatory on importers to deposit in advance an amount equal to the value of foreign currency.

This has also the effect of reducing the reserves of the banks in so far as their deposits are transferred to the central banks in the process. The selective credit control measures may take the form of changing the margin requirements against certain types of collateral, the regulation of consumer credit and the rationing of credit.

**Solving the balance of payments problem:**

The central bank should also aim at preventing and solving the balance of payments problem in a developing economy. Such economies face serious balance of payments difficulties to fulfill the targets of development plans. An imbalance is created between imports and exports which continues to widen with development.

The central bank manages and controls the foreign exchange of the country and also acts as the technical adviser to the government on foreign exchange policy. It is the function of the central bank to avoid fluctuations in the foreign exchange rates and to maintain stability. It does so through exchange controls and variations in the bank rate. For instance, if the value of the national currency continues to fall, it may raise the bank rate and thus encourage the inflow of foreign currencies.

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#### **4.4 Need for Central Bank:**

It is widely recognised that the central bank is a valuable and indispensable institution for the proper functioning of a modern economy. But, there is a difference of opinion regarding the necessity and usefulness of the central bank in economically backward countries having underdeveloped money markets.

Some people argue that the central bank is not necessary in such countries for various reasons: such as the absence of well-organised banking institutions over which the central bank exercises its supervision and control, the absence of short-term money markets and of well-developed bill markets to enable the central bank to perform the rediscounting operations properly, the fear of political pressure of the governments of these countries over the normal working of the central bank, and others. For all these reasons it is argued that the central bank in the under-developed countries cannot execute its monetary policy and control-techniques properly and effectively.

But, the fact remains that the central bank is as indispensable in the underdeveloped countries as it is in the developed countries.

**For this reason it is now established that every country, whether developed or underdeveloped, must set up a central bank for the following reasons:**

***(a) Economic stability:***

The central bank is indispensable for maintaining stability in the economy of a country. It can maintain both price and foreign exchange stability through the exercise of proper and effective control over the country's total money supply.

Such economic stability is as essential for underdeveloped countries as for developed ones, for promoting rapid economic growth. No other institutions except the central bank is competent enough to maintain this overall economic stability.

***(b) Control over bank credit:***

The central bank is necessary to exercise a judicious control over bank credit. As bank credit constitutes the most important component of the money supply, its supply is to be properly regulated in time for avoiding instability in the price-level and for regulating its supply in accordance with the country's requirements.

***(c) Control and supervision over the activities of other banks:***

The central bank of a country can develop the banking system by exercising proper control and supervision over the operations of other banks. In the absence of the central bank, it becomes a difficult task to bring about proper co-ordination among the banks and to develop these institutions along a sound line.

***(d) Proper execution of the monetary policy:***

The central bank is the leader of the money market of a country. Therefore, its existence is of utmost importance for pursuing the country's monetary (credit) policy.

**(e) Special role of the central bank in a developing economy:**

The central bank has a special role to play in a developing economy in promoting economic growth with stability, in providing special finance for agriculture, industry and other top priority sectors.

**(f) Foreign exchange regulations and international dealings:**

Every country, whether a developed or an underdeveloped one, must have a monetary institution like the central bank for foreign exchange regulations and for dealing with international institutions like the International Monetary Fund and the Bank for International Settlements. When the gold standard was in existence, it had some special importance.

**(g) Control over the money supply:**

The central bank is also necessary for the control over the money supply and for the regulation of the country's interest rates. For this reason the central bank enjoys the monopoly power regarding the issue of paper notes, and its rate of interest (i.e., the bank rate) acts as the pace-setter to other rates such as market rates of interest.

## **4.5 Developmental / Promotional Functions of CENTRAL BANK**

Along with the routine traditional functions, central banks especially in the developing country like India have to perform numerous functions. These functions are country specific functions and can change according to the requirements of that country. The CENTRAL BANK has been performing as a promoter of the financial system since its inception. Some of the major development functions of the CENTRAL BANK are maintained below.

**1. Development of the Financial System:** The financial system comprises the financial institutions, financial markets and financial instruments. The sound and efficient financial system is a precondition of the rapid economic development of the nation. The CENTRAL BANK has encouraged establishment of main banking and nonbanking institutions to cater to the credit requirements of diverse sectors of the economy.

**2. Development of Agriculture:** In an agrarian economy like ours, the CENTRAL BANK has to provide special attention for the credit need of agriculture and allied activities. It has successfully rendered service in this direction by increasing the flow of credit to this sector. It has earlier the Agriculture Refinance and Development Corporation (ARDC) to look after the credit, National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRBs).

**3. Provision of Industrial Finance:** Rapid industrial growth is the key to faster economic development. In this regard, the adequate and timely availability of credit to small, medium and large industry is very significant. In this regard the CENTRAL BANK has always been instrumental in setting up special financial institutions such as ICICI Ltd. IDBI, SIDBI and EXIM BANK etc.

**4. Provisions of Training:** The CENTRAL BANK has always tried to provide essential training to the staff of the banking industry. The CENTRAL BANK has set up the bankers' training colleges at several places. National Institute of Bank Management i.e NIBM, Bankers Staff College i.e BSC and College of Agriculture Banking i.e CAB are few to mention.

**5. Collection of Data:** Being the apex monetary authority of the country, the CENTRAL BANK collects process and disseminates statistical data on several topics. It includes interest rate, inflation, savings and investments etc. This data proves to be quite useful for researchers and policy makers.

**6. Publication of the Reports:** The Reserve Bank has its separate publication division. This division collects and publishes data on several sectors of the economy. The reports and bulletins are regularly published by the CENTRAL BANK. It includes CENTRAL BANK weekly reports, CENTRAL BANK Annual Report, Report on Trend and Progress of Commercial Banks India., etc. This information is made available to the public also at cheaper rates.

**7. Promotion of Banking Habits:** As an apex organization, the CENTRAL BANK always tries to promote the banking habits in the country. It institutionalizes savings and takes measures for an expansion of the banking network. It has set up many institutions such as the Deposit Insurance Corporation-1962, UTI-1964, IDBI-1964, NABARD-1982, NHB-1988, etc. These organizations develop and promote banking habits among the people. During economic reforms it has taken many initiatives for encouraging and promoting banking in India.

**8. Promotion of Export through Refinance:** The CENTRAL BANK always tries to encourage the facilities for providing finance for foreign trade especially exports from India. The Export-Import Bank of India (EXIM Bank India) and the Export Credit Guarantee Corporation of India (ECGC) are supported by refinancing their lending for export purpose.

## **4.6 Supervisory Functions of CENTRAL BANK**

The reserve bank also performs many supervisory functions. It has authority to regulate and administer the entire banking and financial system. Some of its supervisory functions are given below.

**1. Granting license to banks:** The CENTRAL BANK grants license to banks for carrying its business. License is also given for opening extension counters, new branches, even to close down existing branches.

**2. Bank Inspection:** The CENTRAL BANK grants license to banks working as per the directives and in a prudent manner without undue risk. In addition to this it can ask for periodical information from banks on various components of assets and liabilities.

**3. Control over NBFIs:** The Non-Bank Financial Institutions are not influenced by the working of a monetary policy. However, CENTRAL BANK has a right to issue directives to the NBFIs from time to time regarding their functioning. Through periodic inspection, it can control the NBFIs.

**4. Implementation of the Deposit Insurance Scheme:** The CENTRAL BANK has set up the Deposit Insurance Guarantee Corporation in order to protect the deposits of small depositors. All bank deposits below Rs. One lakh are insured with this corporation. The CENTRAL BANK work to implement the Deposit Insurance Scheme in case of a bank failure.

**Reserve Bank of India's Credit Policy** The Reserve Bank of India has a credit policy which aims at pursuing higher growth with price stability. Higher economic growth means to produce more quantity of goods and services in different sectors of an economy; Price stability however does not mean no change in the general price level but to control the inflation. The credit policy aims at increasing finance for the agriculture and industrial activities. When credit policy is implemented, the role of other commercial banks is very important. Commercial banks flow of credit to different sectors of the economy depends on the actual cost of credit and availability of funds in the economy.

CENTRAL BANK uses a Credit control monetary policy strategy to ensure that the country's economic development is accompanied by stability. It means that banks will not only contain inflationary trends in the economy but will also stimulate economic growth, resulting in increased real national income stability in the long run. Because of its functions, including issuing notes and keeping track of cash reserves, the CENTRAL BANK does not regulate credit because it would cause social and economic instability in the country.

**CENTRAL BANK-** The Reserve Bank of India is India's central bank and regulatory organisation in charge of overseeing the country's financial sector. It is owned by the Government of India's Ministry of Finance. It is in charge of issuing and distributing the Indian rupee.

## **4.7 Credit Control Policy**

Credit control is a monetary policy tool used by the Reserve Bank of India to control the demand and supply of money, or liquidity, in the economy. The Reserve Bank of India (CENTRAL BANK) supervises the credit granted by commercial banks.

### **Credit Control Objectives**

The following are the broad aims of India's credit control policy:

- To maintain an acceptable amount of liquidity in order to achieve a high rate of economic growth while maximising resource use without causing severe inflationary pressure.
- To achieve stability in the country's currency rate and money market.
- To meet financial obligations during a downturn in the economy as well as in regular times.
- Controlling the business cycle and meeting the needs of the company.

### **Methods and Types of Credit Control**

CENTRAL BANK uses two types of credit control methods for money supply in the Indian economy, Qualitative and Quantitative.

#### **Qualitative Method:**

By quality, we refer to the purposes for which a bank loan is used. Qualitative approaches regulate how money is channelled, and credit is extended in the economy. It is a selective approach of control in that it restricts credit for some sections while expanding credit for others, referred to as

the 'priority sector,' depending on the scenario. The Following Are The Types That Are Used In This Method

#### ***Marginal Requirement***

Loan current value of security supplied for ban-value of loans authorised is a minimum criterion. For those commercial activities whose credit flow is to be controlled in the economy, the marginal requirement is raised.

#### ***Credit Rationing***

There is a maximum limit to the number of loans and advances that can be made using this approach, which commercial banks cannot exceed. The Reserve Bank of India establishes a ceiling for various categories. This type of rationing is utilised when credit flow needs to be monitored, especially for speculative operations. The Reserve Bank of India can also impose a minimum "capital: total assets" ratio (the ratio of capital to total assets).

#### ***Publicity***

The Reserve Bank of India (CENTRAL BANK) uses the media to publicise its opinions on the current market situation and the directives that commercial banks must follow in order to contain the turmoil. However, this strategy is not very effective in poor countries because of the high rate of illiteracy, which makes it difficult for people to understand laws and their repercussions.

#### ***Quantitative Method***

The control of the overall amount of credit is referred to as quantitative credit control.

#### ***Bank Rate***

The discount rate is another name for the bank rate. It's the official lowest rate at which the country's central bank is willing to re-discount approved bills of exchange or lend on recognised securities. Bank Rate is defined as "the standard rate at which it (CENTRAL BANK) is prepared to acquire or re-discount bills of exchange.

When a commercial bank, for example, has lent or invested all of its available funds and has little or no cash above the regulatory minimum, it may request funding from the central bank.

#### ***Working on the Bank Rate***

Changes in bank rates are implemented in order to manage price levels and economic activity by altering loan demand. Its operation is based on the idea that changes in the bank rate cause changes in the market interest rate. Consider a country that is experiencing inflationary pressures. In such circumstances, the central bank will raise the bank rate, resulting in a higher loan rate. Borrowing will be discouraged as a result of this rise.

## **4.8 Role of CENTRAL BANK In Controlling Credit In India**

The Reserve Bank of India, as the country's central bank, takes essential actions to keep credit under control. The Reserve Bank of India (CENTRAL BANK) uses credit control to implement monetary policy and keep inflation under control. The CENTRAL BANK's role in credit control makes it one of the most important bodies for the development of the Indian economy. Control of credit can be thought of as money control for a better understanding.

- Credit control is used to control the demand and supply of money. The credit-control system is utilised by the Reserve Bank of India to ensure the long-term development of the Indian economy.
- Controlling credit helps the CENTRAL BANK and the government achieve economic growth while also keeping inflation under control.
- In India, the CENTRAL BANK is the only authority for currency issuance and the custodian of cash reserves.
- The CENTRAL BANK's role in credit control in India ensures that the country maintains social and economic stability.

## **4.9 CENTRAL BANK Monetary Policy 2023**

The monetary policy is a policy formulated by the central bank, i.e., CENTRAL BANK (Reserve Bank of India) and relates to the monetary matters of the country. The policy involves measures taken to regulate the supply of money, availability, and cost of credit in the economy.

The policy also oversees distribution of credit among users as well as the borrowing and lending rates of interest. In a developing country like India, the monetary policy is significant in the promotion of economic growth.

### **Objectives of Monetary Policy**

While the main objective of the monetary policy is economic growth as well as price and exchange rate stability, there are other aspects that it can help with as well.

- Promotion of saving and investment: Since the monetary policy controls the rate of interest and inflation within the country, it can impact the savings and investment of the people. A higher rate of interest translates to a greater chance of investment and savings, thereby, maintaining a healthy cash flow within the economy.
- Controlling the imports and exports: By helping industries secure a loan at a reduced rate of interest, monetary policy helps export-oriented units to substitute imports and increase exports. This, in turn, helps improve the condition of the balance of payments.
- Managing business cycles: The two main stages of a business cycle are boom and depression. The monetary policy is the greatest tool using which the boom and depression of business cycles can be controlled by managing the credit to control the supply of money. The inflation in the market can be controlled by reducing the supply of money. On the other hand, when the money supply increases, the demand in the economy will also witness a rise.
- Regulation of aggregate demand: Since the monetary policy can control the demand in an economy, it can be used by monetary authorities to maintain a balance between demand and supply of goods and services. When credit is expanded and the rate of interest is reduced, it allows more people to secure loans for the purchase of goods and services. This leads to the rise in demand. On the other hand, when the authorities wish to reduce demand, they can reduce credit and raise the interest rates.
- Generation of employment: As the monetary policy can reduce the interest rate, small and medium enterprises (SMEs) can easily secure a loan for business expansion. This can lead to greater employment opportunities.
- Helping with the development of infrastructure: The monetary policy allows concessional funding for the development of infrastructure within the country.
- Allocating more credit for the priority segments: Under the monetary policy, additional funds are allocated at lower rates of interest for the development of the priority sectors such as small-scale industries, agriculture, underdeveloped sections of the society, etc.
- Managing and developing the banking sector: The entire banking industry is managed by the Reserve Bank of India (CENTRAL BANK). While CENTRAL BANK aims to make banking facilities available far and wide across the nation, it also instructs other banks using the monetary policy to establish rural branches wherever necessary for agricultural development. Additionally, the government has also set up regional rural banks and cooperative banks to help farmers receive the financial aid they require in no time.

## **4.10 Flexible Inflation Targeting Framework (FITF)**

The Flexible Inflation Targeting Framework (FITF) was introduced in India post the amendment of the Reserve Bank of India (CENTRAL BANK) Act, 1934 in 2016. In accordance with the CENTRAL BANK Act, the Government of India sets the inflation target every 5 years after consultation with the CENTRAL BANK. While the inflation target for the period between 5 August 2016 and 31 March 2021 has been determined to be 4% of the Consumer Price Index (CPI), the Central Government has announced that the upper tolerance limit for the same will be 6% and the lower tolerance limit can be 2% for the same.

In this framework, there are chances of not achieving the inflation target fixed for a particular amount of time. This can happen when:

- The average inflation is greater than the upper tolerance level of the inflation target as predetermined by the Central Government for 3 quarters in a row.



- The average inflation is less than the lower tolerance level of the target inflation fixed by the Central Government beforehand for 3 consecutive quarters.

#### 4.11 Monetary Policy Tools

To control inflation, the Reserve Bank of India needs to decrease the supply of money or increase cost of fund in order to keep the demand of goods and services in control.

##### **Quantitative tools -**

The tools applied by the policy that impact money supply in the entire economy, including sectors such as manufacturing, agriculture, automobile, housing, etc.

##### **Reserve Ratio:**

Banks are required to keep aside a set percentage of cash reserves or CENTRAL BANK approved assets. Reserve ratio is of two types:

Cash Reserve Ratio (CRR) - Banks are required to set aside this portion in cash with the CENTRAL BANK. The bank can neither lend it to anyone nor can it earn any interest rate or profit on CRR.

Statutory Liquidity Ratio (SLR) - Banks are required to set aside this portion in liquid assets such as gold or CENTRAL BANK approved securities such as government securities. Banks are allowed to earn interest on these securities, however it is very low.

##### **Open Market Operations (OMO):**

In order to control money supply, the CENTRAL BANK buys and sells government securities in the open market. These operations conducted by the Central Bank in the open market are referred to as Open Market Operations.

When the CENTRAL BANK sells government securities, the liquidity is sucked from the market, and the exact opposite happens when CENTRAL BANK buys securities. The latter is done to control inflation. The objective of OMOs are to keep a check on temporary liquidity mismatches in the market, owing to foreign capital flow.

##### **Qualitative tools:**

Unlike quantitative tools which have a direct effect on the entire economy's money supply, qualitative tools are selective tools that have an effect in the money supply of a specific sector of the economy.

- **Margin requirements** - The CENTRAL BANK prescribes a certain margin against collateral, which in turn impacts the borrowing habit of customers. When the margin requirements are raised by the CENTRAL BANK, customers will be able to borrow less.
- **Moral suasion** -By way of persuasion, the CENTRAL BANK convinces banks to keep money in government securities, rather than certain sectors.
- **Selective credit control** -Controlling credit by not lending to selective industries or speculative businesses.

##### **Market Stabilisation Scheme (MSS) -**

##### **Policy Rates:**

**Bank rate** - The interest rate at which CENTRAL BANK lends long term funds to banks is referred to as the bank rate. However, presently CENTRAL BANK does not entirely control money supply via the bank rate. It uses Liquidity Adjustment Facility (LAF) - repo rate as one of the significant tools to establish control over money supply. Bank rate is used to prescribe penalty to the bank if it does not maintain the prescribed SLR or CRR.

**Liquidity Adjustment Facility (LAF)** - CENTRAL BANK uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are:

- **Repo rate:** Repo rate is the rate at which banks borrow from CENTRAL BANK on a short-term basis against a repurchase agreement. Under this policy, banks are required to provide government securities as collateral and later buy them back after a pre-defined time.

## Monetary Theory and Policy

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- **Reverse Repo rate:** It is the reverse of repo rate, i.e., this is the rate CENTRAL BANK pays to banks in order to keep additional funds in CENTRAL BANK. It is linked to repo rate in the following way:

$$\text{Reverse Repo Rate} = \text{Repo Rate} - 1$$

**Marginal Standing Facility (MSF) Rate:** MSF Rate is the penal rate at which the Central Bank lends money to banks, over the rate available under the rep policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities.

$$\text{MSF Rate} = \text{Repo Rate} + 1$$

### Monetary Policy Transmission

Borrowers fail to fully benefit from CENTRAL BANK's repo rate cut due to the following reasons:

- Banks are not affected by CENTRAL BANK rate cuts as the Central Bank is not their primary money supplier.
- Deposits already made are fixed at the rates when taken and cannot be reduced; the rate cuts will only reflect in the new deposit rates.
- PPF, Post Office accounts and other small saving instruments are available at high administered interest rates and in case of reduction of bank deposit rates, customers have the choice to move to those funds.
- Banks do not prefer to lower their rates as high lending rates keep their profit margins up.
- India does not have a well-developed corporate bond market, therefore corporate customers have little choice but to reach out to banks for borrowing.

### Steps to improve monetary transmission:

Both the government and CENTRAL BANK has taken and plans to take some steps in order to accelerate the transmission of monetary policy.

- Government intends to bring down the interest rates on small saving accounts. If the small saving rates are linked to the bank rate, this could serve as a permanent solution.
- In order to improve monetary transmission, CENTRAL BANK wants banks to change the calculation methodology of base rate to marginal cost of funds from average cost of funds.

Despite banks raising the lending rates immediately after CENTRAL BANK's rate cuts, the Central Bank is unable to control inflation due to the following reasons:

- Financial deficit in the higher government.
- Issues at the supply side, such as crude oil prices, issues in agri marketing, etc.
- Lack of financial inclusion as borrowers still depend on moneylenders, who are not under CENTRAL BANK's control.
- Non-monetised economy in certain rural areas.

### Dear Money Policy or Contractionary Monetary Policy:

Dear money policy is a policy when money become more expensive with the rise of interest rate. Due to this, the supply of money also decreases in the economy, therefore it is also referred to as the contractionary monetary policy.

This policy leads to a drop in business expansions owing to a high cost of credit, as well as a fall in business expansion. This in turn affects employment as it brings down growth rates. Therefore, interest rate cuts such as SLR and CRR are preferred by the government and the corporates.

### Summary

- In the Indian economy, the CENTRAL BANK's role in credit control is crucial. The Reserve Bank of India controls the flow of credit in our economy in order to keep inflation and economic growth in check. Credit changes can cause market instability, so credit control policies must be carefully planned before being implemented.
- The central bank controls the issue of notes. It has the sole right (monopoly) in note issue. It prints notes and authorises the minting of coins by the Mint.
- Old notes and coins are removed by the commercial banks as they deteriorate. The central bank thus provides us with the much-needed medium of exchange. In other words, central bank notes and coins are legal tender.

- In most countries note issue by the central bank is based on a particular principle. In order to prevent an over-issue of notes, apart from a fiduciary issue (that is, notes backed by securities), all notes are to be backed by an equivalent amount of gold in the bank. However, over the years, the fiduciary issue has risen steadily and, today; the whole of the note issue is fiduciary.
- To regulate the supply of currency the central bank in every country has been given the monopoly right to issue paper-notes in accordance with the existing legal provisions.
- The central bank acts as the banker to the government of the country. It keeps the cash balances of the government and maintains its accounts. It gives advances to the government and also takes the responsibility of the sale of government securities. It manages public debt and gives advice to the government on various financial matters.

### Keywords

- **A central bank:** A central bank is a financial institution that is responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply, and setting interest rates.
- **Reserve requirements:** Reserve requirements are a tool used by the central bank to increase or decrease the money supply in the economy and influence interest rates.
- **Excess reserves:** Excess reserves are funds that a bank keeps back beyond what is required by regulation.
- **Liquidity:** Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price.

### Review Questions

1. What is meant by central bank? Why is it known as apex body?
2. Explain 'banker to the government' functions of central bank?
3. What are the open market operations? What is their effect on availability of credit?
4. Explain the effect of an increase in bank rate on credit creation by commercial banks?  
Explain
5. Explain the following functions of the central bank:
  - a. Bank of issue
  - b. Banker's bank
6. Explain the distinction between statutory liquidity ratio and legal reserve ratio?
7. Explain the role of reserve repo rate in controlling credit creation.
8. Explain the role of cash reserve ratio in controlling credit creation?
9. What is monetary policy? State any three instruments of monetary policy?
10. Briefly discuss difference between central bank and commercial bank?
11. How do changes in bank rate affect money supply in an economy? Explain.
12. Describe any two methods by which reserve bank of India can regulate money supply.

### Self-Assessment

1. Which of the following is a step that the central bank will take to encourage greater investment in the economy?
  - a. It will look to increase the cash reserve ratio
  - b. It will look to reduce the cash reserve ratio
  - c. It will look to increase the bank rate
  - d. It will look to sell the government securities in the open market
2. Which of the following is a step that the central bank will take to increase the overall availability of credit?

- a. It will sell the government securities in the market
  - b. It will buy more government securities from the market
  - c. It will raise the reverse repo rate
  - d. It will raise the repo rate
3. Which of the following statements is true about the Indian monetary system?
    - a. The Indian monetary system is based on the gold standard
    - b. The Indian monetary system is based on the credit money standard
    - c. The Indian monetary system is based on the paper standard
    - d. The Indian monetary system is based on the metallic standard
  4. Which of the following statements represents the main function of the central bank in a country?
    - a. It is responsible for the regulation over the supply of money in the market
    - b. It is responsible for the issuance of notes within the country
    - c. It acts as a banker both to the government and to other banks in the country
    - d. All of the above
  5. Which of the following statements is true about demand deposits?
    - a. It includes both fixed deposits and current account deposits
    - b. It includes both savings account deposits and fixed deposits
    - c. It includes both current account deposits and savings account deposits
    - d. It includes fixed deposits, current account deposits and savings account deposits
  6. Which of the following statements is true about the central bank?
    - a. It regulates the entire banking system in the country
    - b. It is under the ownership of the central government of a country
    - c. It is the apex bank of a country
    - d. All of the above
  7. Which of the following statements about the bank rate is true?
    - a. Bank rate is different from interest rate
    - b. Bank rate is the discount rate provided by the central bank of a country
    - c. Bank rate is defined as the rate at which the central bank of a country gives credit to the commercial banks
    - d. All of the above
  8. Which of the statements gives a true picture of the effect of the central bank selling securities in the market?
    - a. The credit creation capacity of commercial banks will fall
    - b. The credit creation capacity of commercial banks will rise
    - c. The credit creation capacity of commercial banks may rise or fall
    - d. There is no effect on the credit creation capacity of commercial banks
  9. Which of the statements gives a true picture of the effect of lowering the cash reserve ratio by the central bank of a country?
    - a. The lending capacity of commercial banks will increase
    - b. The lending capacity of commercial banks will decrease
    - c. The lending capacity of commercial banks may increase or decrease
    - d. There is no effect on the lending capacity of commercial banks
  10. Which of the statements gives an accurate picture of the effect of the rise of the reverse repo rate by the central bank of a country?
    - a. The demand for goods and services in the country will decrease
    - b. The demand for goods and services in the country will increase
    - c. The demand for goods and services in the country may increase or decrease
    - d. There is no effect on the demand for goods and services in the country
  11. Which of the statements gives an accurate picture of the effect of the increase in the repo rate?
    - a. The money supply in the country will decrease
    - b. The money supply in the country will increase

- c. The money supply in the country will increase initially and then decrease  
d. There is no effect on the money supply in the country
12. Which of the following statements is true about credit creation by banks?  
a. Banks create credit on the basis of their total assets  
b. Banks create credit on the basis of their total deposits  
c. Banks create credit on the basis of their total securities  
d. Banks create credit out of nothing
13. Which of the following is not the function of the central bank of a country?  
a. Being the custodian of foreign exchange reserves  
b. Accepting deposits from the general public  
c. Both a and b are correct  
d. Both a and b are incorrect
14. Which agency regulates the money supply in India?  
a. The Government of India  
b. Commercial banks  
c. Reserve Bank of India  
d. None of the above
15. Which of the following statements is true about the money supply?  
a. It is the total volume of money that is held by the government of a country  
b. It is the total volume of money that is held by the general public of a country over a time period  
c. It is the total volume of money that is held by the general public of a country at a particular point in time  
d. All of the above

### **Answers for Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (b)  | 2. (a)  | 3. (c)  | 4. (d)  | 5. (c)  |
| 6. (d)  | 7. (d)  | 8. (a)  | 9. (a)  | 10. (a) |
| 11. (a) | 12. (b) | 13. (b) | 14. (c) | 15. (c) |

### **Further Readings**

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## Unit 05: Co-operative Banks

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5.7 The measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country:

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### Objectives

After this lecture, you would be able

- To explore the concept and origin of cooperative bank in India.
- To evaluate the growth of cooperative bank in India.
- To explore the objectives and features of cooperative banks in India.
- To evaluate the types and functions of cooperative banks in India.

### Introduction

The co-operative banks are government backed financial institutions that work on the principle of co-operation, self-help and mutual help. The co-operative banks are mainly set up to provide access to credit in rural areas. This empowers and secures the poor and the low-income groups. Co-operative banks offer basic banking functions and services in rural, urban and semi-urban areas, where banking facilities are scarce. Unlike commercial banks whose sole purpose is profit making, co-operative banks help encourage rural business and the agricultural sector and work towards growth. In India, co-operative banks play a crucial role in rural financing, with funding of areas under agriculture, livestock, milk, personal finance, self-employment, setting up of small-scale units among the few focus points for both urban and rural cooperative banks.

They provide a much-needed alternative to the age-old exploitative practice of people approaching the village moneylender, most often getting into a debt-trap that they struggle to pull themselves out of. The cooperative banking system came into being with the aim to promote saving and investment habits among people, especially in rural parts of the country.

## 5.1 Meaning of Cooperative Bank

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. People belonging to the same local or professional community having a common interest often establish it. It is formed to promote the upliftment of financially weaker sections of the society and to protect them from the clutches of moneylenders who provide loans at an unreasonably high-interest rate to the needy. The co-operative structure is designed on the principles of cooperation, mutual help, democratic decision making and open membership. It follows the principle of 'one shareholder, one vote' and 'no profit, no loss'.

Cooperatives Banks are **registered under the Cooperative Societies Act, 1912**. These are **regulated by the Reserve Bank of India and National Bank for Agriculture and Rural Development (NABARD) under the Banking Regulation Act, 1949 and Banking Laws (Application to Cooperative Societies) Act, 1965**.

Cooperative banks differ from commercial banks on the grounds of organisation, governance, interest rates, and the scope of functioning, objectives and values. Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the cooperative banks are founded by collecting funds through shares, accept deposits and grant loans.

**The cooperative banks differ from joint stock banks in the following manner:**

- (i) Cooperative banks issue shares of unlimited liability, while the joint stock banks issue shares of limited liability.
- (ii) In a cooperative bank, one shareholder has one vote whatever the number of shares he may hold. In a joint stock bank, the voting right of a shareholder is determined by the number of shares he possesses.
- (iii) Cooperative banks are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities. Joint stock companies are primarily concerned with the credit requirements of trade and industry.
- (iv) Cooperative banking in India is federal in structure. Primary credit societies are at the lowest rung. Then, there are central cooperative banks at the district level and state cooperative banks at the state level. Joint stock banks do not have such a federal structure.
- (v) Cooperative credit societies are located in the villages spread over entire country. Joint stock banks and their branches mainly concentrate in the urban areas, particularly in the big cities.

### History of Cooperative Banking in India:

The genesis of the cooperative movement and its implementation in a modern technical sense can be traced after the Industrial Revolution in England during the period of 18th and 19th century. The idea of Hermann Schulze and Friedrich Wilhelm Raiffeisen during the economic meltdown to provide easy credit to small businesses and poor sections of the society took shape as cooperative banks of today across the world.

### Pre-independence period (prior to 1947)

British India replicated this model and based on the recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901), the Co-operative Credit Societies Act, 1904 was passed. It tried to deal with the problems of rural indebtedness and consequent conditions of farmers in the country. The Act promoted the establishment of credit cooperative societies which led to the formation of first urban co-operative credit society, registered on October 1904 at Kanjeeपुरam now in Tamil Nadu State. It marked the beginning of the institutionalization of the Cooperative Banking system in India. But there were certain defects in the Act which restricted the reach of the expected benefits of cooperatives. The Act only permitted the registration of credit societies, and there was no provision for the protection of non-credit societies or federal societies. These shortcomings were recognised by the Government and to remedy it; more comprehensive legislation was introduced, known as the Cooperative Societies Act of 1912. It recognized the formation and organisation of non-credit societies and the central co-operative federations.

In 1919, after the end of the first world war under the Treaty of Versailles, 1919, the Montague Chelmsford Reforms were introduced in India under which Cooperation becomes a transferred subject which was to be administered by the States. The need for separate acts for effective implementation and to widen the reach of the cooperative banks was felt by the States. The Bombay

Provincial Government was the first to pass its own act which was known as Bombay Provincial Cooperative Societies Act, 1925. Other state governments like Madras, Bengal, Bihar and Punjab followed the Bombay Act and passed their own legislation in the following years.

In 1942, the British Government enacted the Multi-Unit Cooperative Societies Act, 1942, the ambit of which covered societies whose operations are extended to more than one state. The Act provided for the regulation of affairs of such society by the provisions of cooperative societies act of the state where the principal business of the society is located.

### **Post-independence period (after 1947)**

After independence, the movement of cooperative societies maintained its pace even after facing several hardships during that phase and continued to be part of the economic development of the country.

The First Five Year Plan recognized the importance of cooperatives in the implementation of development plans, particularly targeting the farmers and weaker section of the society. In 1954, Government of India appointed a committee called **All India Rural Credit Survey Committee** to remedy the problem of rural credit and other financial issues of the rural community. It recommended a well defined institutional framework for cooperative organizations, particularly for meeting the needs of rural India. The recommendations of the committee were recognized and were put into effect under the Second Five Year Plan.

The Second Five Year Plan recommended expanding the scope of cooperative activities to other fields with special emphasis on the warehousing sector.

The Third Five Year Plan emphasized on training personnel for the cooperative sector and to increase the reach of the cooperative movement.

The Fourth Five Year Plan recommended the consolidation of a cooperative system for effective functioning.

The Fifth Five Year Plan recommended the establishment of Farmers Service Societies. The Sixth Five Year Plan developed a point programme for a cooperative society to bring economic development and for expanding the scope of cooperative societies.

The Seventh Five Year Plan also focussed on expansion and growth of the scope of cooperative societies so as to achieve greater employment and decrease poverty in the country.

## **5.2 Structure of Cooperative Banking:**

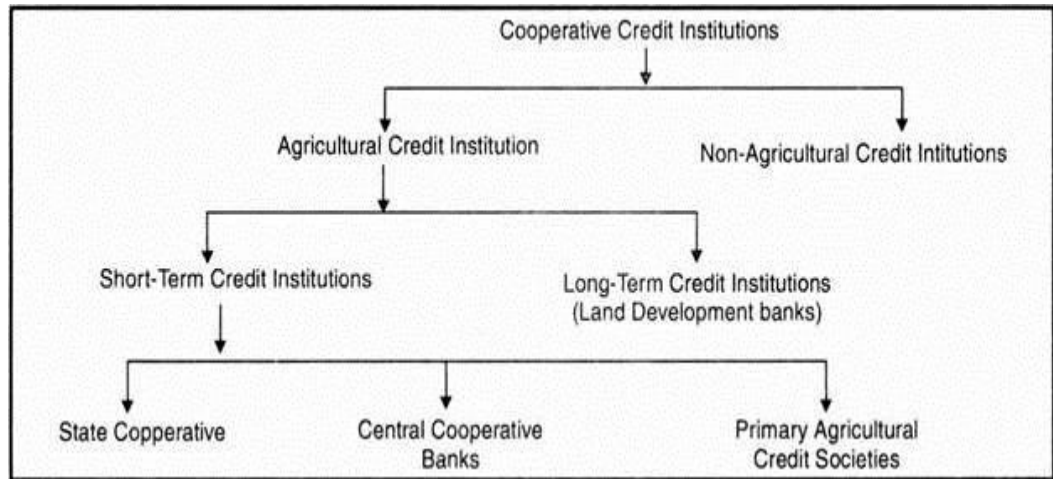
There are different types of cooperative credit institutions working in India. These institutions can be classified into two broad categories- agricultural and non-agricultural. Agricultural credit institutions dominate the entire cooperative credit structure.

Agricultural credit institutions are further divided into short-term agricultural credit institutions and long-term agricultural credit institutions.

The short-term agricultural credit institutions which cater to the short-term financial needs of agriculturists have three-tier federal structure- (a) at the apex, there is the state cooperative bank in each state; (b) at the district level, there are central cooperative banks; (c) at the village level, there are primary agricultural credit societies.

Long-term agricultural credit is provided by the land development banks. The whole structure of cooperative credit institutions is shown in the chart given.





### Short-Term Rural Cooperative Credit Structure:

In rural India, there exists a 3-tier short-term rural cooperative structure. Tier-I includes state cooperative banks (SCBs) at the state level; Tier-II includes central cooperative banks (CCBs) at the district level; and Tier- III includes primary agricultural credit societies (PACs).

In 19 states, there exists a 3-tier short-term cooperative credit structure, comprising SCBs, CCBs and PACs. And in 12 states, there exists a 2-tier short-term cooperative structure. In the north-eastern states, including Sikkim, the structure is 2-tier, comprising only SCBs and PACs.

#### 1. State Cooperative Banks (SCBs):

##### Functions and Organisation:

State cooperative banks are the apex institutions in the three-tier cooperative credit structure, operating at the state level. Every state has a state cooperative bank.

State cooperative banks occupy a unique position in the cooperative credit structure because of their three important functions:

- They provide a link through which the Reserve Bank of India provides credit to the cooperatives and thus participates in the rural finance,
- They function as balancing centers for the central cooperative banks by making available the surplus funds of some central cooperative banks. The central cooperative banks are not permitted to borrow or lend among themselves,
- They finance, control and supervise the central cooperative banks, and, through them, the primary credit societies.

**Capital:** State cooperative banks obtain their working capital from own funds, deposits, borrowings and other sources:

- Own funds include share capital and various types of reserves. Major portion of the share capital is raised from member cooperative societies and the central cooperative banks, and the rest is contributed by the state government. Individual contribution to the share capital is very small;
- The main source of deposits is also the cooperative societies and central cooperative banks. The remaining deposits come from individuals, local bodies and others.
- Borrowings of the state cooperative banks are mainly from the Reserve Bank and the remaining from state governments and others.

**Loans and Advances:** State cooperative banks are mainly interested in providing loans and advances to the cooperative societies. More than 98 per cent loans are granted to these societies of which about 75 per cent are for the short-period. Mostly the loans are given for agricultural purposes. The number of state cooperative banks rose from 15 in 1950-51 to 21 in 1960-61 and to 28 in 1991-92. The loans advanced by these banks increased from Rs. 42 crore in 1950-51 to Rs. 260 crore in 1960-61, and further to Rs. 7685 crore in 1991-92.

## 2. Central Cooperative Banks (CCBs):

**Functions and Organisation:** Central cooperative banks are in the middle of the three-tier cooperative credit structure. Central cooperative banks are of two types:

- (a) There can be cooperative banking unions whose membership is open only to cooperative societies. Such cooperative banking unions exist in Haryana, Punjab, Rajasthan, Orissa and Kerala.
- (b) There can be mixed central cooperative banks whose membership is open to both individuals and cooperative societies. The central cooperative banks in the remaining states are of this type. The main function of the central cooperative banks is to provide loans to the primary cooperative societies. However, some loans are also given to individuals and others.

**Capital:** The central cooperative banks raise their working capital from own funds, deposits, borrowings and other sources. In the own funds, the major portion consists of share capital contributed by cooperative societies and the state government, and the rest is made up of reserves.

Deposits largely come from individuals and cooperative societies. Some deposits are received from local bodies and others. Deposit mobilisation by the central cooperative banks varies from state to state.

For example, it is much higher in Gujarat, Punjab, Maharashtra, and Himachal Pradesh, but very low in Assam, Bihar, West Bengal and Orissa. Borrowings are mostly from the Reserve Bank and apex banks.

**Loans and Advances:** The number of central cooperative banks in 1991-92 was 361 and the total amount of loans advanced by them in 1991-92 stood at Rs. 14226 crore. About 98 per cent loans are received by the cooperative societies and about 75 per cent loans are short-term. Mostly the loans are given for agricultural purpose.

About 80 per cent loans given to the cooperative societies are unsecured and the remaining loans are given against the securities such as merchandise, agricultural produce, immovable property, government and other securities etc.

**Problem of Overdues:** The most distressing feature of the functioning of the central cooperative banks is heavy and increasing overdue loans. In 1997-98, the percentage of overdues to demand at the central cooperative level was 34. According to the Review of the Cooperative Movement in India, 1974-76, by the Reserve Bank of India, the main causes of these overdues are:

- (a) Natural calamities such as floods, draughts, etc., affecting the repaying capacity of the borrowers;
- (b) Inadequate and inefficient supervision exercised by the banks;
- (c) The poor quality and management of societies and banks;
- (d) Absence of linking of credit with marketing;
- (e) Reluctance to coercive measures; and
- (f) Where coercive measures were taken, the inability of the machinery to promptly execute the decrees.

For the rehabilitation of the weak Central cooperative banks, the Central Sector Plan Scheme has been formulated under which semi financial help is given to write off the bad debts, losses and irrecoverable overdues against small and marginal farmers.

## 3. Primary Agricultural Credit Societies (PACs):

**Functions and Organisation:**

Primary agricultural credit society forms the base in the three-tier cooperative credit structure. It is a village-level institution which directly deals with the rural people. It encourages savings among the agriculturists, accepts deposits from them, gives loans to the needy borrowers and collects repayments. It serves as the last link between the ultimate borrowers, i.e., the rural people, on the one hand, and the higher agencies, i.e., Central cooperative bank, state cooperative bank, and the Reserve Bank of India, on the other hand. A primary agricultural credit society may be started with 10 or more persons of a village. The membership fee is nominal so that even the poorest agriculturist can become a member. The members of the society have unlimited liability which

means that each member undertakes full responsibility of the entire loss of the society in case of its failure. The management of the society is under the control of an elected body.

**Capital:**The working capital of the primary credit societies comes from their own funds, deposits, borrowings and other sources. Own funds comprise of share capital, membership fee and reserve funds. Deposits are received from both members and non-members. Borrowings are mainly from central cooperative banks.

In fact, the borrowings form the chief source of working capital of the societies. Normally, people do not deposit their savings with the cooperative societies because of poverty, low saving habits, and non-availability of better assets to the savers in term of rate of return and riskiness from these societies.

**Coverage:**In 1999-2000 there were 88 thousand primary agricultural societies covering more than 96 per cent rural areas. The membership of these societies was 8.68 crore. During the past few decades, the Reserve Bank in collaboration with State governments, has been taking various measures to reorganise the viable primary credit societies and to amalgamate non-viable societies with large-sized multipurpose societies.

This work of reorganisation of primary societies into strong and viable units has been completed in almost all the states except Gujrat, Maharashtra, and Jammu and Kashmir. It is because of reorganisation that the number of primary societies which increased from 105 thousand in 1950-51 to 212 thousand in 1960-61, declined to 92 thousand in 1999-2000.

**Loans Advanced:**The loans advanced by the primary credit societies have been Showing 3 Continuously increasing trend. They rose from Rs. 23 crore in 1950-51 to Rs. 202 crore in 1960-61 and further to Rs. 13600 crore in 1999-2000.

Only the members of the societies are entitled to get loans from them. Most of the loans are short-term loans and are for agricultural purposes. Low interest rates are charged on the loans.

The societies are expected to increase amounts of loans to the weaker sections of the rural community, particularly the small and marginal farmers. There, however, exists a serious problem of overdue loans of the societies which have increased from Rs. 6 crores in 1950-51 to Rs. 44 crore in 1960-61 and to Rs. 2875 crore in 1991-92.

### **5.3 Land Development Banks (LDBs) or Cooperative Agricultural and Rural Development Banks (CARDs):**

Besides short-term credit, the agriculturists also need long-term credit for making permanent improvements in land, for repaying old debts, for purchasing agricultural machinery and other implements. Traditionally, the long-term requirements of agriculturists were mainly met by money lenders and some other agencies. But this source of credit was found defective and has been responsible for the exploitation of farmers. Cooperative banks and commercial banks by their very nature are not in a position to provide long-term loans because their deposits are mainly demand (short-term) deposits. Thus, there was a great need for a specialised institution for supplying long-term credit to agriculturists. The establishment of land development banks now known as cooperative and rural development banks (CARDs) is an effort in this direction.

**Structure:**The land development banks are registered as cooperative societies, but with limited liability. These banks have two-tier structure:

- (a) At the state level, there are state or central land development banks, now known as state cooperative agricultural and rural development banks (SCARDs) generally one for each state. They were previously known as central land mortgage banks,
- (b) At the local level, there are branches of the state land development banks or SCARDs and primary land development banks now known as primary cooperative agricultural and rural development banks (PCARDs).

In some states, there are no primary land development banks, but the branches of the state land development bank. In Madhya Pradesh, the state cooperative bank itself functions as the state land development bank. In other states like Andhra Pradesh, Kerala and Maharashtra, there are more than one state land development banks.

Similarly, the primary land development banks also vary organisationally in different states. At the national level, the land development banks have also formed a union, called All-India Land Development Banks' Union.

**Capital:** Land development banks raise their funds from share capital, reserves, deposits, loans and advances, and debentures. Debentures form the biggest source of finance. The debentures are issued by the state land development banks. They carry fixed interest, have maturity varying from 20 to 25 years, and are guaranteed by the state government. These debentures are subscribed by the co-operative banks, commercial banks, the State Bank of India and the Reserve Bank of India. Besides the ordinary debentures, the land development banks also float rural debentures for the period upto 7 years. These debentures are subscribed by farmers, panchayats, and the Reserve Bank. The Reserve Bank substantially contributes to the finance of land development banks by extending funds to the state governments for contributing to the share capital of these banks and by subscribing to ordinary and rural debentures.

**Growth:** In India, the first cooperative land mortgage bank was organised in Punjab in 1920. But the effective beginning was made in Madras with the establishment of a central land development bank in 1929. Later on other states also established such institutions. The number of state cooperative agricultural and rural development banks (SCARDBs) which was 5 in 1950-51, rose to 20 in 2013. The number of primary cooperative agricultural and rural development banks (PCARDBs) was 697 in 2013.

**Loans and Advances:** The land development banks or SCARDBs provide long-term loans to the agriculturists-

- (a) for redemption of old debt,
- (b) for improvement of land and methods of cultivation,
- (c) purchasing costly machinery, and
- (d) in special cases, for purchasing land.

These banks grant loans against the mortgage of land and the period of loan varies from 15 to 30 years. In 1999-2000, the loans sanctioned by these banks were Rs.2520 crore and the amount of loans outstanding was Rs. 11670 crore. The amount of loans outstanding at the end-March 2012 was Rs. 19400 crore by SCARDBs and Rs.12000 crore by PCARDBs.

#### 5.4 Defects of Land Development Banks:

Although numerically the land development banks have grown over the years, they have not been able to make much progress in providing long-term finance to the farmer. The following are the factors responsible for the unsatisfactory performance of land development banks:

**i. Uneven Growth:** There has been uneven growth of land development banks. These have shown some progress in the states like Andhra Pradesh, Tamil Nadu, Karnataka, Maharashtra, Gujrat. Other states have made very little progress. About half of the states have no land development bank.

**ii. Problem of Overdues:** The major problem faced by the land development banks is the existence of heavy overdues. Moreover, the overdues are continuously rising over the years. In 1991-92, the percentage of the overdues of the land development banks has been put between 42 to 44 per cent. Faulty loaning policies, inadequate supervision, over-utilisation of loans, ineffective measures for recovery, willful defaulters, etc. are the main causes of unsatisfactory level of overdues. In view of the seriousness of the problem, the state governments have been advised to draw up and implement time-bound programmes for special recovery drives.

**iii. Lack of Trained Staff:** In spite of quantitative growth of the land development banks, they have not shown much qualitative improvements in the field of granting loans largely due to inadequate technical and supervisory staff. Necessary changes in the legislation of cooperative institutions are also required if the lending activities are to be diversified for non-traditional developmental purposes and on the basis of non-landed security.

**iv. Other Defects:** Other defects of the land development banks can be summarised below:

- (a) These banks charge very high interest rates on the loans provided by them.
- (b) There is much delay and red-tapism in the granting of loans,
- (c) Second loan is not advanced unless the first is not repaid.
- (d) Installments and the period of loans are not fixed on the basis of the repaying capacity of the borrowers.
- (e) The procedure of receiving a loan from these banks is so complicated that the agriculturist is forced to seek help from the money lender,

(f) Weaker sections of the rural society such as landless labourers, village artisans and marginal farmers, are generally unable to secure loans from these banks for their productive activities simply because they do not have land or adequate security to offer against loans.

(g) Mostly loans are given for the repayment of old loans and for development purposes.

**v. Report of Rural Credit Survey:** The Report of the Committee of Direction of All-India Rural Credit Survey has pointed out the unsatisfactory performance of the land mortgage banks (now called the land development banks) in the following manner:

(a) These banks raise inadequate funds in a manner ill-rated to demand and usually lend them in a manner uncoordinated with development;

(b) They act as if prior debts and not production had claim on its attention; and

(c) They reach only the large cultivator and reach him late.

## 5.5 Advantages of Cooperative

The cooperative banking system has to play a critical role in promoting rural finance and is specially suited to Indian conditions. Various advantages of cooperative credit institutions are given below:

**I. Alternative Credit Source:** The main objective of cooperative credit movement is to provide an effective alternative to the traditional defective credit system of the village money lender. The cooperative banks tend to protect the rural population from the clutches of money lenders. The money lenders have so far dominated the rural areas and have been exploiting the poor people by charging very high rates of interest and manipulating accounts.

**II. Cheap Rural Credit:** Cooperative credit system has cheapened the rural credit both directly as well as indirectly:

(a) Directly, because the cooperative societies charge comparatively low interest rates, and

(b) Indirectly, because the presence of cooperative societies as an alternative agency has broken money lender's monopoly, thereby enforcing him to reduce the rate of interest.

**III. Productive Borrowing:** An important benefit of cooperative credit system is to bring a change in the nature of loans. Previously the cultivators used to borrow for consumption and other unproductive purposes. But, now, they mostly borrow for productive purposes. Cooperative societies discourage unproductive borrowing.

**IV. Encouragement to Saving and Investment:** Cooperative credit movement has encouraged saving and investment by developing the habits of thrift among the agriculturists. Instead of hoarding money the rural people tend to deposit their savings in the cooperative or other banking institutions.

**V. Improvement in Farming Methods:** Cooperative societies have also greatly helped in the introduction of better agricultural methods. Cooperative credit is available for purchasing improved seeds, chemical fertilizers, modern implements, etc. The marketing and processing societies have helped the members to purchase their inputs cheaply and sell their produce at good prices.

**VI. Role of Cooperative Banks before 1969:** Till the nationalisation of major commercial banks in 1969, cooperative societies were practically the only institutional sources of rural credit. Commercial banks and other financial institutions hardly provided any credit for agricultural and other rural activities. Cooperative credit to the agriculturists as a percentage of total agricultural credit increased from 3.1 per cent in 1951-52 to 15.5 per cent in 1961-62 and further to 22.7 per cent in 1970-71. On the other hand, the agricultural credit provided by the commercial banks as a percentage of total agricultural credit remained almost negligible and fell from 0.9 per cent in 1951-52 to 0.6 per cent in 1961-62 and then rose to 4 per cent in 1970-71.

**VII. Role of Cooperative Banks after 1969:** After the nationalisation of commercial banks in 1969, the government has adopted a multi-agency approach. Under this approach, both cooperative banks and commercial banks (including regional rural banks) are being developed to finance the rural sector. But, this new approach also recognised the prime role to be played by the cooperative credit institutions in financing rural areas because of the following reasons:

(a) Co-operative credit societies are best suited to the socio-economic conditions of the Indian villages.

(b) A vast network of the cooperative credit societies has been built over the years throughout the length and breadth of the country. This network can neither be duplicated nor be surpassed easily.

(c) The cooperative institutions have developed intimate knowledge of the local conditions and problems of rural areas.

**VIII. Suitable Federal Structure of Cooperative Banking System:** Cooperative banking system has a federal structure with-

- (a) primary agricultural credit societies at the village level,
- (b) higher financing agencies in the form of central cooperative and state cooperative banks,
- (c) land development banks for providing long-term credit for agriculture. Such a banking structure is essential and particularly suited for effectively meeting the financial requirements of the vast rural areas of the country.

Considering the great importance of cooperative banks, particularly in the rural areas, it is not surprising that every committee or commission, that has examined the working of the cooperative banking system in India, has expressed the common view that "cooperation remains the best hope of rural India." Various committees, commissions and individual studies that have reviewed the working of the cooperative banking system in India have pointed out a number of weaknesses of the system and have made suggestions to improve the system.

## 5.6 Major weaknesses are given below:

**I. General Weaknesses of Primary Credit Societies:** Organisational and financial limitations of the primary credit societies considerably reduce their ability to provide adequate credit to the rural population. The All India Rural Credit Review Committee pointed out the following weaknesses of the primary credit societies:

- (a) Cooperative credit still constitutes a small proportion of the total borrowings of the farmers,
- (b) Needs of tenants and small farmers are not fully met.
- (c) More primary credit societies are financially weak and are unable to meet the production-oriented credit needs,
- (d) Overdues are increasing alarmingly at all levels,
- (e) Primary credit societies have not been able to provide adequate and timely credit to the borrowing farmers.

**II. Inadequate Coverage:** Despite the fact that the cooperatives have now covered almost all the rural areas of the country, its rural household membership is only about 45 per cent. Thus, 55 per cent of rural households are still not covered under the cooperative credit system. In fact, the borrowing membership of the primary credit societies is significantly low and is restricted to a few states like Maharashtra, Gujrat, Punjab, Haryana, Tamil Nadu and to relatively rich land owners.

**Criteria of determining borrowing membership include:**

- (a) Borrowing members as a proportion of rural households,
- (b) The average amount of loan issued per borrowing member, and
- (c) The proportion of loans going to weaker sections.

**The banking Commission 1972 has brought out the following reasons for the low borrowing membership cooperative societies:**

- (a) Inability of the people to provide the prescribed security;
- (b) Lack of up-to-date land records;
- (c) Ineligibility of certain purposes for loans;
- (d) Inadequacy of prescribed credit limits;
- (e) Onerous conditions prescribed for loans such as share capital contribution at 10 or 20 per cent of loans outstanding and compulsory saving deposits; and
- (f) Default of members to repay loans.

**III. Inefficient Societies:** In spite of the fact that the primary agricultural credit societies in most of the states have been reorganised into viable units, their loaning business has not improved. As the Seventh Plan has observed that out of 94089 primary agricultural credit societies in the country in 1982-83, only 66000 societies had full time paid secretaries. About 34000 societies were running at loss.

**IV. Problem of Overdues:** A serious problem of the cooperative credit is the overdue loans of the cooperative institutions which have been continuously increasing over the years. In 1991-92, percentage of overdues to demand at the level of land development banks was 57, at the level of central cooperative banks was 41 and at the level of primary agricultural credit societies was 39. The overdues in the short-term credit structure are most alarming in North-Eastern States. In the long-term loaning sector, the problem of overdues has almost crippled the land development banks in 9 states, viz., Maharashtra, Gujarat, Madhya Pradesh, Bihar, Karnataka, Assam, West Bengal, Orissa

and Tamil Nadu. Large amounts of overdues restrict the recycling of the funds and adversely affect the lending and borrowing capacity of the cooperative societies.

**The Banking Commission 1972 pointed out the following reasons for the overdue loans:**

- (a) Indifferent management or mismanagement of primary societies;
- (b) Unsound lending policies resulting in over-lending or lending unrelated to actual needs, diversions of loans for other purposes;
- (c) Vested interests and group politics in societies and willful defaulters;
- (d) Inadequate supervision over the use of loans and poor recovery efforts;
- (e) Lack of adequate control of central cooperative banks over primary societies;
- (f) Lack of proper links between credit and marketing institutions;
- (g) Failure to take quick action against willful defaulters; and
- (h) Uncertain agricultural prices.

**V. Regional Disparities:** There have been large regional disparities in the distribution of cooperative credit. According to the Seventh Plan, the eight states of Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab and Rajasthan account for about 80 per cent of the total credit disbursed. The per hectare short-term credit disbursed varied from Rs. 4 in Assam to Rs. 718 in Kerala.

**VI. Benefits to Big Land Owners:** Most of the benefits from the cooperatives have been covered by the big land owners because of their strong socio-economic position. For instance, in 1984-85 the farmers having holdings less than two hectares got only 38.8 per cent of the total loans granted by the primary agricultural credit societies, whereas the land owners with holdings of more than 2 hectare received 55 per cent. The share of the poorest rural population (i.e. tenants, share croppers and landless labours) was only 6.2 per cent.

**VII. Lack of Other Facilities:** Besides the provision of adequate and timely credit, the small and marginal farmers also need other facilities in the form of supply of inputs (i.e., better seeds, fertilisers, pesticides, etc), extension and marketing services. These facilities will enable them to utilise the borrowed credit in a proper way. Therefore, the credit societies should be reorganised into multi-purposes cooperatives. Strengthening the cooperative credit movement has been the Reserve Bank of India's special responsibility ever since its establishment in 1935.

### **5.7 The measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country:**

**1. Agricultural Credit Department:** The Reserve Bank has a separate Agricultural Credit Department whose functions are:

- (i) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the central and state governments, state cooperative banks and other banking organisations; and
- (ii) To coordinate the operations of the Reserve Bank in connection with agricultural credit and relations with the state cooperative banks and other institutions engaged in the business of agricultural credit.

**2. All-India Rural Credit Survey:** The Reserve Bank's real role in the cooperative credit movement started with the appointment of All-India Rural Credit Survey Committee in 1951. The objective of this Committee was to study the problems of rural credit and explore possibilities of expanding agricultural credit through cooperative credit system. The committee submitted its report in December 1954 which highlighted the vital importance of cooperative rural credit. The Committee found that while private credit agencies, i.e., money lenders and traders supply 70 per cent of the rural credit, the cooperative societies provided only 3 per cent of the total borrowed amount. The Committee observed that the rural credit in India fell short of the right quantity, was not of right type, did not serve the right purpose, and often fail to go to the right people. Regarding the future of cooperative credit movement the committee said, "cooperation had failed, but cooperation must succeed."

**3. Integrated Scheme of Rural Credit:** For the success of cooperative credit movement, the Survey Committee suggested an integrated scheme of rural credit based on the following fundamental principles-

- (a) state partnership in cooperative credit institutions;
- (b) full coordination between credit and other agricultural activities, particularly, marketing and processing; and

(c) administration through adequately trained and efficient personnel, responsive to the needs of the rural population.

**4. Provision of Finance:** In pursuance of the recommendations of the Survey Committee and the later committees like the Committee on Cooperative Credit (1960), the Reserve Bank has activity helped the cooperative system to expand rural credit. The Reserve Bank does not provide finance directly to the agriculturists, but only through cooperative sector. The Reserve Bank provides financial assistance for meeting short-term, medium-term and long-term rural needs.

**The needs are explained as under:**

**(i) Short-Term Finance:** The Reserve Bank provides short-term finance to the state cooperative banks in two ways-

- (a) through loans and advances;
- (b) through rediscounting facility.

The financial assistance is given for seasonal agricultural operations and for marketing of crops.

In 1950-51, the Reserve Bank sanctioned short-term credit of Rs. 7.6 crore. This amount increased to Rs. 147 crore in 1960-61 and to Rs. 1090 crore in 1981-82.

**(ii) Medium-Term Finance:** The Reserve Bank provides medium-term loans to state cooperative banks generally for 3 to 5 years. These loans are provided for-

- (a) land improvements like bunding, digging of wells and water channels;
- (b) repair of wells and other irrigational schemes;
- (c) purchase of livestock, implements and machinery;
- (d) construction of farm houses and cattle sheds.

The Reserve Bank also provides medium-term loans in scarcity affected areas. Over the years, the amount of medium-term loans sanctioned by the Reserve Bank has considerably increased from Rs. 27 lakh in 1954-55 to Rs. 24 crore in 1970-71 and to Rs. 110 crore in 1981-82.

**(iii) Long-Term Finance:** The Reserve Bank provides long-term financial assistance for a maximum period of 20 years for agriculture in three ways-

- (a) It subscribes a portion of debentures issued by the land development banks.
- (b) It grants long term loans to such banks,
- (c) It grants loans to state governments for subscribing to the share capital of cooperative credit institutions. The total long-term loans sanctioned by the Reserve Bank were Rs. 212 crore in 1981-82.

**5. Setting Up of Funds:** To meet its financial obligations, the Reserve Bank set up two national funds in 1956, i.e., the National Agricultural Credit (Long-Term Operations) Funds, and the National Agricultural Credit (Stabilisation) Fund. The Purpose of the Long-Term Operations Funds was-

- (a) to make long-term loans available to state governments to enable them to subscribe the share capital of cooperative credit institutions;
- (b) to make medium-term loans to state cooperative banks for agricultural purposes;
- (c) to make long-term loans to the central land mortgage banks against the guarantee of the state government; and
- (d) to purchase debentures of central land mortgage banks against the guarantee of state government. The Stabilisation Fund helps the state cooperative banks to convert their short-term loans into medium-term loans in cases of draught, famine or other calamities.

**6. Strengthening of Cooperative Banking Structure:** With a view to strengthen cooperative banking structure and promote cooperative credit, the Reserve Bank undertakes the following measures:

- (i) It pays special attention towards rehabilitating and revitalising the weaker cooperative units.
- (ii) It makes arrangements for maintaining the flow of cooperative credit by involving commercial banks to finance the primary agricultural societies.
- (iii) It makes efforts in improving the lending policies and operational efficiency of cooperative credit institutions.
- (iv) It provides financial accommodation to cooperative credit institutions.
- (v) It conducts special training courses at the Cooperative Bankers' Training Colleges for the personnel of state, central and urban banks.

## Summary

A cooperative bank is an institution of finance that is owned and operated by its members, who are also the bank's customers. It is frequently founded by persons who share a mutual interest and belong to the very same regional or professional group. It was established to promote the



development of economically deprived members of the community and to keep them from the claws of lenders who supply needy people with loans at unnecessarily high-interest rates. Cooperation, mutual aid, democratic decision-making, and open membership are the guiding principles of the cooperative structure. It operates on the 'one shareholder, one vote' and 'no profit, no loss' principles. Organization, governance, interest rates, the scope of operations, objectives, and values distinguish cooperative banks from commercial banks.

Cooperative banks play an integral part in the implementation of development plans and are important for the effective functioning of the banking system in India. India is termed as an underbanked country, and after so many scams, it is need of the hour to take necessary measures to remedy the lacuna and to boost the confidence and trust of the public in the banking system.

Cooperative banks are essential to the smooth running of India's banking sector and play a major role in the process of development goals. In India, cooperative banks have become an important component of the country's financial inclusion story. Since their inception, they have set numerous milestones and assisted ordinary rural Indians in feeling empowered and secure. The plot has had its own share of procedural flaws and difficulties, with diverse areas of procedural flaws and woes.

### Keywords

**Co-operative bank:** A co-operative bank is a small-sized, financial entity, where its members are the owners and customers of the Bank.

**Loan:** A loan is a form of debt incurred by an individual or other entity.

**Capital:** capital is the money that a bank has obtained from its shareholders and other investors and any profit that it has made and not paid out.

**Rural Credit:** any kind of loan or financial assistance that is taken by the people residing in the rural areas for the purpose of agriculture or setting up small businesses.

**Fund:** a collection of different people's money collected & managed by high market professionals.

### Review Questions

1. Write and explain the Structure of Cooperative Banking.
2. What are the Challenges Faced by the Cooperative Banks? Explain.
3. Critically explain the Cooperative Agricultural and Rural Development Banks.
4. Explain the measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country

### Self-Assessment

1. Co-operative banks which work at a metropolitan level are called as?
  - a) District Central Co-operative Bank
  - b) State Co-operative Bank
  - c) Primary Urban Co-operative Bank
  - d) Primary Agricultural Credit Societies
2. Which one of the apex bodies regulates the cooperative banks in India?
  - a) NABARD
  - b) RBI
  - c) Sponsor Banks
  - d) Both A and B
3. All banks registered under the
  - a) Banking Regulation Act 1949
  - b) The Bankers' Books Evidence Act-1891
  - c) Cooperative Societies Act, 1912

- d) Both (A) and (C)
4. Who manages the registration and management activities of Urban co-operative banks?
    - a) RBI
    - b) NABARD
    - c) RCS
    - d) None of the above
  5. Which of these are at the lowest rung of Rural Cooperative banking structure in India?
    - a) State Cooperative Banks
    - b) District Central Cooperative Banks
    - c) Primary Agricultural Credit Societies
    - d) None of the above
  6. Who regulates the functioning of District Cooperative Banks in India?
    - a) State Government
    - b) SBI
    - c) State Cooperative Banks
    - d) None
  7. Which was the first Cooperative Bank established in India?
    - a) Bharat Cooperative Bank Limited
    - b) Kangra Central Co-operative Bank Limited
    - c) Anyonya Co-operative Bank Limited
    - d) Abhyudaya Co-operative Limited
  8. Which of these is a Cooperative Bank in India?
    - a) Cosmos Bank
    - b) SVC Bank
    - c) Janata Sahakari Bank
    - d) All of the above
  9. Which is the largest cooperative bank of India presently?
    - a) Saraswat Bank
    - b) NSB Bank
    - c) Apna Sahakari Bank L
    - d) None of above
  10. Which of the following organizational structure is followed by Co-operatives in India?
    - a) Federal Structure:
    - b) Unitary Structure
    - c) Centralized Structure
    - d) Decentralized Structure
  11. DCCBs
    - a) District Central Cooperative Banks
    - b) Director of Central Cooperative Banks
    - c) Danish Credit Cooperative Banks
    - d) Dane Creative Cooperative Banks
  12. Co-operative banks which work at a metropolitan level are called as?
    - a. District Central Co-operative Bank
    - b. State Co-operative Bank
    - c. Primary Urban Co-operative Bank

- d. Primary Agricultural Credit Societies
13. All banks registered under the \_\_\_\_\_ are considered co-operative banks.
- Banking Regulation Act 1949
  - The Bankers' Books Evidence Act-1891
  - Cooperative Societies Act, 1912
  - Both (A) and (C)
14. Besides banks, the other formal major source of cheap credit in rural areas, are:
- money lenders
  - zamindars
  - the cooperative societies
  - friends and relatives
15. ....is the vertex of the pyramidal structure in a State for the provision of short and medium term credit to agriculturists on cooperative basis.
- District Central Cooperative Banks
  - Primary Agricultural Credit Societies
  - State Cooperative Banks
  - All the above Answer

### Answers for Self-Assessment

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (b)  | 3. (c)  | 4. (c)  | 5. (c)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (a) |
| 11. (a) | 12. (a) | 13. (c) | 14. (c) | 15. (c) |

### Further Readings

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## Unit 06: Regional Rural Banks in India

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### Objectives

- After this lecture, you would be able to
- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it is mobilization of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

### **Meaning of Financial System:**

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

#### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as "a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions."
2. Prof.S.B.Gupta defines the financial system as "a set of institutional arrangements through which financial surpluses available in the economy are mobilized".
3. Van Horne has defined the financial system as "the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption".
4. According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth".

#### **Features/Characteristics/Role of Financial System:**

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.
13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.

19. It includes financial institutions, markets, instruments, services, practices and transactions.

20. The main objective is to formulate capital, investment and profit generation.

### **6.1 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of financial system in an economy. The major and primary objectives of a financial system are as follows:

1. **To mobilize the Savings:** The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. **To distribute the savings for the industrial investment:** The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. **To stimulate capital formation:** The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. **To accelerate the pace of economic growth:** The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

### **6.2 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares. It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.
3. **Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.
4. **Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.
5. **Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.
6. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.
7. **Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.
8. **Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.

**9. Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.

**10. Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

**11. Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.

**12. Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

### **6.3 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

**Formal (organized) financial system:** This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

- Financial Institutions.
- Financial Markets.
- Financial Instruments.
- Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

### **6.4 Money:**

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

## 6.5 Meaning and Definitions of Money:

The word “money” is believed to originate from a temple of ‘Juno’, located on Capitoline, one of Rome’s seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name “Juno” may derive from the Etruscan goddess Uni (which means “the one”, “unique”, “unit”, “union”, “united”) and “Moneta” either from the Latin word “monere” (remind, warn or instruct) or the Greek word “moneres” (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

### Definitions of Money:

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, “Money is what money does”. It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability. Looking from this criterion, we find Crowther’s definition to be the most suitable.

“Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value.” – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

### Legal Tender Money and fiduciary Money:

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

### Legal tender money is of two kinds:

(a) Limited legal tender, and

(b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

### Stages in the Evolution of Money:

#### (i) Animal Money:

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.



**(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

**(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

**(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

**(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

Characteristics of Money:

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

#### **6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

#### **7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

Classification of Money:

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

#### **(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

#### **(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

#### **(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

#### **(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

- (a) Standard Money, and
- (b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

- (a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

**(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

## **6.6 Modern Forms of Money:**

### 1. Currency:

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

#### (a) Metallic Money:

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

#### (b) Paper Money:

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

### 2. Deposit Money or Bank Money:

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

### 3. Legal Tender Money (Force Tender):

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.

### 4. Near Money:

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

### 5. Electronic Money:

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money. The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

### 6. Fiat Money:

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country. The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

## 6.7 Importance of Money:

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

### 1. Money and Production:

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

### 2. Money and Consumption:

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

### 3. Money and Distribution:

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

### 4. Removal of the Difficulties of Barter:

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

### 5. Money and Capital Formation:

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

### 6. Money and Public Finance:

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

### 7. External Trade:

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

### **8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

Value of Money:

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

**The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

#### **(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

#### **(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

#### **(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

Evils of Money:

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:****(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

**6.8 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

Process of Intermediation:

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

## **6.9 Roles of Financial Intermediaries:**

### 1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

#### **(i) Reduce Hoarding:**

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

#### **(ii) Help the Household Sector:**

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

#### **(iii) Help the Business Sector:**

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

#### **(iv) Help the State and Local Government:**

FIs help the state and local bodies financially by purchasing their bonds.

#### **(v) Help the Central Government:**

Similarly, they buy and sell central government securities and thus they help the central government.

#### **(vi) Lenders and FIs both Earn:**

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

#### **(vii) Spread of Risks:**

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

#### **(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.



Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

## 6.10 Functions of the Financial Sector

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:

**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### Value exchange

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.

**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

### Intermediation

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

#### Risk transfer

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

#### Liquidity

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

## The Characteristics of Finance

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

## Summary

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets,

instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and

various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

### **Keywords**

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

### **Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups."

Comment.

5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

**Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. — — — — — represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset
  - d. none of these
3. Financial derivatives include
  - a. Stocks
  - b. Bonds
  - c. Futures
  - d. None of the above
4. Which of the following is the regulator of Money market?
  - a) Reserve Bank of India
  - b) Government of India
  - c) Telecom Regularity Authority
  - d) Insurance Regularity Department
5. What is Call Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
6. What is Notice Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
7. What is Term Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is a loan provided on certain terms and conditions by Bank to its customer
8. Which of the following is not related with Money Market?
  - a) Treasury Bills
  - b) Commercial Bills
  - c) Certificates of Deposit
  - d) Shares
9. Which of the following is related with Money Market?
  - a) Treasury Bills
  - b) Commercial money
  - c) Cheque
  - d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:
  - a) Shorter term Markets
  - b) Capital Markets
  - c) Counter Markets

- d) Long-term Markets
11. What is the main function of financial intermediaries?
    - a. Connecting savers and borrowers.
    - b. Regulating the finance industry.
    - c. Acting as a fail-safe during financial crises, such as the Great Recession.
    - d. Facilitating investment in major corporations.
  12. Which of the following is not an example of a common financial intermediary?
    - a. A commercial bank.
    - b. The Federal Reserve
    - c. The stock market
    - d. The bond market
  13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?
    - a. The federal government is indirectly involved because it regulates financial intermediaries.
    - b. Financial intermediaries do not deal directly with borrower-spenders.
    - c. Financial intermediaries do not deal directly with saver-lenders.
    - d. Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
  14. Which of the following statements about financial markets is not true?
    - a. Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.
    - b. Sometimes intermediaries invest in the financial markets.
    - c. Financial markets are associated with "direct" finance.
    - d. When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.
  15. Which one of the following is not a financial intermediary?
    - a. A money market mutual fund
    - b. A steel manufacturing plant
    - c. A property and casualty insurance company
    - d. A commercial bank

**Answers: Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

**Further Readings****Text Books:**

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## Unit 07: Risk and Financial Assets

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it is mobilization of savings or their efficient, effective and equitable allocation

for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

### **7.1 Meaning of Financial System:**

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

#### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as "a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions."
2. Prof.S.B.Gupta defines the financial system as "a set of institutional arrangements through which financial surpluses available in the economy are mobilized".
3. Van Horne has defined the financial system as "the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption".
4. According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth".

### **7.2 Features/Characteristics/Role of Financial System:**

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.
13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.
19. It includes financial institutions, markets, instruments, services, practices and transactions.
20. The main objective is to formulate capital, investment and profit generation.

### **7.3 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of

financial system in an economy. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

### **7.4 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares. It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.
3. **Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.
4. **Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.
5. **Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.
6. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.
7. **Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.
8. **Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.
9. **Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.
10. **Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.
11. **Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.
12. **Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

### **7.5 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

**Formal (organized) financial system:** This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

- Financial Institutions.
- Financial Markets.
- Financial Instruments.
- Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

### **7.6 Money:**

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

### **7.7 Meaning and Definitions of Money:**

The word "money" is believed to originate from a temple of 'Juno', located on Capitoline, one of Rome's seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn or instruct) or the Greek word "moneres" (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

#### **Definitions of Money:**

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various

economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, "Money is what money does". It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability.

Looking from this criterion, we find Crowther's definition to be the most suitable.

"Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value." – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

#### **Legal Tender Money and fiduciary Money:**

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

#### **Legal tender money is of two kinds:**

(a) Limited legal tender, and

(b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

## **7.8 Stages in the Evolution of Money:**

### **(i) Animal Money:**

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.

### **(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

### **(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

### **(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

### **(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

**Characteristics of Money:**

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

**6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

**7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

**Classification of Money:**

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

**(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

**(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

**(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

**(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

(a) Standard Money, and

(b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

(a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

**(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

## 7.9 Modern Forms of Money:

### 1. Currency:

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

**(a) Metallic Money:**

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

**(b) Paper Money:**

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

### 2. Deposit Money or Bank Money:

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

### 3. Legal Tender Money (Force Tender):

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.

### 4. Near Money:

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

### 5. Electronic Money:

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money.

The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

**6. Fiat Money:**

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country.

The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

**7.10 Importance of Money:**

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

**1. Money and Production:**

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

**2. Money and Consumption:**

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

**3. Money and Distribution:**

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

**4. Removal of the Difficulties of Barter:**

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

**5. Money and Capital Formation:**

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

**6. Money and Public Finance:**

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

**7. External Trade:**

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

**8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

**Value of Money:**

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.



In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

**The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

**(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

**(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

**(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

**Evils of Money:**

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:**

**(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

### **7.11 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

**Process of Intermediation:**

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a

reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

## 7.12 Roles of Financial Intermediaries:

### 1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

#### (i) Reduce Hoarding:

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

#### (ii) Help the Household Sector:

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

#### (iii) Help the Business Sector:

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

#### (iv) Help the State and Local Government:

FIs help the state and local bodies financially by purchasing their bonds.

#### (v) Help the Central Government:

Similarly, they buy and sell central government securities and thus they help the central government.

#### (vi) Lenders and FIs both Earn:

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

#### (vii) Spread of Risks:

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

**(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

## **7.13 Functions of the Financial Sector**

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:

**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### Value exchange

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.

**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

### Intermediation

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

**Risk transfer**

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

**Liquidity**

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

**The Characteristics of Finance**

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the

assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

## Summary

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets,

instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

## Keywords

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

### **Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups." Comment.
5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

### **Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. - - - - represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset
  - d. none of these
3. Financial derivatives include
  - a. Stocks
  - b. Bonds
  - c. Futures
  - d. None of the above
4. Which of the following is the regulator of Money market?
  - a) Reserve Bank of India
  - b) Government of India
  - c) Telecom Regularity Authority
  - d) Insurance Regularity Department
5. What is Call Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
6. What is Notice Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
7. What is Term Money?
  - a) It is an overnight loan in the Money Market



- b) It is loan of above 1 day to 14 days in the money market  
 c) It is loan of above 14 day to 364 days in the money market  
 d) It is a loan provided on certain terms and conditions by Bank to its customer
8. Which of the following is not related with Money Market?  
 a) Treasury Bills  
 b) Commercial Bills  
 c) Certificates of Deposit  
 d) Shares
9. Which of the following is related with Money Market?  
 a) Treasury Bills  
 b) Commercial money  
 c) Cheque  
 d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:  
 a) Shorter term Markets  
 b) Capital Markets  
 c) Counter Markets  
 d) Long-term Markets
11. What is the main function of financial intermediaries?  
 a. Connecting savers and borrowers.  
 b. Regulating the finance industry.  
 c. Acting as a fail-safe during financial crises, such as the Great Recession.  
 d. Facilitating investment in major corporations.
12. Which of the following is not an example of a common financial intermediary?  
 a. A commercial bank.  
 b. The Federal Reserve  
 c. The stock market  
 d. The bond market
13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?  
 a. The federal government is indirectly involved because it regulates financial intermediaries.  
 b. Financial intermediaries do not deal directly with borrower-spenders.  
 c. Financial intermediaries do not deal directly with saver-lenders.  
 d. Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
14. Which of the following statements about financial markets is not true?  
 a. Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.  
 b. Sometimes intermediaries invest in the financial markets.  
 c. Financial markets are associated with "direct" finance.  
 d. When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.
15. Which one of the following is not a financial intermediary?  
 a. A money market mutual fund  
 b. A steel manufacturing plant  
 c. A property and casualty insurance company  
 d. A commercial bank

### **Answers: Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

### **Further Readings**

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## Unit 08: Non-Bank Financial Intermediaries

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions. Banks provide packages of financial services which individuals find too costly to search out, produce and monitor by them. Commercial banking offers a wide variety of services to small, medium and large-scale business units. The role of banking is more prominent in the open economy.

*“A bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits.” – Benhams*

A central bank is the essential wellspring of cash supply in an economy through the flow of currency. It guarantees the accessibility of cash for meeting the exchange needs of an economy and encouraging different financial exercises, for example, creation, dissemination, and utilization.

Notwithstanding, for this reason, the central bank needs to rely on the reserves of commercial banks. These reserves of commercial banks are the optional wellspring of money supply in an economy. The main function of a commercial bank is the creation of credit.

Credit creation isolates a bank from other monetary establishments. In basic terms, credit creation is the development of reserves. Furthermore, banks can extend their demand deposits as numerous of their money holds since demand deposits fill in as the important medium of trade.

## **8.1 Commercial Banks**

The Indian financial sector has considerably widened and deepened, thereby lending strong support to capital accumulation and overall economic growth. The commercial banks in India constitute the single-most important component of the Indian financial system in bringing about the bulk of financial intermediation process in the country. A significant part of this impressive record of financial development in India is attributable to the crucial role played by banks in the financial intermediation process. In India the financial sector comprises the banking system (i.e. commercial and cooperative banks), financial institutions (which include term lending institutions, i.e. IDBI, NABARD, ICICI, IRBI, IFCI, EXIM Bank and NHB at the all-India level and SFCs and SIDCs at the state level, besides investment institutions, i.e. UTI, LIC and GIC and other institutions including DICGC and ECGC), non-banking financial intermediaries and the capital market.

### **Evolution of Commercial Banking**

The evolution of banking which lasted for centuries until two types of modern banking developed in the industrially advanced economies in the late nineteenth century was an integral part of the expansion of capitalism. The techniques of banking developed in the 17th century facilitated the industrial and territorial expansion that began about the same time. Banking systems evolved to meet the demands of the constituents, vested interests are regulations governing their establishment. The British system evolved around the central banking system with a central bank and clearing banks with a large network of offices regulated by the central bank while the German one evolved out of an identification of interests of finance, industry and government to

provide multiple services to the constituents. The US system however was set apart by the dominance of the unit banks, the role played by an active interbank market in deposits and reserves and the cooperative lending practices. It also features wholesale banking, which was the source of several innovative practices such as rollover credit or flexi rate lending.

### **Structure of Indian Commercial Banks**

Having established the pivotal role performed by the banking system in the Indian financial sector and by implication, in the overall financial intermediation process, thus supporting the real sector of the economy. The strong points of the financial system are its ability to mobilize savings, its vast geographical and functional reach and institutional diversity.

The commercial banking structure in India consists of: Scheduled Commercial Banks and Unscheduled Banks. Scheduled commercial banks constitute those banks, which have been

included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI includes only those banks in this schedule, which satisfy the criteria laid down vide section 42 (6) (a) of the Act. Indian banks can be broadly classified into nationalized banks/ public sector banks, private banks and foreign banks. The Indian banks include 27 public sector banks excluding 196 Regional Rural Banks (RRBs).

### **Asset Structure of Commercial Banks**

Assets structure will reflect the deployment of sources of funds of commercial banks. The main source of funds of commercial banks is deposits. The other sources of funds are borrowings from other banks, capital, reserves and surplus. The deposits of commercial banks are from savings

deposits, current account deposits and term deposits. These deposits constitute 80 per cent of the total sources of funds. Out of the total deposits, term deposits constitute 50 per cent. Borrowings are around 5 per cent of the total liabilities of the commercial banks. These sources are deployed by the commercial banks mainly on its financial assets i.e, loans and advances which constitute 48.6 per cent of the total assets of the banks. The investments is another important component of the assets of commercial banks which is around 40 per cent of the total assets of the banks during the year 2005. This is because of pre-emptions like SLR and CRR requirements in the banking sector. The investments in commercial banks have increased also because of surplus liquidity in Indian banks during this period due to reduction of SLR and CRR to 25 and 4.5 respectively during that period and less demand for loans and advances from credit-worthy customers. This scenario is changing in India due to increasing demand in credit from industrial, agriculture sector and also the growth of FMCG market.

The assets structure of the banks is governed by certain principles, like liquidity, profitability, shiftability and risklessness. The other factors which influence the assets structure of commercial banks are nature of money market, economic growth of the country, policies and vision of the governments. In the countries like India, China, Russia, North Korea and Brazil there is a boom in the growth of the economy hence naturally there will be heavy demand for the credit. Now let us examine each of the important assets of the commercial bank.

**1. Cash in hand and balances with RBI.** From the point of the liquidity in the commercial banks cash in hand is a very important asset but it is idle and it will not fetch any earnings to the banks. Cash in commercial banks depends upon various factors like uncertainty in the economy due to wars, famine, internal disturbance, the growth of banking system, network of branches, networking of banks, automation in banks and so on. The cash reserve requirements in the commercial banks was more during pre-reform period it was 15 per cent during the year 1994-95. Gradually RBI reduced it to 4 per cent based on the requirements of credit and it is now 5 per cent on Net Demand and Time Liabilities.

**2. Money at Call and Short Notice.** It is second line of defense of the commercial banks in cases of emergencies. If the call money market is well developed the commercial banks can lend their surplus funds in the call market for a day or up to 14 days it is called call market or overnight market without keeping their surplus money idle. It can also lend for short period, where the borrower has to return the money borrowed from the banks when short notice is given by the banks. This is becoming a good business in the money market and constitutes around 4 per cent of the total assets of the commercial banks. The banks instead of keeping the money idle lend their surplus funds for short periods in the call market.

**3. Investments.** Investments constitute one of the important assets of the bank next to loans and advances. A bank makes investments for the purpose of earning profits. First, it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject

to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity.

**4. Loans and Advances.** The commercial banking industry in India has been playing a very important role in intermediating between the economic units, which have surpluses and deficits in their current budgets. By mobilizing financial surpluses in the economy and by channeling these resources into various sectors and segments of the economy, they are guiding the pattern of utilisation of a large proportion of the economy. The Government of India which owns a large segment of the industry, and the RBI, which is the central banking authority of the country, have been persuading the commercial banks to deploy larger and larger volumes of financial resources into certain identified priority sectors, for the purpose of accelerating the growth of these sectors. The total advances of commercial banks include bills purchased and discounted, cash credits, overdrafts, loans, unsecured loans, and priority sector advances. The component of loans and advances in the total assets of commercial banks is 48 to 50 per cent – in fact still growing in India. The management of this asset is a very important aspect in the banking sector. The non-performing assets in banks is increasing. In addition to this banks are exposed to various risks such as credit risk, liquidity risk, market risk and operational risk.

**5. Fixed Assets and other assets.** The component of fixed assets and other assets do not form an important aspect in the funds of commercial banks since deals are more in financial assets than real assets.

### **Factors affecting Banking Systems Growth**

While provision of payment services involving the transfer of ownership of bank deposits from one account to another, provision of deposit facilities and advance credit by means of overdrafts and loans, by the discounting of bills and by trade finance constitutes the ordinary business of banking, there has been a sea change in the business of banking in the last forty years as exemplified by the rise of wholesale banking, liability management, international banking, multiple currency loans, rollover credits, securities lending collateralised mortgages note issuance facilities, interest rate and currency options and financial futures.

*Example:*

Credit cards

Debit cards

Automated teller machines

E-cash and on-line banking

Banks globally have undergone fundamental changes because of the ongoing revolution in information technology and communications. The winds of change are reshaping the nature of banking and financial markets. The demand for new types of services as well as the need to step up earnings through fee income is the major factor. On the other hand, technological advances by reducing costs give individuals and business firms direct access to markets reducing the need for banks to offer certain services. Technological advances and subsequent innovations have also led to the creation of new markets in terms of future options, secondary mortgage markets expanding the range of portfolio strategies open to financial intermediaries.

The changes in competitive conditions since 1990s with banks as a leading partner of financial services industry have transformed banks (especially large international ones) into new financial firms. Among the important factors behind changes in competitive conditions are the internationalization of banking and financial markets. The opening up of financial markets, the supply of cross-border financial services and the impact of the entry of foreign commercial and investment banks are the important features of the process. Other factors are the continuous process of deregulation, partly as a consequence of the globalization of the markets and partly as a middle through process. The sources of change of banking industry, mergers and amalgamations of banks, integration of markets by exchanges, growth of financial information business and internet.

## **8.2 Functions of Commercial Banks**

Prof. Syers, defined banks as “institutions whose debt – usually referred to as ‘bank deposits’ – are commonly accepted in final settlement of other people’s debts”. According to Banking Regulation Act of 1949, “Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise”. From the above definitions we can analyze that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

**1. Receiving deposits from the public.** The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity.

**2. Giving loans and advances.** The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and silver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and foreign banks, the other commercial banks also started giving loans and advances not only to their

traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.

**3. Use of cheque system and credit cards.** The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

**4. Credit creation.** Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

**5. Financing foreign trade.** The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

**6. Transfer of funds.** Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transferring funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.

**7. Agency functions.** The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers.

**8. Miscellaneous functions.** The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc. advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. The Ghosh Committee recommended that "a bank's investment portfolio should be bifurcated into two parts, namely, 'permanent investment' and 'current investment'. The committee recommended that banks should make necessary provision for the depreciation in the value of current investment and there is no need to provide for permanent investment. RBI has also advised the banks to classify the existing investment in approved securities into two categories. Initially from the accounting year 1992-93, banks should not keep more than 70% of their investment in permanent category, and 30% of the portfolio as current investments to facilitate valuing all the investments on fully 'marked to market' basis. Guidelines were laid down for transfer of approved securities from 'current' to 'permanent' and 'vice versa' in 1992. These guidelines ensure that latent losses are provided for at the time of such transfer. In 1993 the entire investment portfolio of banks other than investments classified as 'permanent' has to be classified into six categories for the purpose of valuation. The valuation will be done for each category of investments. While net depreciation has to be provided by debit to the profit and loss account, net gains have to be ignored. Permanent investments can be carried at book value. Premium will have to be amortized over the life of the investment but discount cannot be recognized as income.

## Transformation Services

Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process. Firstly, liability, asset and size transformation consist of mobilization funds and their allocation (provision of large loans on the basis of numerous small deposits). Secondly, maturity transformation by offering the savers, the relatively short-term claim on liquid deposits they prefer and providing borrowers long-term

loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. Commercial banks by effectively appraising credit requests can channel funds into productive uses.

### **Transformation Services and Risks**

Banks incur risks while undertaking transformation services. In the past three decades, banks abroad assumed new roles and accepted new forms of financial intermediation by undertaking currency and interest rate swaps and of dealing in financial futures, options and forward agreements. These new instruments reflect considerable flexibility in responding to market situations and adjusting continually assets and liabilities both on and off-balance sheet, while enhancing profitability.

### **8.3 Risk Management**

Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management. In the words of Alan Greenspan, former Chairman of the Federal Reserve Board of US (Conference at Federal Reserve Bank of Chicago, May 12, 1994), "traditional banking can be viewed at an elemental level as simply the measurement, management and acceptance of risk" and banking involves understanding, processing and using massive amounts of information regarding the credit risks, market risks and other risks inherent in a vast array of products and services, many of which do not involve traditional lending, deposit taking and payment services. Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks. To some extent, these risks could be managed through sound business practices and the others through a combination of product design and pricing. In the past banks concentrated on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that for given liquidity level, the return was the maximum.

**Overall Risk of a Bank:** A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.

**Types of Risk:** Banks have to manage four types of risk to earn profits for maximizing shareholder wealth. These are credit risk, interest rate risk, liquidity risk and operational risk. In addition there is a systematic risk arising due to various disruptions in the working of a major bank, which in notime could spread to other banks or the whole financial system. Credit risk arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by an increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of the borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally, operational risk arises out of an inability to control operating expenses, especially non-interest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardize the banks prospects to survive. Empirical analysis reveals that banks risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks maturity gaps, the duration and interest elasticity of its assets and liabilities and the ability of the management to measure and control the exposure.

**Interest Sensitive Assets Notes:** These risks are a part of either assets or liabilities or both of a bank them. Assets are managed through money market instruments such as interbank lending, treasury bills and repos. Shortening the maturity of these assets makes them interest sensitive. Shifting liabilities such as interbank borrowing, issue of CDs while shortening the maturity of the liability side of the balance sheet makes liabilities more interest-sensitive and increases the risk of the bank's portfolio.

**Credit Risk:** The assets of a bank whether a loan or investment carries credit risk. Credit risk is the risk of losing money when loans default. Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans. Banks can raise their credit standards to avoid high risk loans. Guarantees and collaterals can reduce risk. After the loan is made, compliance can be ensured by monitoring the behaviour of the borrower which reduces risk. Credit risk can be transferred by selling standardized loans. Loans portfolio can be



diversified by making loans to a variety of firms whose returns are not perfectly and positively correlated.

**RBI Guidelines:** RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk. Banks are also expected to evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

**Interest Rate Risk:** Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both. On-balance sheet adjustment involves changes in banks portfolio of assets and liabilities, as interest rates change. When medium or long-term loans are funded by short-term deposits, a rise in the rate of interest will increase the cost of funds but the earnings on the assets will not, thereby reducing the margin or spread on the assets. The problem could be resolved by adopting adjustable interest rate on loans on the asset side of the balance sheet and increasing the maturity pattern of deposits on the liability side of balance sheet. These decisions relating to banks portfolio of assets and liabilities represent balance sheet adjustments. The interest rate risk position can also be adjusted by the bank by making off-balance sheet adjustments which involve the use of various non-traditional financial instruments referred to as derivatives such as futures, options, swaps or creation of synthetic loans through use of futures.

**Liquidity Risk:** Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank. The mismatch between short-term liabilities and long-term assets creates a severe funding problem as the liabilities mature. Again, if the duration of assets exceeds the duration of liabilities, the ability to realize liquidity from the assets of the bank is reduced. Liquidity needs are increasingly met by deposit and non-deposit sources of funds paying market rates of interest.

Banks have decreased the quantity of liquid assets they hold for the purpose of deposits withdrawal and loan demand. Liability management has replaced asset management as a method to fund liquidity needs. The effect of replacement of asset management by liability management would be enhancement of credit risk since liquid assets have been replaced by loans. The replacement of short-term assets by long-term assets would also require an increase in gross rates of return, since upward sloping yield curves require higher rate of return on long-term assets than on short-term assets.

**Foreign Exchange Risk:** Foreign exchange risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur. An open foreign exchange position implies a foreign exchange risk. When a bank owns an uncovered claim in foreign currency, it is said to be long and when it has uncovered liability in foreign currency, it is said to be short. There are several techniques available to hedge or cover exposure to foreign exchange risk. These techniques help in minimize the impact of unfavourable potential outcomes. Forward contracts, money market alternative, foreign currency futures, currency swaps and foreign currency options are used to cover exposure to foreign exchange risk.

**Treasury Functions:** To take advantage of the opportunities provided by development of new financial markets and the internationalization of banking while managing risk has led to the growth of treasury function within bank. The role of new treasury department is to manage a wide range of short-term assets and liabilities. The dealers employed in treasury department are constantly trading in wholesale deposits, interbank deposits, certificates of deposit, foreign exchange, repurchase agreements, securities, financial futures and options. Apart from trading in short-term assets and liabilities, the treasury department monitors the bank's position with respect to earnings and risks due to maturity gaps and interest rate or foreign currency exposures. The treasury department usually reports to a high-level treasury or asset and liability management committee. The committee after considering the entire balance sheet of the bank as well as off-balance sheet liabilities decides the treasury policy.

**Monitoring Risks:** To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed. A maturity profile shows all assets and all liabilities by maturities to enable the calculation of mismatches within each period. Rate-of-interest ladder classifies all assets and liabilities by repricing dates and allows the calculation of rate of interest risk for each period. Duration presents the interest exposure.

## **8.4 Asset and Liability Management**

Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals. Frozen lending was offset by increasing flexibility by making new loans against the provision of tradable assets which could be sold before expiry, in case of need. Against a background of rapid growth in the banking business, integrated approach to managing all assets and all liabilities evolved as balance sheets became more complex and as the volatility of interest rates and exchange rates increased. In the eighties, the rescheduling of debt of developing countries on account of their serious payments difficulties involved conversion of short-term and medium term assets into long-term and became frozen.

Banks abroad met the problem by raising long-term funds including capital liabilities. In the process, banks could meet the rise in capital adequacy norms stipulated by bank supervisors. Banks shifted their focus from growth to profitability and asset quality. Banks also started lending against negotiable assets and to the packaging for resale of conventional bank loans. Borrowers were encouraged to raise funds directly through issue of negotiable short-term paper by providing guarantees, standbys and backup facilities. Banks benefited from fee income without expanding balance sheet which would worsen capital ratios. Of course, off-balance sheet contingent liabilities went up.

There was a deliberate attempt to extend asset liability management beyond the range of on-balance sheet assets and liabilities which arises from the bank acting as principal in direct transactions with borrowers and lenders of money. Asset and liability management has helped to bring about securitisation of banking blurring the distinction between commercial banking and investment banking.

## **8.5 RBI Guidelines for Risk Management**

Consequent to the liberalization of domestic market in India, the volatility in interest/exchange rates would be transmitted to the financial sector as a whole. To address these risks, banks have to undertake a comprehensive Asset Liability Management (ALM) strategy. The objectives of ALM are to control volatility of net interest income and net economic value of a bank. RBI issued guidelines on 21.10.1999 for risk management in banks which broadly cover credit, market and operational risks. Earlier, guidelines were issued on 10.2.1999 on asset-liability management system which covered management of liquidity and interest rate risks. Together they are purported to serve as benchmark to banks.

**Notes Credit Risk:** Banks should put in place the loan policy covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive credit ratings system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions. Proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. Portfolio quality should be evaluated on an ongoing basis rather than near about balance sheet date. Risk evaluation should be on the basis of total exposure, credit and investment decisions combined. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. A suitable framework to provide a centralized overview of the aggregate exposure on other banks is to be evolved. The banks should also develop an internal matrix that reckons the counter party and country risk.

**Liquidity Risk:** Banks should put in place prudential limits on interbank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments and swapped funds. Liquidity profile should be evaluated under bank specific and market crisis scenarios. Contingency plans should be prepared to measure the ability to withstand sudden adverse swings in liquidity conditions.

**Interest Rate Risk:** A time-frame should be fixed for moving over to value at risk (VAR) and duration approaches for measurement of interest rate risk.

**Market Risk:** Explicit capital cushion based on international standards should be provided for the market risks to which banks are exposed.

**Operational Risk:** In view of the phenomenal increase in the volume of financial transactions, proper systems for measurement, monitoring and control of operational risk should be set up. Suitable methodologies for estimating and maintaining economic capital should be developed.

The design of the risk management should be oriented towards the banks own requirements dictated by the size and complexity of business risk philosophy, market perception and the existing level of

capital. Banks can evolve their own systems compatible with the type and size of operations as well as risk perception. It is neither possible nor necessary to adopt uniform risk management system in all banks on account of the diversity and varying size of balance sheet items. The success of ALM depends on the effective existence of (1) information and policies, and (2) risk management system. There should be asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimize the volatility in its earnings, liquidity and equity to changes in market conditions. The successful pursuit of the objective would manifest in stable net interest margins, optimal earnings, adequate liquidity and effective control of financial risk. For this purpose the strong ALCO must be aware of policies which would address asset liability management goals and risk limits and by information that relates directly to its asset liability position.

## 8.6 Risk Management Systems

Measurement, control and monitoring of risk will help banks to attain the objective. Techniques such as gap, duration and value at risk are suggested to analyse risk. Strengthening of information technology in commercial banks is a prerequisite to implement effectively A.I.M system. The role of a broad-based ALCO in advising boards of banks is of significance.

**Financial Services:** Commercial banks provide securities related services. Commercial banks in India have set up subsidiaries to provide capital market related services, advice on portfolio management or investment counseling. In US, the Glass-Steagall Act of 1933 restricts the nature of services provided by commercial banks. In US, they may offer discount brokerage services but not general-purpose brokerage services. US banks facilitate mergers and acquisitions and in trading in currencies and US Government securities.

The Glass-Steagall Banking Act prohibits commercial banks from owning a firm dealing in securities. The Act has been challenged by banks offering money market mutual funds and other investment services. US Federal Reserve Board in January, 1997 issued a proposal that would allow bank holding companies and their securities industry affiliates to offer one stop shopping for their customers. Commercial banks in US in 1990s have become very active in the management and distribution of mutual funds, managing more than 10 per cent of the assets of all mutual funds. In India, several commercial banks such as Bank of India, Canara Bank, Indian Bank and State Bank of India have set up subsidiaries under the guidelines issued by the Reserve Bank in 1987, followed by guidelines laid down by the Ministry of Finance in 1991.

**Fiduciary Services:** In US, banks manage employee pension and profit-sharing programs that do not show up on banks balance sheet. In US, banks operate separate trust departments which manage the funds of others for a fee under the guidance of a trust agreement. The assets held in trust do not show up on banks balance sheet because they do not own the assets held in trust.

## 8.7 Nature of Primary Reserve in Commercial Banks

The term primary reserve is an analytical term used commonly in banking to refer to absolutely non-earning liquid assets held by a commercial bank. The aggregate of cash holdings by bank with itself and with the central bank and other commercial banks is designated as the primary reserve. It consists of cash in hand, the balance with RBI and demand deposits with other banks. A major function of primary reserve is to maintain liquidity in the bank with a view to protecting

it against illiquidity crises. It enables the bank to satisfy the depositors' claims immediately to perform its expected crisis. The primary reserve plays the role of first day-to-day business needs but to comply with the obligation imposed on it by law. The primary reserve may be divided into:

1. Legal Reserve
2. Working Reserve

**The legal reserve** represents that portion of the primary reserve, which the law requires a bank to maintain. The reserves are computed on the basis of the average deposits outstanding on the bank's books over a short period (one or two weeks). Since the bank is a dealer in public money and attracts public deposits on the premise that the deposits on the premises that the depositors will get back their money on demand, the government has the responsibility to ensure sufficient liquidity in the banking system so that the depositors' claims are met in full as promised. The law prescribes the minimum percentage of deposits, which a commercial bank has to carry with the central bank. By changing the reserve requirements, the central bank can regulate the magnitude of credit. In order to curb inflationary trends, banks may raise the reserve requirements and restrict the lending and investment activities of banks. Similarly the legal reserve weapon may be used along with

other control techniques to take out economy from the possibility of depression, which is another undesired situation to keep the nation on growth track.

The regulatory function of legal reserve involves three steps by the government of the central banking authority:

1. Defines those particular types of assets which can be counted towards the legal reserve requirements. According to RBI the two types of assets- Cash in hand and balance with RBI are considered eligible for legal reserve purpose.
2. Regulates the rupee volume of the legal reserve maintainable by banks. In India, this is the main function of the RBI.
3. Requires banks to hold legal reserves equal to at least some stated fraction of their deposit liabilities.

**Statutory Provisions Regarding Cash Holdings:** The RBI Act, 1934 empowered RBI to require scheduled banks to keep with it not less than 5 percent of their demand liabilities and 2 percent of their time liabilities. RBI announces its CRR policy for the year such that the banks can cope up with the maintaining of adequate Cash Reserve Ratios to prevent illiquidity.

### **Working Reserve - Nature and Functions**

Commercial Banks have to carry cash reserves in excess of the legal minimum reserve to meet the depositors' claims, satisfy the credit needs of the community and provide protection against unforeseen withdrawals. This excess cash reserves held by the commercial banks to fulfill day-to-day business requirements is designated as working reserve. This consists of:

1. Cash in their own vaults.
2. Demand deposits with other banks
3. Excess reserve with the central bank.

The principal function of the working reserve is to take care of both regular and exceptional requirements. Since they have to meet the obligatory demands of human, predicting about their requirements is very difficult and that's why determining working reserve determining is complicated. How much of total deposit liabilities should be held in the form of working reserves is a basic problem which confronts a commercial bank. A commercial bank has to trade off between liquidity and profit. In order to determine the proper size of the working reserve a banker should consider all those variables, which affect the quantum and nature of money inflows, and cheques are collected. The various factors, which generally affect are:

1. Banking habit of the people
2. Nature of Business conditions
3. Seasonal factors
4. Existence of clearing house arrangements
5. Cash reserves held by other Banks
6. Structure of Deposits
7. Size of Deposit Accounts
8. Ownership of deposit accounts
9. Size of secondary Reserve
10. Location of Bank
11. availability and cost of borrowings
12. Ownership of deposit account
13. Banks inclination and ability to adjust working reserve position.

### **8.8 Cash Management in a Commercial Bank**

An efficient utilization of cash is essential for the successful survival of a bank. A bank receives money from customers in various deposit accounts and pays cash to depositors and demand cheques or demand drafts or bank orders etc. The basic issues involved in cash management in a bank are:

1. The management has to keep the cash balance at the lowest possible level in order to avoid the loss of opportunity income.
2. A low cash level will mean a greater risk of running out of cash and higher cost of replenishment.

Prudence in the management of cash lies in striking a balance between the two factors. The banks have to compile data weekly about:

1. Cash receipts from the customers
2. Cash receipts by way of remittances
3. Routine cash payments to customers.

4. Payments in the form of remittances to the head office
5. The amount of cash receipts utilized for the purpose of making everyday.

Cash Management system should be effective to increase profitability and liquidity of any bank. The bank managers should compile periodically information relating to cash receipts, cash payments and similar other information (weekly) and submit to the head office. The head office should analyze the data and determine the optimal cash levels for huge withdrawals and determine cash inventory levels by scientific inventory management techniques. They can be applied to determine optimal cash levels for each bank and if followed that would improve the profitability of a bank.

### **8.9 Nature of Secondary Reserve in Commercial Banks**

A commercial bank generally relies on highly liquid earning assets to meet its expected and unexpected financial needs because it can't afford to hold a larger proportion of funds in the vault for the reasons stated earlier. The aggregate of highly liquid earning assets is designated as the secondary reserve in banking circles. The principal objective of holding the secondary reserve is to impart adequate liquidity to funds without adversely affecting the profitability of a bank. The bank must have such assets which are highly liquid and at the same time generate some yield on them. Call loans to brokers or bankers which may be terminated at any time at a very short notice may be regarded as highly liquid assets. Keeping above requirements of high liquidity, yield and shiftability, the following types of assets may be grouped in the category of secondary reserve:

1. Call loans to stock brokers and commercial banks.
2. Short term loans to commercial banks.
3. Short term loans secured against self liquidating assets or blue chips.
4. Investment in treasury bills.
5. Promissory notes of short period maturity.
6. Discounting of usance bills eligible for rediscounting from the RBI.
7. Short period debentures of companies.

### **8.10 Functions of Secondary Reserve in Commercial Banks**

The principal function of the secondary reserve is to replenish the primary reserve, while its subsidiary function is to earn a moderate income. Since it is very difficult to estimate correctly the working reserve requirements because the bank deals with human beings who are motivated by a variety of factors, a banker would like to keep a little more cash in the vault than is absolutely necessary to avoid an illiquid crisis. Secondary reserve helps a banker to trade off successfully between liquidity and profitability. Where a bank has a surplus in the primary reserve because of heavy cash inflows, it is invested in secondary reserve assets so that it may be drawn conveniently. Moreover the bank can earn some yield rather than earning nothing or a less yield.

### **Factors Influencing the Level of Secondary Reserve in Commercial Banks**

The factors can be classified into External factors and Local factors:

#### ***External Factors***

1. **General state of Economy:** If the level of business activity is expected to increase, which means more demand for business loans the banker can keep large proportion of loans in secondary reserve to meet the requirements.
2. **Political conditions:** When there are uncertain political conditions in the country, banks generally lose public confidence and consequently there is a run on the banks. In such conditions to meet the heavy customers banks have to invest in secondary reserves more and release conveniently.
3. **Taxation policy** of the government may affect the size and composition of the secondary reserve. A bank may be tempted to invest more in government securities if the government decides to exempt them from the levy of tax because this investment will not only strengthen the liquidity position of the bank and also profitability.
4. **Monetary policy:** A banker has to understand the monetary policies announced by the central bank and expected to be followed at the same time liquidity and profitability are also balanced.

#### **Local Factors**

Character of the local economy- A banker must be familiar with the characteristics of the economy in which he is operating because the character and magnitude of deposits and loans is affected by them. Indian economy is dominated by agriculture and its requirements are highly vulnerable therefore because banks receive large deposits after the harvest season, while withdrawals take place throughout the year. Similarly the banks in industrial locality must familiarize with the industrial requirements pattern and accordingly invest the surplus in secondary reserves. A large number of internal factors such as deposit structures, ownership of

deposit accounts, average size of bank accounts, access to money market, nature of bank loan, maturities and diversification of investment portfolio are such other factors influence regarding the size of secondary reserves of a bank. Banks can apply statistical methods to analyse the various demand supply requirements of money and accordingly determine the structure its secondary reserve portfolio to maintain liquidity and profitability.

### **8.11 Management of Loans in a Commercial Bank**

Lending is the most important function commercial banks. At they aim at lending results in maximum return and their survival depends on high they can do it with in the frame work of central bank regulations and guidelines along with the social responsibility for the economy development as expected by the society. The important characteristics of commercial bank loans are:

1. The bulk of the loans in India are provided to trade and industries.
2. As the banks look at liquidity they give maximum proportion of loans of less than year type which are short term nature.
3. Commercial banks in India demand sound security like goods, financial assets, gold, and hypothecation. Unsecured credit loans are given to firms with a sound financial position and stable earning records.

Lending is the most profitable business of a commercial bank but at the same time it is highly risky. A banker is supposed to do the lending business on the sound principles of safety, liquidity and profitability. Banks should diversify their risk of lending by evolving to a right portfolio. It should not be merely defensive but provide for earning for increasing average rate of return on fund. The principle of maturity diversification allows the loan portfolio is staggered over different maturity periods so that a certain amount of loans mature at regular intervals of timeperiods so that the realizations can be utilized to meet the investors obligations. The funds can be invested in securities of diversified nature to earn reasonable returns.

Banks should check well into the purpose of loan an applicant seeks and track whether the loan is applied. This is important for productive purpose and the banks social obligations are also satisfied. An advance made to for non productive and speculative purposes is subject to high risk of recovery. A banker should avoid making loans against wasteful expenditure on social functions. The banker should examine whether the credit granted is not for a purpose other than that is sought. A bank has the social obligation of meeting the diverse credit needs of the society ranging from personal needs to small businesses to large industrial business needs. It can not afford to lend the funds of its depositors indiscriminately and incur losses. The loan policy should be carefully structured to maintain uniformity and standardization of lending policies. There is always a risk of misunderstanding and misinterpretation of the policy. In general, the loan policy in a bank largely influenced by the following factors:

1. **Capital position:** A bank having strong capital base can follow a liberal lending policy.
2. **Earning Requirements:** Profit making and required rate of return becomes the basis while structuring lending policy.
3. **Deposit variability:** Large variation is found between the urban banks and rural banks regarding demand and of supply of money. Banks expecting a rising tendency can go for liberal credit policy.
4. **State of local economy and National economy:** Banks have to understand the local needs and national needs due to variation in seasonality, commercial activity or agricultural needs.
5. **Monetary policy of the Central bank:** RBI announces the lending policy of term loans and interest rates range focusing on sectoral growth for prosperity and to put a check on inflationary movements affecting the common man and welfare of the economy. Fiscal disciplinary measures are to be followed by the banks and need to follow the directives of the central banks.
6. Term lending policy of a commercial bank is usually based on industrial activity and sectoral growth needs. Banks have to commit large funds to long term loans to industry. Commercial banks generally seek the assistance of banks like NABARD, IDBI etc. while granting collaborative lending to commercial purposes with respect to term loans. The commercial banks thus play an important role in the growth of an economy by mobilizing funds from small investors to business and play a critical role in the transformation of the nation to a greater and powerful economy. *Task* Prepare a project feasibility proposal as per the guidelines of a merchant Banker by selecting an entrepreneurial activity.

## Summary

The importance of Commercial banks and their contribution are discussed. An attempt is made to provide the effect of RBI banking regulations, demand supply theory of money, interest and profitability of banks are explained. The risk management practices observed by banks are discussed. The management of primary and secondary reserves, loan policy formulation and issues involved are discussed. There is also discussion on the financial institutions, which offer a variety of specialized to traditional services to the business and act as mediators and agents of transfer of funds to create wealth to the society at some charge for the service, which would be their source of revenue. They have the obligation of creating a qualitative Financial System and should cooperate with the regulatory bodies engaged with various measures to discipline the economic system.

## Keywords

**Credit or loan:** Credit or loan refers to sum of money along with interest payable.

**Finance:** Finance is monetary resources comprising debt and ownership funds of the state, company or person.

**Financial Institutions:** Financial Institutions are business organizations that act as mobilizers and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the society.

**Financial System:** Financial System is concerned about money, credit and finance.

**Money:** Money refers to the current medium of exchange or means of payment.

## Review Questions

1. What is the role of commercial banking in developing the economy?
2. Explain about the functions of commercial banks.
3. Write about the regulating policies RBI with respect to commercial banks.
4. What are the various factors influencing the level of secondary reserve in commercial banks?

## Self Assessment

1. In a market-oriented financial system, specialized .....including banks, financial markets and market intermediaries cater to the different financial needs.
2. In a .....financial system, savings are largely transferred directly from those who generate them to those wishing to use them by the intermediation of banks.
3. ....consists of provision of banking services by a single institution.
4. A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the .....of the value.
5. ....arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise.
6. Liquidity risk refers to the bank's ability to meet its .....obligations to depositors and borrowers.
7. ....risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.
8. ....is the link between financial markets and bank's profitability.
9. A capital shortage of a bank indicates that it should change, among others, its .....policies.
10. .... indicates how well a bank's programmes can be sustained and the capital sum serves as a cushion against temporary losses.
11. Market discipline according to .....is a lever to strengthen the safety and soundness of the banking system.
12. ....is the most profitable business of a commercial bank but at the same time it is highly risky.

13. Term lending policy of a commercial bank is usually based on industrial activity and .....needs.
14. A bank has the social obligation of meeting the diverse ..... needs of the society ranging from personal needs to small businesses to large industrial business needs.
15. .... reserve helps a banker to trade off successfully between liquidity and profitability.

### **Answers for Self-Assessment**

1. financial institutions
2. bank-oriented
3. Unit banking
4. standard deviation
5. Credit risk
6. cash
7. Foreign exchange
8. Bank capital
9. Operating
10. Return on bank capital
11. BCBS
12. Lending
13. sectoral growth
14. credit
15. Secondary

### **Further Readings**

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## Unit 09: Capital market

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Summary

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### Objectives

After this lecture, you would be able to

- To explore the structure of a central bank in an economy.
- To evaluate the functions of central bank in an economy.
- To explore the process of credit control by central bank
- To evaluate the methods of credit control by central bank
- To explore the central banks and monetary policy of India.
- To evaluate the central banks and monetary policy of India.

### Introduction

The origins of the Reserve Bank of India can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton-Young Commission – recommended the creation of a central bank for India to separate the control of currency and credit from the Government and to augment banking facilities throughout the country. The Reserve Bank of India Act of 1934 established the Reserve Bank and set in motion a series of actions culminating in the start of operations in 1935. Since then, the Reserve Bank's role and functions have undergone numerous changes, as the nature of the Indian economy and financial sector changed. Starting as a private shareholders' bank, the Reserve Bank was nationalized in 1949. It then assumed the responsibility to meet the aspirations of a newly independent country and its people. The Reserve Bank's nationalisation aimed at achieving coordination between the policies of the government and those of the central bank.

## 9.1 Central Bank

A central bank has been defined in terms of its functions. According to Vera Smith, "The primary definition of central banking is a banking system in which a single bank has either complete control or a residuary monopoly of note issue." W.A. Shaw defines a central bank as a bank which control credit. To Hawtrey, a central bank is that which is the lender of the last resort. According to A.C.L. Day, a central bank is "to help control and stabilise the monetary and banking system."

According to Sayers, the central bank "is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behaviour of financial institutions so as to support the economic policy of the Government." Sayers refers only to the nature of the central bank as the government's bank. All these definitions are narrow because they refer only to one particular function of a central bank.

On the other hand, Samuelson's definition is wide. According to him, a central bank "is a bank of bankers. Its duty is to control the monetary base.... and through control of this 'high-powered money' to control the community's supply of money." But the broadest definition has been given by De Kock.

Reserve Bank of India being an apex court of the center enjoys enormous power and functions under banking system in India. It has monopoly over the issue of bank-notes and monetary system of the country. These power and functions as to issue of bank notes and currency system are governed by the Reserve Bank of India Act, 1934. Besides it the Banking Regulation Act, 1949 also empowers certain power and Function of the Reserve Bank.

### Main Functions of CENTRAL BANK

A central bank is "a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions:

- i) The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof,
- (ii) The performance of general banking and agency for the state,
- (iii) The custody of the cash reserves of the commercial banks,
- (iv) The custody and management of the nation's reserves of international currency,
- (v) The granting of accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions and the general acceptance of the responsibility of lender of the last resort,
- (vi) The settlement of clearance balances between the banks,
- (vii) The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state." De Kock's definition is too long to be called a definition. For, a definition must be brief.

Main functions are those functions which every central bank of each nation performs all over the world. Basically, these functions are in line with the objectives with which the bank is set up. It includes fundamental functions of the Central Bank. They comprise the following tasks.

**1. Issue of Currency Notes:** The central bank is the bank of issue. It has the monopoly of note issue. Notes issued by it circulate as legal tender money. It has its issue department which issues notes and coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank.

Central banks have been following different methods of note issue in different countries. The centred bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued.

In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank. This system is operative in India whereby the Reserve Bank of India is required to keep Rs115crores in gold and Rs85crores in foreign securities. There is no limit to the issue of notes after keeping this minimum amount of Rs200crores in gold and foreign securities.

The monopoly of issuing notes vested in the central bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public.

The central bank can restrict or expand the supply of cash according to the requirements of the economy. Thus it provides elasticity to the monetary system. By having a monopoly of note issue, the central bank also controls the banking system by being the ultimate source of cash. Last but not the least, by entrusting the monopoly of note issue to the central bank, the government is able to earn profits from printing notes whose cost is very low as compared with their face value.

**2. Banker to other Banks:** Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on governments deposits. It buys and sells foreign currencies on behalf of the government., It keeps the stock of gold of the government.

Thus it is the custodian of government money and wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt.

The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc. As pointed out by De Kock, "Central banks everywhere operate as bankers to the state not only because it may be more convenient and economical to the state, but also because of the intimate connection between public finance and monetary affairs."

**3. Banker to the Government:** The CENTRAL BANK being the apex monetary body has to work as an agent of the central and state governments. It performs various banking function such as to accept deposits, taxes and make payments on behalf of the government. It works as a representative of the government even at the international level. It maintains government accounts, provides financial advice to the government. It manages government public debts and maintains foreign exchange reserves on behalf of the government. It provides overdraft facility to the government when it faces financial crunch.

**4. Custodian of cash reserves of commercial banks:** Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions.

- There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock.
- In the first place, the centralisation of cash reserves in the central bank is a source of great strength to the banking system of a country.
- Secondly, centralised cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks.
- Thirdly, centralised cash reserves can be utilised fully and most effectively during periods of seasonal strains and in financial crises or emergencies.
- Fourthly, by varying these cash reserves the central bank can control the credit creation by commercial banks. Lastly, the central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

**5. Exchange Rate Management:** It is an essential function of the CENTRAL BANK. In order to maintain stability in the external value of rupee, it has to prepare domestic policies in that direction. Also, it needs to prepare and implement the foreign exchange rate policy which will help in attaining the exchange rate stability. In order to maintain the exchange rate stability, it has to bring demand and supply of the foreign currency (U.S Dollar) close to each other.

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed prices to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the exchange rates of the domestic currency in terms of foreign currencies.

It holds these rates within narrow limits in keeping with its obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons

visiting foreign countries on business, studies, etc. in keeping with the rules laid down by the government.

**5. Lender of the last resort:** De Kock regards this function as a sine qua non of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse.

It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at "the front door". The other method is to give temporary accommodation to the commercial banks or discount houses directly through the "back door". The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

**6. Clearing house for transfer and settlement:** As bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques.

This is done by making transfer entries in their accounts on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centres. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and convenient for the commercial banks to settle their claims at one place. It also economises the use of money. "It is not only a means of economising cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining."

**7. Credit Control Function:** The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods.

Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilise economic activity in the country.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce. Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks.

They are the issuing of licences; the regulation of branch expansion; to see that every bank maintains the minimum paid up capital and reserves as provided by law; inspecting or auditing the accounts of banks; to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; to control and recommend merger of weak banks in order to avoid their failures and to protect the interest of depositors; to recommend nationalisation of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc. Commercial bank in the country creates credit according to the demand in the economy. But if this credit creation is unchecked or unregulated then it leads the economy into inflationary cycles. On the other credit creation is below the required limit then it harms the growth of the economy. As a central bank of the nation the CENTRAL BANK has to look for growth with price stability. Thus, it regulates the credit creation capacity of commercial banks by using various credit control tools.

**6. Supervisory Function:** The CENTRAL BANK has been endowed with vast powers for supervising the banking system in the country. It has powers to issue license for setting up new banks, to open new branches, to decide minimum reserves, to inspect functioning of commercial banks in India and abroad, and to guide and direct the commercial banks in India. It can have periodical inspections an audit of the commercial banks in India.

## **9.2 Objectives of Credit Control by the Central Bank:**

Credit control is the means to control the lending policy of commercial banks by the central bank.

The central bank controls credit to achieve the following objectives:

**1. To stabilise the internal price level:** One of the objective of controlling credit is to stabilise the price level in the country. Frequent changes in prices adversely affect the economy. Inflationary or deflationary trends need to be prevented. This can be achieved by adopting a judicious policy of credit control.

**2. To stabilise the rate of foreign exchange:** With the change in the internal prices level, exports and imports of the country are affected. When prices fall, exports increase and imports decline. Consequently, the demand for domestic currency increases in the foreign market and its exchange rate rises. On the contrary, a rise in domestic prices leads to a decline in exports and an increase in imports.

As a result, the demand for foreign currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilise the rate of foreign exchange by controlling bank credit.

**3. To protect the outflow of gold:** The central bank holds the gold reserves of the country in its vaults. Expansion of bank credit leads to rise in prices which reduce exports and increase imports, thereby creating an unfavourable balance of payments. This necessitates the export of gold to other countries. The central bank has to control credit in order to prevent such outflows of gold to other countries.

**4. To control business cycles:** Business cycles are a common phenomenon of capitalist countries which lead to periodic fluctuations in production, employment and prices. They are characterised by alternating periods of prosperity and depression. During prosperity, there is large expansion in the volume of credit, and production, employment and prices rise.

During depression, credit contracts, and production, employment and prices fall. The central bank can counteract such cyclical fluctuations through contraction of bank credit during boom periods, and expansion of bank credit during depression.

**5. To meet business needs:** According to Burgess, one of the important objectives of credit control is the "adjustment of the volume of credit to the volume of business." Credit is needed to meet the requirements of trade and industry. As business expands, larger quantity of credit is needed, and when business contracts less credit is needed. Therefore, it is the central bank which can meet the requirements of business by controlling credit.

**6. To have growth with stability:** In recent years, the principal objective of credit control is to have growth with stability. The other objectives, such as price stability, foreign exchange rate stability, etc., are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of payments deficits.

## **9.3 Role of Central Bank in a Developing Economy:**

The central bank in a developing economy performs both traditional and non-traditional functions. The principal traditional functions performed by it are the monopoly of note issue, banker to the government, bankers' bank, lender of the last resort, controller of credit and maintaining stable exchange rate. But all these functions are related to the foremost function of helping in the economic development of the country.

The central bank in a developing country aims at the promotion and maintenance of a rising level of production, employment and real income in the country. The central banks in the majority of underdeveloped countries have been given wide powers to promote the growth of such economies.

### **Creation and expansion of financial institutions:**

One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are

localised in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses.

In order to remedy this, the central bank should extend branch banking to rural areas to make credit available to peasants, small businessmen and traders. In underdeveloped countries, the commercial banks provide only short-term loans. Credit facilities in rural areas are mostly non-existent.

The only source is the village moneylender who charges exorbitant interest rates. The hold of the village moneylender in rural areas can be slackened if new institutional arrangements are made by the central bank in providing short-term, medium term and long-term credit at lower interest rates to the cultivators.

A network of co-operative credit societies with apex banks financed by the central bank can help solve the problem. Similarly, it can help the establishment of lead banks and through them regional rural banks for providing credit facilities to marginal farmers, landless agricultural workers and other weaker sections.

With the vast resources at its command, the central bank can also help in establishing industrial banks and financial corporations in order to finance large and small industries.

#### **Proper adjustment between demand for and supply of money:**

The central bank plays an important role in bringing about a proper adjustment between demand for and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops, the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agricultural and industrial production and prices.

The demand for money for transactions and speculative motives will also rise. So the increase in money supply will have to be more than proportionate to the increase in the demand for money in order to avoid inflation. There is, however, the likelihood of increased money supply being used for speculative purposes, thereby inhibiting growth and causing inflation.

The central bank controls the uses of money and credit by an appropriate monetary policy. Thus in an underdeveloped economy, the central bank should control the supply of money in such a way that the price level is prevented from rising without affecting investment and production adversely.

#### **A suitable interest rate policy:**

In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates and between interest rates in different sectors of the economy. The existence of high interest rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy. A low interest rate is, therefore, essential for encouraging private investment in agriculture and industry.

Since in an underdeveloped country businessmen have little savings out of undistributed profits, they have to borrow from the banks or from the capital market for purposes of investment and they would borrow only if the interest rate is low.

A low interest rate policy is also essential for encouraging public investment. A low interest rate policy is a cheap money policy. It makes public borrowing cheap, keeps the cost of servicing public debt low, and thus helps in financing economic development.

In order to discourage the flow of resources into speculative borrowing and investment, the central bank should follow a policy of discriminatory interest rates, charging high rates for non-essential and unproductive loans and low rates for productive loans.

But this does not imply that savings are interest-elastic in an underdeveloped economy. Since the level of income is low in such economies, a high rate of interest is not likely to raise the propensity to save.

In the context of economic growth, as the economy develops, a progressive rise in the price level is inevitable. The value of money falls and the propensity to save declines further. Money conditions become tight and there is a tendency for the rate of interest to rise automatically. This would result in inflation. In such a situation any effort to control inflation by raising the rate of interest would be disastrous. A stable price level is, therefore, essential for the success of a low interest rate policy which can be maintained by following a judicious monetary policy by the central bank.

**Debt management:**

Debt management is one of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing public debt. It is the central bank which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt.

In order to strengthen and stabilize the market for government bonds, the policy of low interest rates is essential. For, a low rate of interest raises the price of government bonds, thereby making them more attractive to the public and giving an impetus to the public borrowing programmes of the government.

The maintenance of structure of low interest rates is also called for minimizing the cost of servicing the national debt. Further, it encourages funding of debt by private firms. However, the success of debt management would depend upon the existence of well-developed money and capital markets in which wide range of securities exist both for short and long periods. It is the central bank which can help in the development of these markets.

**Credit control:**

Central Bank should also aim at controlling credit in order to influence the patterns of investment and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control.

Open market operations are not successful in controlling inflation in underdeveloped countries because the bill market is small and undeveloped. Commercial banks keep an elastic cash-deposit ratio because the central bank's control over them is not complete. They are also reluctant to invest in government securities due to their relatively low interest rates.

Moreover, instead of investing in government securities, they prefer to keep their reserves in liquid form such as gold, foreign exchange and cash. Commercial banks are also not in the habit of rediscounting or borrowing from the central bank.

**The bank rate policy is also not so effective in controlling credit in LDCs due to:**

- (a) The lack of bills of discount;
- (b) The narrow size of the bill market;
- (c) A large non-monetized sector where barter transactions take place;
- (d) The existence of a large unorganised money market;
- (e) The existence of indigenous banks which do not discount bills with the central banks;
- (f) The habit of commercial banks to keep large cash reserves.

The use of variable reserve ratio as method of credit control is more effective than open market operations and bank rate policy in LDCs. Since the market for securities is very small, open market operations are not successful. But a rise or fall in the reserve ratio by the central bank reduces or increases the cash available with the commercial banks without affecting adversely the prices of securities. Again, the commercial banks keep large cash reserves which cannot be reduced by a raise in the bank rate or sale of securities by the central bank.

But raising the cash-reserve ratio reduces liquidity with the banks. However, the use of variable reserve ratio has certain limitations in LDCs. First, the non-banking financial intermediaries do not keep deposits with the central bank so they are not affected by it. Second, banks which do not maintain excess liquidity are not affected than those who maintain it.

The qualitative credit control measures are, however, more effective than the quantitative measures in influencing the allocation of credit, and thereby the pattern of investment. In underdeveloped countries, there is a strong tendency to invest in gold, jewellery, inventories, real estate, etc., instead of in alternative productive channels available in agriculture, mining, plantations and industry.

The selective credit controls are more appropriate for controlling and limiting credit facilitates for such unproductive purposes. They are beneficial in controlling speculative activities in food grains and raw materials. They prove more useful in controlling 'sectional inflations' in the economy. They curtail the demand for imports by making it obligatory on importers to deposit in advance an amount equal to the value of foreign currency.

This has also the effect of reducing the reserves of the banks in so far as their deposits are transferred to the central banks in the process. The selective credit control measures may take the form of changing the margin requirements against certain types of collateral, the regulation of consumer credit and the rationing of credit.

**Solving the balance of payments problem:**

The central bank should also aim at preventing and solving the balance of payments problem in a developing economy. Such economies face serious balance of payments difficulties to fulfill the targets of development plans. An imbalance is created between imports and exports which continues to widen with development.

The central bank manages and controls the foreign exchange of the country and also acts as the technical adviser to the government on foreign exchange policy. It is the function of the central bank to avoid fluctuations in the foreign exchange rates and to maintain stability. It does so through exchange controls and variations in the bank rate. For instance, if the value of the national currency continues to fall, it may raise the bank rate and thus encourage the inflow of foreign currencies.

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### **9.4 Need for Central Bank:**

It is widely recognised that the central bank is a valuable and indispensable institution for the proper functioning of a modern economy. But, there is a difference of opinion regarding the necessity and usefulness of the central bank in economically backward countries having underdeveloped money markets.

Some people argue that the central bank is not necessary in such countries for various reasons: such as the absence of well-organised banking institutions over which the central bank exercises its supervision and control, the absence of short-term money markets and of well-developed bill markets to enable the central bank to perform the rediscounting operations properly, the fear of political pressure of the governments of these countries over the normal working of the central bank, and others. For all these reasons it is argued that the central bank in the under-developed countries cannot execute its monetary policy and control-techniques properly and effectively.

But, the fact remains that the central bank is as indispensable in the underdeveloped countries as it is in the developed countries.

**For this reason it is now established that every country, whether developed or underdeveloped, must set up a central bank for the following reasons:**

***(a) Economic stability:***

The central bank is indispensable for maintaining stability in the economy of a country. It can maintain both price and foreign exchange stability through the exercise of proper and effective control over the country's total money supply.

Such economic stability is as essential for underdeveloped countries as for developed ones, for promoting rapid economic growth. No other institutions except the central bank is competent enough to maintain this overall economic stability.

***(b) Control over bank credit:***

The central bank is necessary to exercise a judicious control over bank credit. As bank credit constitutes the most important component of the money supply, its supply is to be properly regulated in time for avoiding instability in the price-level and for regulating its supply in accordance with the country's requirements.

***(c) Control and supervision over the activities of other banks:***

The central bank of a country can develop the banking system by exercising proper control and supervision over the operations of other banks. In the absence of the central bank, it becomes a difficult task to bring about proper co-ordination among the banks and to develop these institutions along a sound line.

***(d) Proper execution of the monetary policy:***

The central bank is the leader of the money market of a country. Therefore, its existence is of utmost importance for pursuing the country's monetary (credit) policy.



**(e) Special role of the central bank in a developing economy:**

The central bank has a special role to play in a developing economy in promoting economic growth with stability, in providing special finance for agriculture, industry and other top priority sectors.

**(f) Foreign exchange regulations and international dealings:**

Every country, whether a developed or an underdeveloped one, must have a monetary institution like the central bank for foreign exchange regulations and for dealing with international institutions like the International Monetary Fund and the Bank for International Settlements. When the gold standard was in existence, it had some special importance.

**(g) Control over the money supply:**

The central bank is also necessary for the control over the money supply and for the regulation of the country's interest rates. For this reason the central bank enjoys the monopoly power regarding the issue of paper notes, and its rate of interest (i.e., the bank rate) acts as the pace-setter to other rates such as market rates of interest.

## **9.5 Developmental / Promotional Functions of CENTRAL BANK**

Along with the routine traditional functions, central banks especially in the developing country like India have to perform numerous functions. These functions are country specific functions and can change according to the requirements of that country. The CENTRAL BANK has been performing as a promoter of the financial system since its inception. Some of the major development functions of the CENTRAL BANK are maintained below.

**1. Development of the Financial System:** The financial system comprises the financial institutions, financial markets and financial instruments. The sound and efficient financial system is a precondition of the rapid economic development of the nation. The CENTRAL BANK has encouraged establishment of main banking and nonbanking institutions to cater to the credit requirements of diverse sectors of the economy.

**2. Development of Agriculture:** In an agrarian economy like ours, the CENTRAL BANK has to provide special attention for the credit need of agriculture and allied activities. It has successfully rendered service in this direction by increasing the flow of credit to this sector. It has earlier the Agriculture Refinance and Development Corporation (ARDC) to look after the credit, National Bank for Agriculture and Rural Development (NABARD) and Regional Rural Banks (RRBs).

**3. Provision of Industrial Finance:** Rapid industrial growth is the key to faster economic development. In this regard, the adequate and timely availability of credit to small, medium and large industry is very significant. In this regard the CENTRAL BANK has always been instrumental in setting up special financial institutions such as ICICI Ltd. IDBI, SIDBI and EXIM BANK etc.

**4. Provisions of Training:** The CENTRAL BANK has always tried to provide essential training to the staff of the banking industry. The CENTRAL BANK has set up the bankers' training colleges at several places. National Institute of Bank Management i.e NIBM, Bankers Staff College i.e BSC and College of Agriculture Banking i.e CAB are few to mention.

**5. Collection of Data:** Being the apex monetary authority of the country, the CENTRAL BANK collects process and disseminates statistical data on several topics. It includes interest rate, inflation, savings and investments etc. This data proves to be quite useful for researchers and policy makers.

**6. Publication of the Reports:** The Reserve Bank has its separate publication division. This division collects and publishes data on several sectors of the economy. The reports and bulletins are regularly published by the CENTRAL BANK. It includes CENTRAL BANK weekly reports, CENTRAL BANK Annual Report, Report on Trend and Progress of Commercial Banks India., etc. This information is made available to the public also at cheaper rates.

**7. Promotion of Banking Habits:** As an apex organization, the CENTRAL BANK always tries to promote the banking habits in the country. It institutionalizes savings and takes measures for an expansion of the banking network. It has set up many institutions such as the Deposit Insurance Corporation-1962, UTI-1964, IDBI-1964, NABARD-1982, NHB-1988, etc. These organizations develop and promote banking habits among the people. During economic reforms it has taken many initiatives for encouraging and promoting banking in India.

**8. Promotion of Export through Refinance:** The CENTRAL BANK always tries to encourage the facilities for providing finance for foreign trade especially exports from India. The Export-Import Bank of India (EXIM Bank India) and the Export Credit Guarantee Corporation of India (ECGC) are supported by refinancing their lending for export purpose.

## 9.6 Supervisory Functions of CENTRAL BANK

The reserve bank also performs many supervisory functions. It has authority to regulate and administer the entire banking and financial system. Some of its supervisory functions are given below.

1. **Granting license to banks:** The CENTRAL BANK grants license to banks for carrying its business. License is also given for opening extension counters, new branches, even to close down existing branches.

2. **Bank Inspection:** The CENTRAL BANK grants license to banks working as per the directives and in a prudent manner without undue risk. In addition to this it can ask for periodical information from banks on various components of assets and liabilities.

3. **Control over NBFIs:** The Non-Bank Financial Institutions are not influenced by the working of a monetary policy. However, CENTRAL BANK has a right to issue directives to the NBFIs from time to time regarding their functioning. Through periodic inspection, it can control the NBFIs.

4. **Implementation of the Deposit Insurance Scheme:** The CENTRAL BANK has set up the Deposit Insurance Guarantee Corporation in order to protect the deposits of small depositors. All bank deposits below Rs. One lakh are insured with this corporation. The CENTRAL BANK work to implement the Deposit Insurance Scheme in case of a bank failure.

**Reserve Bank of India's Credit Policy** The Reserve Bank of India has a credit policy which aims at pursuing higher growth with price stability. Higher economic growth means to produce more quantity of goods and services in different sectors of an economy; Price stability however does not mean no change in the general price level but to control the inflation. The credit policy aims at increasing finance for the agriculture and industrial activities. When credit policy is implemented, the role of other commercial banks is very important. Commercial banks flow of credit to different sectors of the economy depends on the actual cost of credit and availability of funds in the economy.

CENTRAL BANK uses a Credit control monetary policy strategy to ensure that the country's economic development is accompanied by stability. It means that banks will not only contain inflationary trends in the economy but will also stimulate economic growth, resulting in increased real national income stability in the long run. Because of its functions, including issuing notes and keeping track of cash reserves, the CENTRAL BANK does not regulate credit because it would cause social and economic instability in the country.

**CENTRAL BANK-** The Reserve Bank of India is India's central bank and regulatory organisation in charge of overseeing the country's financial sector. It is owned by the Government of India's Ministry of Finance. It is in charge of issuing and distributing the Indian rupee.

## 9.7 Credit Control Policy

Credit control is a monetary policy tool used by the Reserve Bank of India to control the demand and supply of money, or liquidity, in the economy. The Reserve Bank of India (CENTRAL BANK) supervises the credit granted by commercial banks.

### Credit Control Objectives

The following are the broad aims of India's credit control policy:

- To maintain an acceptable amount of liquidity in order to achieve a high rate of economic growth while maximising resource use without causing severe inflationary pressure.
- To achieve stability in the country's currency rate and money market.
- To meet financial obligations during a downturn in the economy as well as in regular times.
- Controlling the business cycle and meeting the needs of the company.

### Methods and Types of Credit Control

CENTRAL BANK uses two types of credit control methods for money supply in the Indian economy, Qualitative and Quantitative.

#### Qualitative Method:

By quality, we refer to the purposes for which a bank loan is used. Qualitative approaches regulate how money is channelled, and credit is extended in the economy. It is a selective approach of control in that it restricts credit for some sections while expanding credit for others, referred to as

the 'priority sector,' depending on the scenario. The Following Are The Types That Are Used In This Method

### ***Marginal Requirement***

Loan current value of security supplied for ban-value of loans authorised is a minimum criterion. For those commercial activities whose credit flow is to be controlled in the economy, the marginal requirement is raised.

### ***Credit Rationing***

There is a maximum limit to the number of loans and advances that can be made using this approach, which commercial banks cannot exceed. The Reserve Bank of India establishes a ceiling for various categories. This type of rationing is utilised when credit flow needs to be monitored, especially for speculative operations. The Reserve Bank of India can also impose a minimum "capital: total assets" ratio (the ratio of capital to total assets).

### ***Publicity***

The Reserve Bank of India (CENTRAL BANK) uses the media to publicise its opinions on the current market situation and the directives that commercial banks must follow in order to contain the turmoil. However, this strategy is not very effective in poor countries because of the high rate of illiteracy, which makes it difficult for people to understand laws and their repercussions.

### ***Quantitative Method***

The control of the overall amount of credit is referred to as quantitative credit control.

### ***Bank Rate***

The discount rate is another name for the bank rate. It's the official lowest rate at which the country's central bank is willing to re-discount approved bills of exchange or lend on recognised securities. Bank Rate is defined as "the standard rate at which it (CENTRAL BANK) is prepared to acquire or re-discount bills of exchange.

When a commercial bank, for example, has lent or invested all of its available funds and has little or no cash above the regulatory minimum, it may request funding from the central bank.

### ***Working on the Bank Rate***

Changes in bank rates are implemented in order to manage price levels and economic activity by altering loan demand. Its operation is based on the idea that changes in the bank rate cause changes in the market interest rate. Consider a country that is experiencing inflationary pressures. In such circumstances, the central bank will raise the bank rate, resulting in a higher loan rate. Borrowing will be discouraged as a result of this rise.

## **9.8 Role of CENTRAL BANK In Controlling Credit In India**

The Reserve Bank of India, as the country's central bank, takes essential actions to keep credit under control. The Reserve Bank of India (CENTRAL BANK) uses credit control to implement monetary policy and keep inflation under control. The CENTRAL BANK's role in credit control makes it one of the most important bodies for the development of the Indian economy. Control of credit can be thought of as money control for a better understanding.

- Credit control is used to control the demand and supply of money. The credit-control system is utilised by the Reserve Bank of India to ensure the long-term development of the Indian economy.
- Controlling credit helps the CENTRAL BANK and the government achieve economic growth while also keeping inflation under control.
- In India, the CENTRAL BANK is the only authority for currency issuance and the custodian of cash reserves.
- The CENTRAL BANK's role in credit control in India ensures that the country maintains social and economic stability.

## 9.9 CENTRAL BANK Monetary Policy 2023

The monetary policy is a policy formulated by the central bank, i.e., CENTRAL BANK (Reserve Bank of India) and relates to the monetary matters of the country. The policy involves measures taken to regulate the supply of money, availability, and cost of credit in the economy.

The policy also oversees distribution of credit among users as well as the borrowing and lending rates of interest. In a developing country like India, the monetary policy is significant in the promotion of economic growth.

### **Objectives of Monetary Policy**

While the main objective of the monetary policy is economic growth as well as price and exchange rate stability, there are other aspects that it can help with as well.

- Promotion of saving and investment: Since the monetary policy controls the rate of interest and inflation within the country, it can impact the savings and investment of the people. A higher rate of interest translates to a greater chance of investment and savings, thereby, maintaining a healthy cash flow within the economy.
- Controlling the imports and exports: By helping industries secure a loan at a reduced rate of interest, monetary policy helps export-oriented units to substitute imports and increase exports. This, in turn, helps improve the condition of the balance of payments.
- Managing business cycles: The two main stages of a business cycle are boom and depression. The monetary policy is the greatest tool using which the boom and depression of business cycles can be controlled by managing the credit to control the supply of money. The inflation in the market can be controlled by reducing the supply of money. On the other hand, when the money supply increases, the demand in the economy will also witness a rise.
- Regulation of aggregate demand: Since the monetary policy can control the demand in an economy, it can be used by monetary authorities to maintain a balance between demand and supply of goods and services. When credit is expanded and the rate of interest is reduced, it allows more people to secure loans for the purchase of goods and services. This leads to the rise in demand. On the other hand, when the authorities wish to reduce demand, they can reduce credit and raise the interest rates.
- Generation of employment: As the monetary policy can reduce the interest rate, small and medium enterprises (SMEs) can easily secure a loan for business expansion. This can lead to greater employment opportunities.
- Helping with the development of infrastructure: The monetary policy allows concessional funding for the development of infrastructure within the country.
- Allocating more credit for the priority segments: Under the monetary policy, additional funds are allocated at lower rates of interest for the development of the priority sectors such as small-scale industries, agriculture, underdeveloped sections of the society, etc.
- Managing and developing the banking sector: The entire banking industry is managed by the Reserve Bank of India (CENTRAL BANK). While CENTRAL BANK aims to make banking facilities available far and wide across the nation, it also instructs other banks using the monetary policy to establish rural branches wherever necessary for agricultural development. Additionally, the government has also set up regional rural banks and cooperative banks to help farmers receive the financial aid they require in no time.

## 9.10 Flexible Inflation Targeting Framework (FITF)

The Flexible Inflation Targeting Framework (FITF) was introduced in India post the amendment of the Reserve Bank of India (CENTRAL BANK) Act, 1934 in 2016. In accordance with the CENTRAL BANK Act, the Government of India sets the inflation target every 5 years after consultation with the CENTRAL BANK. While the inflation target for the period between 5 August 2016 and 31 March 2021 has been determined to be 4% of the Consumer Price Index (CPI), the Central Government has announced that the upper tolerance limit for the same will be 6% and the lower tolerance limit can be 2% for the same.

In this framework, there are chances of not achieving the inflation target fixed for a particular amount of time. This can happen when:

- The average inflation is greater than the upper tolerance level of the inflation target as predetermined by the Central Government for 3 quarters in a row.

- The average inflation is less than the lower tolerance level of the target inflation fixed by the Central Government beforehand for 3 consecutive quarters.

### 9.11 Monetary Policy Tools

To control inflation, the Reserve Bank of India needs to decrease the supply of money or increase cost of fund in order to keep the demand of goods and services in control.

#### **Quantitative tools -**

The tools applied by the policy that impact money supply in the entire economy, including sectors such as manufacturing, agriculture, automobile, housing, etc.

#### **Reserve Ratio:**

Banks are required to keep aside a set percentage of cash reserves or CENTRAL BANK approved assets. Reserve ratio is of two types:

Cash Reserve Ratio (CRR) - Banks are required to set aside this portion in cash with the CENTRAL BANK. The bank can neither lend it to anyone nor can it earn any interest rate or profit on CRR.

Statutory Liquidity Ratio (SLR) - Banks are required to set aside this portion in liquid assets such as gold or CENTRAL BANK approved securities such as government securities. Banks are allowed to earn interest on these securities, however it is very low.

#### **Open Market Operations (OMO):**

In order to control money supply, the CENTRAL BANK buys and sells government securities in the open market. These operations conducted by the Central Bank in the open market are referred to as Open Market Operations.

When the CENTRAL BANK sells government securities, the liquidity is sucked from the market, and the exact opposite happens when CENTRAL BANK buys securities. The latter is done to control inflation. The objective of OMOs are to keep a check on temporary liquidity mismatches in the market, owing to foreign capital flow.

#### **Qualitative tools:**

Unlike quantitative tools which have a direct effect on the entire economy's money supply, qualitative tools are selective tools that have an effect in the money supply of a specific sector of the economy.

- **Margin requirements** - The CENTRAL BANK prescribes a certain margin against collateral, which in turn impacts the borrowing habit of customers. When the margin requirements are raised by the CENTRAL BANK, customers will be able to borrow less.
- **Moral suasion** -By way of persuasion, the CENTRAL BANK convinces banks to keep money in government securities, rather than certain sectors.
- **Selective credit control** -Controlling credit by not lending to selective industries or speculative businesses.

#### **Market Stabilisation Scheme (MSS) -**

#### **Policy Rates:**

**Bank rate** - The interest rate at which CENTRAL BANK lends long term funds to banks is referred to as the bank rate. However, presently CENTRAL BANK does not entirely control money supply via the bank rate. It uses Liquidity Adjustment Facility (LAF) - repo rate as one of the significant tools to establish control over money supply. Bank rate is used to prescribe penalty to the bank if it does not maintain the prescribed SLR or CRR.

**Liquidity Adjustment Facility (LAF)** - CENTRAL BANK uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are:

- **Repo rate:** Repo rate is the rate at which banks borrow from CENTRAL BANK on a short-term basis against a repurchase agreement. Under this policy, banks are required to provide government securities as collateral and later buy them back after a pre-defined time.

## Monetary Theory and Policy

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- **Reverse Repo rate:** It is the reverse of repo rate, i.e., this is the rate CENTRAL BANK pays to banks in order to keep additional funds in CENTRAL BANK. It is linked to repo rate in the following way:

$$\text{Reverse Repo Rate} = \text{Repo Rate} - 1$$

**Marginal Standing Facility (MSF) Rate:** MSF Rate is the penal rate at which the Central Bank lends money to banks, over the rate available under the rep policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities.

$$\text{MSF Rate} = \text{Repo Rate} + 1$$

### Monetary Policy Transmission

Borrowers fail to fully benefit from CENTRAL BANK's repo rate cut due to the following reasons:

- Banks are not affected by CENTRAL BANK rate cuts as the Central Bank is not their primary money supplier.
- Deposits already made are fixed at the rates when taken and cannot be reduced; the rate cuts will only reflect in the new deposit rates.
- PPF, Post Office accounts and other small saving instruments are available at high administered interest rates and in case of reduction of bank deposit rates, customers have the choice to move to those funds.
- Banks do not prefer to lower their rates as high lending rates keep their profit margins up.
- India does not have a well-developed corporate bond market, therefore corporate customers have little choice but to reach out to banks for borrowing.

### Steps to improve monetary transmission:

Both the government and CENTRAL BANK has taken and plans to take some steps in order to accelerate the transmission of monetary policy.

- Government intends to bring down the interest rates on small saving accounts. If the small saving rates are linked to the bank rate, this could serve as a permanent solution.
- In order to improve monetary transmission, CENTRAL BANK wants banks to change the calculation methodology of base rate to marginal cost of funds from average cost of funds.

Despite banks raising the lending rates immediately after CENTRAL BANK's rate cuts, the Central Bank is unable to control inflation due to the following reasons:

- Financial deficit in the higher government.
- Issues at the supply side, such as crude oil prices, issues in agri marketing, etc.
- Lack of financial inclusion as borrowers still depend on moneylenders, who are not under CENTRAL BANK's control.
- Non-monetised economy in certain rural areas.

### Dear Money Policy or Contractionary Monetary Policy:

Dear money policy is a policy when money become more expensive with the rise of interest rate. Due to this, the supply of money also decreases in the economy, therefore it is also referred to as the contractionary monetary policy.

This policy leads to a drop in business expansions owing to a high cost of credit, as well as a fall in business expansion. This in turn affects employment as it brings down growth rates. Therefore, interest rate cuts such as SLR and CRR are preferred by the government and the corporates.

### Summary

- In the Indian economy, the CENTRAL BANK's role in credit control is crucial. The Reserve Bank of India controls the flow of credit in our economy in order to keep inflation and economic growth in check. Credit changes can cause market instability, so credit control policies must be carefully planned before being implemented.
- The central bank controls the issue of notes. It has the sole right (monopoly) in note issue. It prints notes and authorises the minting of coins by the Mint.
- Old notes and coins are removed by the commercial banks as they deteriorate. The central bank thus provides us with the much-needed medium of exchange. In other words, central bank notes and coins are legal tender.

- In most countries note issue by the central bank is based on a particular principle. In order to prevent an over-issue of notes, apart from a fiduciary issue (that is, notes backed by securities), all notes are to be backed by an equivalent amount of gold in the bank. However, over the years, the fiduciary issue has risen steadily and, today; the whole of the note issue is fiduciary.
- To regulate the supply of currency the central bank in every country has been given the monopoly right to issue paper-notes in accordance with the existing legal provisions.
- The central bank acts as the banker to the government of the country. It keeps the cash balances of the government and maintains its accounts. It gives advances to the government and also takes the responsibility of the sale of government securities. It manages public debt and gives advice to the government on various financial matters.

## Keywords

- **A central bank:** A central bank is a financial institution that is responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply, and setting interest rates.
- **Reserve requirements:** Reserve requirements are a tool used by the central bank to increase or decrease the money supply in the economy and influence interest rates.
- **Excess reserves:** Excess reserves are funds that a bank keeps back beyond what is required by regulation.
- **Liquidity:** Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price.

## Review Questions

1. What is meant by central bank? Why is it known as apex body?
2. Explain 'banker to the government' functions of central bank?
3. What are the open market operations? What is their effect on availability of credit?
4. Explain the effect of an increase in bank rate on credit creation by commercial banks? Explain
5. Explain the following functions of the central bank:
  - a. Bank of issue
  - b. Banker's bank
6. Explain the distinction between statutory liquidity ratio and legal reserve ratio?
7. Explain the role of reserve repo rate in controlling credit creation.
8. Explain the role of cash reserve ratio in controlling credit creation?
9. What is monetary policy? State any three instruments of monetary policy?
10. Briefly discuss difference between central bank and commercial bank?
11. How do changes in bank rate affect money supply in an economy? Explain.
12. Describe any two methods by which reserve bank of India can regulate money supply.

## Self-Assessment

1. Which of the following is a step that the central bank will take to encourage greater investment in the economy?
  - a. It will look to increase the cash reserve ratio
  - b. It will look to reduce the cash reserve ratio
  - c. It will look to increase the bank rate
  - d. It will look to sell the government securities in the open market
2. Which of the following is a step that the central bank will take to increase the overall availability of credit?

- a. It will sell the government securities in the market
  - b. It will buy more government securities from the market
  - c. It will raise the reverse repo rate
  - d. It will raise the repo rate
3. Which of the following statements is true about the Indian monetary system?
    - a. The Indian monetary system is based on the gold standard
    - b. The Indian monetary system is based on the credit money standard
    - c. The Indian monetary system is based on the paper standard
    - d. The Indian monetary system is based on the metallic standard
  4. Which of the following statements represents the main function of the central bank in a country?
    - a. It is responsible for the regulation over the supply of money in the market
    - b. It is responsible for the issuance of notes within the country
    - c. It acts as a banker both to the government and to other banks in the country
    - d. All of the above
  5. Which of the following statements is true about demand deposits?
    - a. It includes both fixed deposits and current account deposits
    - b. It includes both savings account deposits and fixed deposits
    - c. It includes both current account deposits and savings account deposits
    - d. It includes fixed deposits, current account deposits and savings account deposits
  6. Which of the following statements is true about the central bank?
    - a. It regulates the entire banking system in the country
    - b. It is under the ownership of the central government of a country
    - c. It is the apex bank of a country
    - d. All of the above
  7. Which of the following statements about the bank rate is true?
    - a. Bank rate is different from interest rate
    - b. Bank rate is the discount rate provided by the central bank of a country
    - c. Bank rate is defined as the rate at which the central bank of a country gives credit to the commercial banks
    - d. All of the above
  8. Which of the statements gives a true picture of the effect of the central bank selling securities in the market?
    - a. The credit creation capacity of commercial banks will fall
    - b. The credit creation capacity of commercial banks will rise
    - c. The credit creation capacity of commercial banks may rise or fall
    - d. There is no effect on the credit creation capacity of commercial banks
  9. Which of the statements gives a true picture of the effect of lowering the cash reserve ratio by the central bank of a country?
    - a. The lending capacity of commercial banks will increase
    - b. The lending capacity of commercial banks will decrease
    - c. The lending capacity of commercial banks may increase or decrease
    - d. There is no effect on the lending capacity of commercial banks
  10. Which of the statements gives an accurate picture of the effect of the rise of the reverse repo rate by the central bank of a country?
    - a. The demand for goods and services in the country will decrease
    - b. The demand for goods and services in the country will increase
    - c. The demand for goods and services in the country may increase or decrease
    - d. There is no effect on the demand for goods and services in the country
  11. Which of the statements gives an accurate picture of the effect of the increase in the repo rate?
    - a. The money supply in the country will decrease
    - b. The money supply in the country will increase



- c. The money supply in the country will increase initially and then decrease  
d. There is no effect on the money supply in the country
12. Which of the following statements is true about credit creation by banks?  
a. Banks create credit on the basis of their total assets  
b. Banks create credit on the basis of their total deposits  
c. Banks create credit on the basis of their total securities  
d. Banks create credit out of nothing
13. Which of the following is not the function of the central bank of a country?  
a. Being the custodian of foreign exchange reserves  
b. Accepting deposits from the general public  
c. Both a and b are correct  
d. Both a and b are incorrect
14. Which agency regulates the money supply in India?  
a. The Government of India  
b. Commercial banks  
c. Reserve Bank of India  
d. None of the above
15. Which of the following statements is true about the money supply?  
a. It is the total volume of money that is held by the government of a country  
b. It is the total volume of money that is held by the general public of a country over a time period  
c. It is the total volume of money that is held by the general public of a country at a particular point in time  
d. All of the above

### **Answers for Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (b)  | 2. (a)  | 3. (c)  | 4. (d)  | 5. (c)  |
| 6. (d)  | 7. (d)  | 8. (a)  | 9. (a)  | 10. (a) |
| 11. (a) | 12. (b) | 13. (b) | 14. (c) | 15. (c) |

### **Further Readings**

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## Unit10:Bonds Market

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### Objectives

After this lecture, you would be able

- To explore the concept and origin of cooperative bank in India.
- To evaluate the growth of cooperative bank in India.
- To explore the objectives and features of cooperative banks in India.
- To evaluate the types and functions of cooperative banks in India.

### Introduction

The co-operative banks are government backed financial institutions that work on the principle of co-operation, self-help and mutual help. The co-operative banks are mainly set up to provide access to credit in rural areas. This empowers and secures the poor and the low-income groups. Co-operative banks offer basic banking functions and services in rural, urban and semi-urban areas, where banking facilities are scarce. Unlike commercial banks whose sole purpose is profit making, co-operative banks help encourage rural business and the agricultural sector and work towards growth. In India, co-operative banks play a crucial role in rural financing, with funding of areas under agriculture, livestock, milk, personal finance, self-employment, setting up of small-scale units among the few focus points for both urban and rural cooperative banks.

They provide a much-needed alternative to the age-old exploitative practice of people approaching the village moneylender, most often getting into a debt-trap that they struggle to pull themselves out of. The cooperative banking system came into being with the aim to promote saving and investment habits among people, especially in rural parts of the country.

## 10.1 Meaning of Cooperative Bank

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. People belonging to the same local or professional community having a common interest often establish it. It is formed to promote the upliftment of financially weaker sections of the society and to protect them from the clutches of moneylenders who provide loans at an unreasonably high-interest rate to the needy. The co-operative structure is designed on the principles of cooperation, mutual help, democratic decision making and open membership. It follows the principle of 'one shareholder, one vote' and 'no profit, no loss'.

Cooperatives Banks are **registered under the Cooperative Societies Act, 1912**. These are **regulated by the Reserve Bank of India and National Bank for Agriculture and Rural Development (NABARD) under the Banking Regulation Act, 1949 and Banking Laws (Application to Cooperative Societies) Act, 1965**.

Cooperative banks differ from commercial banks on the grounds of organisation, governance, interest rates, and the scope of functioning, objectives and values. Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the cooperative banks are founded by collecting funds through shares, accept deposits and grant loans.

**The cooperative banks differ from joint stock banks in the following manner:**

- (i) Cooperative banks issue shares of unlimited liability, while the joint stock banks issue shares of limited liability.
- (ii) In a cooperative bank, one shareholder has one vote whatever the number of shares he may hold. In a joint stock bank, the voting right of a shareholder is determined by the number of shares he possesses.
- (iii) Cooperative banks are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities. Joint stock companies are primarily concerned with the credit requirements of trade and industry.
- (iv) Cooperative banking in India is federal in structure. Primary credit societies are at the lowest rung. Then, there are central cooperative banks at the district level and state cooperative banks at the state level. Joint stock banks do not have such a federal structure.
- (v) Cooperative credit societies are located in the villages spread over entire country. Joint stock banks and their branches mainly concentrate in the urban areas, particularly in the big cities.

### **History of Cooperative Banking in India:**

The genesis of the cooperative movement and its implementation in a modern technical sense can be traced after the Industrial Revolution in England during the period of 18th and 19th century. The idea of Hermann Schulze and Friedrich Wilhelm Raiffeisen during the economic meltdown to provide easy credit to small businesses and poor sections of the society took shape as cooperative banks of today across the world.

### **Pre-independence period (prior to 1947)**

British India replicated this model and based on the recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901), the Co-operative Credit Societies Act, 1904 was passed. It tried to deal with the problems of rural indebtedness and consequent conditions of farmers in the country. The Act promoted the establishment of credit cooperative societies which led to the formation of first urban co-operative credit society, registered on October 1904 at Kanjeeपुरam now in Tamil Nadu State. It marked the beginning of the institutionalization of the Cooperative Banking system in India. But there were certain defects in the Act which restricted the reach of the expected benefits of cooperatives. The Act only permitted the registration of credit societies, and there was no provision for the protection of non-credit societies or federal societies. These shortcomings were recognised by the Government and to remedy it; more comprehensive legislation was introduced, known as the Cooperative Societies Act of 1912. It recognized the formation and organisation of non-credit societies and the central co-operative federations.

In 1919, after the end of the first world war under the Treaty of Versailles, 1919, the Montague Chelmsford Reforms were introduced in India under which Cooperation becomes a transferred subject which was to be administered by the States. The need for separate acts for effective implementation and to widen the reach of the cooperative banks was felt by the States. The Bombay

Provincial Government was the first to pass its own act which was known as Bombay Provincial Cooperative Societies Act, 1925. Other state governments like Madras, Bengal, Bihar and Punjab followed the Bombay Act and passed their own legislation in the following years.

In 1942, the British Government enacted the Multi-Unit Cooperative Societies Act, 1942, the ambit of which covered societies whose operations are extended to more than one state. The Act provided for the regulation of affairs of such society by the provisions of cooperative societies act of the state where the principal business of the society is located.

### **Post-independence period (after 1947)**

After independence, the movement of cooperative societies maintained its pace even after facing several hardships during that phase and continued to be part of the economic development of the country.

The First Five Year Plan recognized the importance of cooperatives in the implementation of development plans, particularly targeting the farmers and weaker section of the society. In 1954, Government of India appointed a committee called **All India Rural Credit Survey Committee** to remedy the problem of rural credit and other financial issues of the rural community. It recommended a well defined institutional framework for cooperative organizations, particularly for meeting the needs of rural India. The recommendations of the committee were recognized and were put into effect under the Second Five Year Plan.

The Second Five Year Plan recommended expanding the scope of cooperative activities to other fields with special emphasis on the warehousing sector.

The Third Five Year Plan emphasized on training personnel for the cooperative sector and to increase the reach of the cooperative movement.

The Fourth Five Year Plan recommended the consolidation of a cooperative system for effective functioning.

The Fifth Five Year Plan recommended the establishment of Farmers Service Societies. The Sixth Five Year Plan developed a point programme for a cooperative society to bring economic development and for expanding the scope of cooperative societies.

The Seventh Five Year Plan also focussed on expansion and growth of the scope of cooperative societies so as to achieve greater employment and decrease poverty in the country.

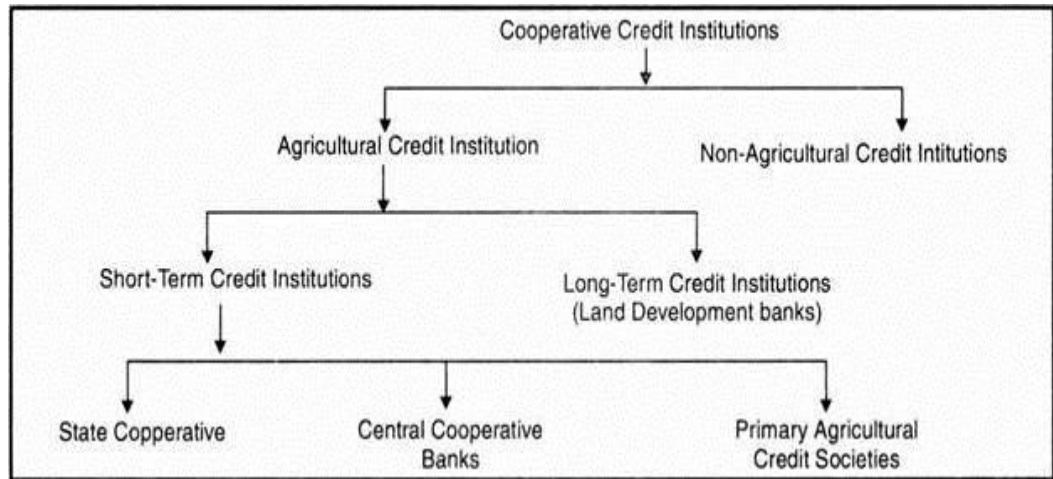
## **10.2 Structure of Cooperative Banking:**

There are different types of cooperative credit institutions working in India. These institutions can be classified into two broad categories- agricultural and non-agricultural. Agricultural credit institutions dominate the entire cooperative credit structure.

Agricultural credit institutions are further divided into short-term agricultural credit institutions and long-term agricultural credit institutions.

The short-term agricultural credit institutions which cater to the short-term financial needs of agriculturists have three-tier federal structure- (a) at the apex, there is the state cooperative bank in each state; (b) at the district level, there are central cooperative banks; (c) at the village level, there are primary agricultural credit societies.

Long-term agricultural credit is provided by the land development banks. The whole structure of cooperative credit institutions is shown in the chart given.



### Short-Term Rural Cooperative Credit Structure:

In rural India, there exists a 3-tier short-term rural cooperative structure. Tier-I includes state cooperative banks (SCBs) at the state level; Tier-II includes central cooperative banks (CCBs) at the district level; and Tier- III includes primary agricultural credit societies (PACs).

In 19 states, there exists a 3-tier short-term cooperative credit structure, comprising SCBs, CCBs and PACs. And in 12 states, there exists a 2-tier short-term cooperative structure. In the north-eastern states, including Sikkim, the structure is 2-tier, comprising only SCBs and PACs.

#### 1. State Cooperative Banks (SCBs):

##### Functions and Organisation:

State cooperative banks are the apex institutions in the three-tier cooperative credit structure, operating at the state level. Every state has a state cooperative bank.

State cooperative banks occupy a unique position in the cooperative credit structure because of their three important functions:

- They provide a link through which the Reserve Bank of India provides credit to the cooperatives and thus participates in the rural finance,
- They function as balancing centers for the central cooperative banks by making available the surplus funds of some central cooperative banks. The central cooperative banks are not permitted to borrow or lend among themselves,
- They finance, control and supervise the central cooperative banks, and, through them, the primary credit societies.

*Capital:* State cooperative banks obtain their working capital from own funds, deposits, borrowings and other sources:

- Own funds include share capital and various types of reserves. Major portion of the share capital is raised from member cooperative societies and the central cooperative banks, and the rest is contributed by the state government. Individual contribution to the share capital is very small;
- The main source of deposits is also the cooperative societies and central cooperative banks. The remaining deposits come from individuals, local bodies and others.
- Borrowings of the state cooperative banks are mainly from the Reserve Bank and the remaining from state governments and others.

*Loans and Advances:* State cooperative banks are mainly interested in providing loans and advances to the cooperative societies. More than 98 per cent loans are granted to these societies of which about 75 per cent are for the short-period. Mostly the loans are given for agricultural purposes. The number of state cooperative banks rose from 15 in 1950-51 to 21 in 1960-61 and to 28 in 1991-92. The loans advanced by these banks increased from Rs. 42 crore in 1950-51 to Rs. 260 crore in 1960-61, and further to Rs. 7685 crore in 1991-92.

## 2. Central Cooperative Banks (CCBs):

**Functions and Organisation:** Central cooperative banks are in the middle of the three-tier cooperative credit structure. Central cooperative banks are of two types:

- (a) There can be cooperative banking unions whose membership is open only to cooperative societies. Such cooperative banking unions exist in Haryana, Punjab, Rajasthan, Orissa and Kerala.
- (b) There can be mixed central cooperative banks whose membership is open to both individuals and cooperative societies. The central cooperative banks in the remaining states are of this type. The main function of the central cooperative banks is to provide loans to the primary cooperative societies. However, some loans are also given to individuals and others.

**Capital:** The central cooperative banks raise their working capital from own funds, deposits, borrowings and other sources. In the own funds, the major portion consists of share capital contributed by cooperative societies and the state government, and the rest is made up of reserves.

Deposits largely come from individuals and cooperative societies. Some deposits are received from local bodies and others. Deposit mobilisation by the central cooperative banks varies from state to state.

For example, it is much higher in Gujarat, Punjab, Maharashtra, and Himachal Pradesh, but very low in Assam, Bihar, West Bengal and Orissa. Borrowings are mostly from the Reserve Bank and apex banks.

**Loans and Advances:** The number of central cooperative banks in 1991-92 was 361 and the total amount of loans advanced by them in 1991-92 stood at Rs. 14226 crore. About 98 per cent loans are received by the cooperative societies and about 75 per cent loans are short-term. Mostly the loans are given for agricultural purpose.

About 80 per cent loans given to the cooperative societies are unsecured and the remaining loans are given against the securities such as merchandise, agricultural produce, immovable property, government and other securities etc.

**Problem of Overdues:** The most distressing feature of the functioning of the central cooperative banks is heavy and increasing overdue loans. In 1997-98, the percentage of overdues to demand at the central cooperative level was 34. According to the Review of the Cooperative Movement in India, 1974-76, by the Reserve Bank of India, the main causes of these overdues are:

- (a) Natural calamities such as floods, draughts, etc., affecting the repaying capacity of the borrowers;
- (b) Inadequate and inefficient supervision exercised by the banks;
- (c) The poor quality and management of societies and banks;
- (d) Absence of linking of credit with marketing;
- (e) Reluctance to coercive measures; and
- (f) Where coercive measures were taken, the inability of the machinery to promptly execute the decrees.

For the rehabilitation of the weak Central cooperative banks, the Central Sector Plan Scheme has been formulated under which semi financial help is given to write off the bad debts, losses and irrecoverable overdues against small and marginal farmers.

## 3. Primary Agricultural Credit Societies (PACs):

**Functions and Organisation:**

Primary agricultural credit society forms the base in the three-tier cooperative credit structure. It is a village-level institution which directly deals with the rural people. It encourages savings among the agriculturists, accepts deposits from them, gives loans to the needy borrowers and collects repayments. It serves as the last link between the ultimate borrowers, i.e., the rural people, on the one hand, and the higher agencies, i.e., Central cooperative bank, state cooperative bank, and the Reserve Bank of India, on the other hand. A primary agricultural credit society may be started with 10 or more persons of a village. The membership fee is nominal so that even the poorest agriculturist can become a member. The members of the society have unlimited liability which

means that each member undertakes full responsibility of the entire loss of the society in case of its failure. The management of the society is under the control of an elected body.

**Capital:**The working capital of the primary credit societies comes from their own funds, deposits, borrowings and other sources. Own funds comprise of share capital, membership fee and reserve funds. Deposits are received from both members and non-members. Borrowings are mainly from central cooperative banks.

In fact, the borrowings form the chief source of working capital of the societies. Normally, people do not deposit their savings with the cooperative societies because of poverty, low saving habits, and non-availability of better assets to the savers in term of rate of return and riskiness from these societies.

**Coverage:**In 1999-2000 there were 88 thousand primary agricultural societies covering more than 96 per cent rural areas. The membership of these societies was 8.68 crore. During the past few decades, the Reserve Bank in collaboration with State governments, has been taking various measures to reorganise the viable primary credit societies and to amalgamate non-viable societies with large-sized multipurpose societies.

This work of reorganisation of primary societies into strong and viable units has been completed in almost all the states except Gujrat, Maharashtra, and Jammu and Kashmir. It is because of reorganisation that the number of primary societies which increased from 105 thousand in 1950-51 to 212 thousand in 1960-61, declined to 92 thousand in 1999-2000.

**Loans Advanced:**The loans advanced by the primary credit societies have been Showing 3 Continuously increasing trend. They rose from Rs. 23 crore in 1950-51 to Rs. 202 crore in 1960-61 and further to Rs. 13600 crore in 1999-2000.

Only the members of the societies are entitled to get loans from them. Most of the loans are short-term loans and are for agricultural purposes. Low interest rates are charged on the loans.

The societies are expected to increase amounts of loans to the weaker sections of the rural community, particularly the small and marginal farmers. There, however, exists a serious problem of overdue loans of the societies which have increased from Rs. 6 crores in 1950-51 to Rs. 44 crore in 1960-61 and to Rs. 2875 crore in 1991-92.

### **10.3 Land Development Banks (LDBs) or Cooperative Agricultural and Rural Development Banks (CARDs):**

Besides short-term credit, the agriculturists also need long-term credit for making permanent improvements in land, for repaying old debts, for purchasing agricultural machinery and other implements. Traditionally, the long-term requirements of agriculturists were mainly met by money lenders and some other agencies. But this source of credit was found defective and has been responsible for the exploitation of farmers. Cooperative banks and commercial banks by their very nature are not in a position to provide long-term loans because their deposits are mainly demand (short-term) deposits. Thus, there was a great need for a specialised institution for supplying long-term credit to agriculturists. The establishment of land development banks now known as cooperative and rural development banks (CARDs) is an effort in this direction.

**Structure:**The land development banks are registered as cooperative societies, but with limited liability. These banks have two-tier structure:

- (a) At the state level, there are state or central land development banks, now known as state cooperative agricultural and rural development banks (SCARDs) generally one for each state. They were previously known as central land mortgage banks,
- (b) At the local level, there are branches of the state land development banks or SCARDs and primary land development banks now known as primary cooperative agricultural and rural development banks (PCARDs).

In some states, there are no primary land development banks, but the branches of the state land development bank. In Madhya Pradesh, the state cooperative bank itself functions as the state land development bank. In other states like Andhra Pradesh, Kerala and Maharashtra, there are more than one state land development banks.

Similarly, the primary land development banks also vary organisationally in different states. At the national level, the land development banks have also formed a union, called All-India Land Development Banks' Union.

**Capital:** Land development banks raise their funds from share capital, reserves, deposits, loans and advances, and debentures. Debentures form the biggest source of finance. The debentures are issued by the state land development banks. They carry fixed interest, have maturity varying from 20 to 25 years, and are guaranteed by the state government. These debentures are subscribed by the co-operative banks, commercial banks, the State Bank of India and the Reserve Bank of India. Besides the ordinary debentures, the land development banks also float rural debentures for the period upto 7 years. These debentures are subscribed by farmers, panchayats, and the Reserve Bank. The Reserve Bank substantially contributes to the finance of land development banks by extending funds to the state governments for contributing to the share capital of these banks and by subscribing to ordinary and rural debentures.

**Growth:** In India, the first cooperative land mortgage bank was organised in Punjab in 1920. But the effective beginning was made in Madras with the establishment of a central land development bank in 1929. Later on other states also established such institutions. The number of state cooperative agricultural and rural development banks (SCARDBs) which was 5 in 1950-51, rose to 20 in 2013. The number of primary cooperative agricultural and rural development banks (PCARDBs) was 697 in 2013.

**Loans and Advances:** The land development banks or SCARDBs provide long-term loans to the agriculturists-

- (a) for redemption of old debt,
- (b) for improvement of land and methods of cultivation,
- (c) purchasing costly machinery, and
- (d) in special cases, for purchasing land.

These banks grant loans against the mortgage of land and the period of loan varies from 15 to 30 years. In 1999-2000, the loans sanctioned by these banks were Rs.2520 crore and the amount of loans outstanding was Rs. 11670 crore. The amount of loans outstanding at the end-March 2012 was Rs. 19400 crore by SCARDBs and Rs.12000 crore by PCARDBs.

#### 10.4 Defects of Land Development Banks:

Although numerically the land development banks have grown over the years, they have not been able to make much progress in providing long-term finance to the farmer. The following are the factors responsible for the unsatisfactory performance of land development banks:

**i. Uneven Growth:** There has been uneven growth of land development banks. These have shown some progress in the states like Andhra Pradesh, Tamil Nadu, Karnataka, Maharashtra, Gujrat. Other states have made very little progress. About half of the states have no land development bank.

**ii. Problem of Overdues:** The major problem faced by the land development banks is the existence of heavy overdues. Moreover, the overdues are continuously rising over the years. In 1991-92, the percentage of the overdues of the land development banks has been put between 42 to 44 per cent. Faulty loaning policies, inadequate supervision, over-utilisation of loans, ineffective measures for recovery, willful defaulters, etc. are the main causes of unsatisfactory level of overdues. In view of the seriousness of the problem, the state governments have been advised to draw up and implement time-bound programmes for special recovery drives.

**iii. Lack of Trained Staff:** In spite of quantitative growth of the land development banks, they have not shown much qualitative improvements in the field of granting loans largely due to inadequate technical and supervisory staff. Necessary changes in the legislation of cooperative institutions are also required if the lending activities are to be diversified for non-traditional developmental purposes and on the basis of non-landed security.

**iv. Other Defects:** Other defects of the land development banks can be summarised below:

- (a) These banks charge very high interest rates on the loans provided by them.
- (b) There is much delay and red-tapism in the granting of loans,
- (c) Second loan is not advanced unless the first is not repaid.
- (d) Installments and the period of loans are not fixed on the basis of the repaying capacity of the borrowers.
- (e) The procedure of receiving a loan from these banks is so complicated that the agriculturist is forced to seek help from the money lender,



(f) Weaker sections of the rural society such as landless labourers, village artisans and marginal farmers, are generally unable to secure loans from these banks for their productive activities simply because they do not have land or adequate security to offer against loans.

(g) Mostly loans are given for the repayment of old loans and for development purposes.

**v. Report of Rural Credit Survey:** The Report of the Committee of Direction of All-India Rural Credit Survey has pointed out the unsatisfactory performance of the land mortgage banks (now called the land development banks) in the following manner:

- (a) These banks raise inadequate funds in a manner ill-rated to demand and usually lend them in a manner uncoordinated with development;
- (b) They act as if prior debts and not production had claim on its attention; and
- (c) They reach only the large cultivator and reach him late.

## 10.5 Advantages of Cooperative

The cooperative banking system has to play a critical role in promoting rural finance and is specially suited to Indian conditions. Various advantages of cooperative credit institutions are given below:

**I. Alternative Credit Source:** The main objective of cooperative credit movement is to provide an effective alternative to the traditional defective credit system of the village money lender. The cooperative banks tend to protect the rural population from the clutches of money lenders. The money lenders have so far dominated the rural areas and have been exploiting the poor people by charging very high rates of interest and manipulating accounts.

**II. Cheap Rural Credit:** Cooperative credit system has cheapened the rural credit both directly as well as indirectly:

- (a) Directly, because the cooperative societies charge comparatively low interest rates, and
- (b) Indirectly, because the presence of cooperative societies as an alternative agency has broken money lender's monopoly, thereby enforcing him to reduce the rate of interest.

**III. Productive Borrowing:** An important benefit of cooperative credit system is to bring a change in the nature of loans. Previously the cultivators used to borrow for consumption and other unproductive purposes. But, now, they mostly borrow for productive purposes. Cooperative societies discourage unproductive borrowing.

**IV. Encouragement to Saving and Investment:** Cooperative credit movement has encouraged saving and investment by developing the habits of thrift among the agriculturists. Instead of hoarding money the rural people tend to deposit their savings in the cooperative or other banking institutions.

**V. Improvement in Farming Methods:** Cooperative societies have also greatly helped in the introduction of better agricultural methods. Cooperative credit is available for purchasing improved seeds, chemical fertilizers, modern implements, etc. The marketing and processing societies have helped the members to purchase their inputs cheaply and sell their produce at good prices.

**VI. Role of Cooperative Banks before 1969:** Till the nationalisation of major commercial banks in 1969, cooperative societies were practically the only institutional sources of rural credit. Commercial banks and other financial institutions hardly provided any credit for agricultural and other rural activities. Cooperative credit to the agriculturists as a percentage of total agricultural credit increased from 3.1 per cent in 1951-52 to 15.5 per cent in 1961-62 and further to 22.7 per cent in 1970-71. On the other hand, the agricultural credit provided by the commercial banks as a percentage of total agricultural credit remained almost negligible and fell from 0.9 per cent in 1951-52 to 0.6 per cent in 1961-62 and then rose to 4 per cent in 1970-71.

**VII. Role of Cooperative Banks after 1969:** After the nationalisation of commercial banks in 1969, the government has adopted a multi-agency approach. Under this approach, both cooperative banks and commercial banks (including regional rural banks) are being developed to finance the rural sector. But, this new approach also recognised the prime role to be played by the cooperative credit institutions in financing rural areas because of the following reasons:

- (a) Co-operative credit societies are best suited to the socio-economic conditions of the Indian villages.
- (b) A vast network of the cooperative credit societies has been built over the years throughout the length and breadth of the country. This network can neither be duplicated nor be surpassed easily.

- (c) The cooperative institutions have developed intimate knowledge of the local conditions and problems of rural areas.

**VIII. Suitable Federal Structure of Cooperative Banking System:** Cooperative banking system has a federal structure with-

- (a) primary agricultural credit societies at the village level,
- (b) higher financing agencies in the form of central cooperative and state cooperative banks,
- (c) land development banks for providing long-term credit for agriculture. Such a banking structure is essential and particularly suited for effectively meeting the financial requirements of the vast rural areas of the country.

Considering the great importance of cooperative banks, particularly in the rural areas, it is not surprising that every committee or commission, that has examined the working of the cooperative banking system in India, has expressed the common view that "cooperation remains the best hope of rural India." Various committees, commissions and individual studies that have reviewed the working of the cooperative banking system in India have pointed out a number of weaknesses of the system and have made suggestions to improve the system.

## 10.6 Major weaknesses are given below:

**I. General Weaknesses of Primary Credit Societies:** Organisational and financial limitations of the primary credit societies considerably reduce their ability to provide adequate credit to the rural population. The All India Rural Credit Review Committee pointed out the following weaknesses of the primary credit societies:

- (a) Cooperative credit still constitutes a small proportion of the total borrowings of the farmers,
- (b) Needs of tenants and small farmers are not fully met.
- (c) More primary credit societies are financially weak and are unable to meet the production-oriented credit needs,
- (d) Overdues are increasing alarmingly at all levels,
- (e) Primary credit societies have not been able to provide adequate and timely credit to the borrowing farmers.

**II. Inadequate Coverage:** Despite the fact that the cooperatives have now covered almost all the rural areas of the country, its rural household membership is only about 45 per cent. Thus, 55 per cent of rural households are still not covered under the cooperative credit system. In fact, the borrowing membership of the primary credit societies is significantly low and is restricted to a few states like Maharashtra, Gujrat, Punjab, Haryana, Tamil Nadu and to relatively rich land owners.

**Criteria of determining borrowing membership include:**

- (a) Borrowing members as a proportion of rural households,
- (b) The average amount of loan issued per borrowing member, and
- (c) The proportion of loans going to weaker sections.

**The banking Commission 1972 has brought out the following reasons for the low borrowing membership cooperative societies:**

- (a) Inability of the people to provide the prescribed security;
- (b) Lack of up-to-date land records;
- (c) Ineligibility of certain purposes for loans;
- (d) Inadequacy of prescribed credit limits;
- (e) Onerous conditions prescribed for loans such as share capital contribution at 10 or 20 per cent of loans outstanding and compulsory saving deposits; and
- (f) Default of members to repay loans.

**III. Inefficient Societies:** In spite of the fact that the primary agricultural credit societies in most of the states have been reorganised into viable units, their loaning business has not improved. As the Seventh Plan has observed that out of 94089 primary agricultural credit societies in the country in 1982-83, only 66000 societies had full time paid secretaries. About 34000 societies were running at loss.

**IV. Problem of Overdues:** A serious problem of the cooperative credit is the overdue loans of the cooperative institutions which have been continuously increasing over the years. In 1991-92, percentage of overdues to demand at the level of land development banks was 57, at the level of central cooperative banks was 41 and at the level of primary agricultural credit societies was 39. The overdues in the short-term credit structure are most alarming in North-Eastern States. In the long-term loaning sector, the problem of overdues has almost crippled the land development banks in 9 states, viz., Maharashtra, Gujarat, Madhya Pradesh, Bihar, Karnataka, Assam, West Bengal, Orissa

and Tamil Nadu. Large amounts of overdues restrict the recycling of the funds and adversely affect the lending and borrowing capacity of the cooperative societies.

**The Banking Commission 1972 pointed out the following reasons for the overdue loans:**

- (a) Indifferent management or mismanagement of primary societies;
- (b) Unsound lending policies resulting in over-lending or lending unrelated to actual needs, diversions of loans for other purposes;
- (c) Vested interests and group politics in societies and willful defaulters;
- (d) Inadequate supervision over the use of loans and poor recovery efforts;
- (e) Lack of adequate control of central cooperative banks over primary societies;
- (f) Lack of proper links between credit and marketing institutions;
- (g) Failure to take quick action against willful defaulters; and
- (h) Uncertain agricultural prices.

**V. Regional Disparities:** There have been large regional disparities in the distribution of cooperative credit. According to the Seventh Plan, the eight states of Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab and Rajasthan account for about 80 per cent of the total credit disbursed. The per hectare short-term credit disbursed varied from Rs. 4 in Assam to Rs. 718 in Kerala.

**VI. Benefits to Big Land Owners:** Most of the benefits from the cooperatives have been covered by the big land owners because of their strong socio-economic position. For instance, in 1984-85 the farmers having holdings less than two hectares got only 38.8 per cent of the total loans granted by the primary agricultural credit societies, whereas the land owners with holdings of more than 2 hectare received 55 per cent. The share of the poorest rural population (i.e. tenants, share croppers and landless labours) was only 6.2 per cent.

**VII. Lack of Other Facilities:** Besides the provision of adequate and timely credit, the small and marginal farmers also need other facilities in the form of supply of inputs (i.e., better seeds, fertilisers, pesticides, etc), extension and marketing services. These facilities will enable them to utilise the borrowed credit in a proper way. Therefore, the credit societies should be reorganised into multi-purposes cooperatives. Strengthening the cooperative credit movement has been the Reserve Bank of India's special responsibility ever since its establishment in 1935.

## **10.7 The measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country:**

**1. Agricultural Credit Department:** The Reserve Bank has a separate Agricultural Credit Department whose functions are:

- (i) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the central and state governments, state cooperative banks and other banking organisations; and
- (ii) To coordinate the operations of the Reserve Bank in connection with agricultural credit and relations with the state cooperative banks and other institutions engaged in the business of agricultural credit.

**2. All-India Rural Credit Survey:** The Reserve Bank's real role in the cooperative credit movement started with the appointment of All-India Rural Credit Survey Committee in 1951. The objective of this Committee was to study the problems of rural credit and explore possibilities of expanding agricultural credit through cooperative credit system. The committee submitted its report in December 1954 which highlighted the vital importance of cooperative rural credit. The Committee found that while private credit agencies, i.e., money lenders and traders supply 70 per cent of the rural credit, the cooperative societies provided only 3 per cent of the total borrowed amount. The Committee observed that the rural credit in India fell short of the right quantity, was not of right type, did not serve the right purpose, and often fail to go to the right people. Regarding the future of cooperative credit movement the committee said, "cooperation had failed, but cooperation must succeed."

**3. Integrated Scheme of Rural Credit:** For the success of cooperative credit movement, the Survey Committee suggested an integrated scheme of rural credit based on the following fundamental principles-

- (a) state partnership in cooperative credit institutions;
- (b) full coordination between credit and other agricultural activities, particularly, marketing and processing; and

(c) administration through adequately trained and efficient personnel, responsive to the needs of the rural population.

**4. Provision of Finance:** In pursuance of the recommendations of the Survey Committee and the later committees like the Committee on Cooperative Credit (1960), the Reserve Bank has activity helped the cooperative system to expand rural credit. The Reserve Bank does not provide finance directly to the agriculturists, but only through cooperative sector. The Reserve Bank provides financial assistance for meeting short-term, medium-term and long-term rural needs.

**The needs are explained as under:**

**(i) Short-Term Finance:** The Reserve Bank provides short-term finance to the state cooperative banks in two ways-

- (a) through loans and advances;
- (b) through rediscounting facility.

The financial assistance is given for seasonal agricultural operations and for marketing of crops.

In 1950-51, the Reserve Bank sanctioned short-term credit of Rs. 7.6 crore. This amount increased to Rs. 147 crore in 1960-61 and to Rs. 1090 crore in 1981-82.

**(ii) Medium-Term Finance:** The Reserve Bank provides medium-term loans to state cooperative banks generally for 3 to 5 years. These loans are provided for-

- (a) land improvements like bunding, digging of wells and water channels;
- (b) repair of wells and other irrigational schemes;
- (c) purchase of livestock, implements and machinery;
- (d) construction of farm houses and cattle sheds.

The Reserve Bank also provides medium-term loans in scarcity affected areas. Over the years, the amount of medium-term loans sanctioned by the Reserve Bank has considerably increased from Rs. 27 lakh in 1954-55 to Rs. 24 crore in 1970-71 and to Rs. 110 crore in 1981-82.

**(iii) Long-Term Finance:** The Reserve Bank provides long-term financial assistance for a maximum period of 20 years for agriculture in three ways-

- (a) It subscribes a portion of debentures issued by the land development banks.
- (b) It grants long term loans to such banks,
- (c) It grants loans to state governments for subscribing to the share capital of cooperative credit institutions. The total long-term loans sanctioned by the Reserve Bank were Rs. 212 crore in 1981-82.

**5. Setting Up of Funds:** To meet its financial obligations, the Reserve Bank set up two national funds in 1956, i.e., the National Agricultural Credit (Long-Term Operations) Funds, and the National Agricultural Credit (Stabilisation) Fund. The Purpose of the Long-Term Operations Funds was-

- (a) to make long-term loans available to state governments to enable them to subscribe the share capital of cooperative credit institutions;
- (b) to make medium-term loans to state cooperative banks for agricultural purposes;
- (c) to make long-term loans to the central land mortgage banks against the guarantee of the state government; and
- (d) to purchase debentures of central land mortgage banks against the guarantee of state government. The Stabilisation Fund helps the state cooperative banks to convert their short-term loans into medium-term loans in cases of draught, famine or other calamities.

**6. Strengthening of Cooperative Banking Structure:** With a view to strengthen cooperative banking structure and promote cooperative credit, the Reserve Bank undertakes the following measures:

- (i) It pays special attention towards rehabilitating and revitalising the weaker cooperative units.
- (ii) It makes arrangements for maintaining the flow of cooperative credit by involving commercial banks to finance the primary agricultural societies.
- (iii) It makes efforts in improving the lending policies and operational efficiency of cooperative credit institutions.
- (iv) It provides financial accommodation to cooperative credit institutions.
- (v) It conducts special training courses at the Cooperative Bankers' Training Colleges for the personnel of state, central and urban banks.

## Summary

A cooperative bank is an institution of finance that is owned and operated by its members, who are also the bank's customers. It is frequently founded by persons who share a mutual interest and belong to the very same regional or professional group. It was established to promote the

development of economically deprived members of the community and to keep them from the claws of lenders who supply needy people with loans at unnecessarily high-interest rates. Cooperation, mutual aid, democratic decision-making, and open membership are the guiding principles of the cooperative structure. It operates on the 'one shareholder, one vote' and 'no profit, no loss' principles. Organization, governance, interest rates, the scope of operations, objectives, and values distinguish cooperative banks from commercial banks.

Cooperative banks play an integral part in the implementation of development plans and are important for the effective functioning of the banking system in India. India is termed as an underbanked country, and after so many scams, it is need of the hour to take necessary measures to remedy the lacuna and to boost the confidence and trust of the public in the banking system.

Cooperative banks are essential to the smooth running of India's banking sector and play a major role in the process of development goals. In India, cooperative banks have become an important component of the country's financial inclusion story. Since their inception, they have set numerous milestones and assisted ordinary rural Indians in feeling empowered and secure. The plot has had its own share of procedural flaws and difficulties, with diverse areas of procedural flaws and woes.

### Keywords

**Co-operative bank:** A co-operative bank is a small-sized, financial entity, where its members are the owners and customers of the Bank.

**Loan:** A loan is a form of debt incurred by an individual or other entity.

**Capital:** capital is the money that a bank has obtained from its shareholders and other investors and any profit that it has made and not paid out.

**Rural Credit:** any kind of loan or financial assistance that is taken by the people residing in the rural areas for the purpose of agriculture or setting up small businesses.

**Fund:** a collection of different people's money collected & managed by high market professionals.

### Review Questions

1. Write and explain the Structure of Cooperative Banking.
2. What are the Challenges Faced by the Cooperative Banks? Explain.
3. Critically explain the Cooperative Agricultural and Rural Development Banks.
4. Explain the measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country

### Self-Assessment

1. Co-operative banks which work at a metropolitan level are called as?
  - a) District Central Co-operative Bank
  - b) State Co-operative Bank
  - c) Primary Urban Co-operative Bank
  - d) Primary Agricultural Credit Societies
2. Which one of the apex bodies regulates the cooperative banks in India?
  - a) NABARD
  - b) RBI
  - c) Sponsor Banks
  - d) Both A and B
3. All banks registered under the
  - a) Banking Regulation Act 1949
  - b) The Bankers' Books Evidence Act-1891
  - c) Cooperative Societies Act, 1912

- d) Both (A) and (C)
4. Who manages the registration and management activities of Urban co-operative banks?
- RBI
  - NABARD
  - RCS
  - None of the above
5. Which of these are at the lowest rung of Rural Cooperative banking structure in India?
- State Cooperative Banks
  - District Central Cooperative Banks
  - Primary Agricultural Credit Societies
  - None of the above
6. Who regulates the functioning of District Cooperative Banks in India?
- State Government
  - SBI
  - State Cooperative Banks
  - None
7. Which was the first Cooperative Bank established in India?
- Bharat Cooperative Bank Limited
  - Kangra Central Co-operative Bank Limited
  - Anyonya Co-operative Bank Limited
  - Abhyudaya Co-operative Limited
8. Which of these is a Cooperative Bank in India?
- Cosmos Bank
  - SVC Bank
  - Janata Sahakari Bank
  - All of the above
9. Which is the largest cooperative bank of India presently?
- Saraswat Bank
  - NSB Bank
  - Apna Sahakari Bank L
  - None of above
10. Which of the following organizational structure is followed by Co-operatives in India?
- Federal Structure:
  - Unitary Structure
  - Centralized Structure
  - Decentralized Structure
11. DCCBs
- District Central Cooperative Banks
  - Director of Central Cooperative Banks
  - Danish Credit Cooperative Banks
  - Dane Creative Cooperative Banks
12. Co-operative banks which work at a metropolitan level are called as?
- District Central Co-operative Bank
  - State Co-operative Bank
  - Primary Urban Co-operative Bank

- d. Primary Agricultural Credit Societies
13. All banks registered under the \_\_\_\_\_ are considered co-operative banks.
- Banking Regulation Act 1949
  - The Bankers' Books Evidence Act-1891
  - Cooperative Societies Act, 1912
  - Both (A) and (C)
14. Besides banks, the other formal major source of cheap credit in rural areas, are:
- money lenders
  - zamindars
  - the cooperative societies
  - friends and relatives
15. ....is the vertex of the pyramidal structure in a State for the provision of short and medium term credit to agriculturists on cooperative basis.
- District Central Cooperative Banks
  - Primary Agricultural Credit Societies
  - State Cooperative Banks
  - All the above Answer

### **Answers for Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (b)  | 3. (c)  | 4. (c)  | 5. (c)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (a) |
| 11. (a) | 12. (a) | 13. (c) | 14. (c) | 15. (c) |

### **Further Readings**

#### **Text Books:**

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## Unit 11: Structure of Bond Market

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super



economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it is mobilization of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

Meaning of Financial System:

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as “a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions.”
2. Prof.S.B.Gupta defines the financial system as “a set of institutional arrangements through which financial surpluses available in the economy are mobilized”.
3. Van Horne has defined the financial system as “the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption”.
4. According to Robinson, the primary function of the system is “to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth”.

Features/Characteristics/Role of Financial System:

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.

13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.
19. It includes financial institutions, markets, instruments, services, practices and transactions.
20. The main objective is to formulate capital, investment and profit generation.

### **11.1 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of financial system in an economy. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

### **11.2 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares.

It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.

**3. Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.

**4. Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.

**5. Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.

**6. Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.

**7. Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.

**8. Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.

**9. Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.

**10. Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

**11. Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.

**12. Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

### **11.3 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

**Formal (organized) financial system:** This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

Financial Institutions.

Financial Markets.

Financial Instruments.

Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

## 11.4 Money:

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

Meaning and Definitions of Money:

The word "money" is believed to originate from a temple of 'Juno', located on Capitoline, one of Rome's seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn or instruct) or the Greek word "moneres" (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

## 11.5 Definitions of Money:

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of

economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, "Money is what money does". It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability. Looking from this criterion, we find Crowther's definition to be the most suitable.

"Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value." – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

### **11.6 Legal Tender Money and fiduciary Money:**

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

**Legal tender money is of two kinds:**

- (a) Limited legal tender, and
- (b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

Stages in the Evolution of Money:

#### **(i) Animal Money:**

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.

#### **(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

#### **(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

**(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

**(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

Characteristics of Money:

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

**6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

**7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

Classification of Money:

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

**(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

**(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

**(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

**(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

- (a) Standard Money, and
- (b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

- (a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

#### **(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

Modern Forms of Money:

#### **1. Currency:**

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

##### **(a) Metallic Money:**

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

##### **(b) Paper Money:**

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

#### **2. Deposit Money or Bank Money:**

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

#### **3. Legal Tender Money (Force Tender):**

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.



**4. Near Money:**

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

**5. Electronic Money:**

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money. The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

**6. Fiat Money:**

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country. The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

Importance of Money:

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

**1. Money and Production:**

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

**2. Money and Consumption:**

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

**3. Money and Distribution:**

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

**4. Removal of the Difficulties of Barter:**

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

**5. Money and Capital Formation:**

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

#### **6. Money and Public Finance:**

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

#### **7. External Trade:**

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

#### **8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

### **11.7 Value of Money:**

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

#### **The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value

can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

**(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

**(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

**(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

## **11.8 Evils of Money:**

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:**

**(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

### **11.9 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct

finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

### **Process of Intermediation:**

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

Roles of Financial Intermediaries:

#### 1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

**(i) Reduce Hoarding:**

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the “mattress”, as is commonly said.

**(ii) Help the Household Sector:**

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

**(iii) Help the Business Sector:**

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

**(iv) Help the State and Local Government:**

FIs help the state and local bodies financially by purchasing their bonds.

**(v) Help the Central Government:**

Similarly, they buy and sell central government securities and thus they help the central government.

**(vi) Lenders and FIs both Earn:**

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

**(vii) Spread of Risks:**

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

**(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency

and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the

country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

Functions of the Financial Sector

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:

**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### 11.10 Value exchange

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.



**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

Intermediation

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

### **11.11 Risk transfer**

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall

in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

### **11.12 Liquidity**

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

### **11.13 The Characteristics of Finance**

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

### **Summary**

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

### **Keywords**

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

### **Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups."  
Comment.
5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

### **Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. — — — — — represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset

- d. none of these
3. Financial derivatives include
- a. Stocks
  - b. Bonds
  - c. Futures
  - d. None of the above
4. Which of the following is the regulator of Money market?
- a) Reserve Bank of India
  - b) Government of India
  - c) Telecom Regularity Authority
  - d) Insurance Regularity Department
5. What is Call Money?
- a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
6. What is Notice Money?
- a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
7. What is Term Money?
- a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is a loan provided on certain terms and conditions by Bank to its customer
8. Which of the following is not related with Money Market?
- a) Treasury Bills
  - b) Commercial Bills
  - c) Certificates of Deposit
  - d) Shares

9. Which of the following is related with Money Market?
- a) Treasury Bills
  - b) Commercial money
  - c) Cheque
  - d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:
- a) Shorter term Markets
  - b) Capital Markets
  - c) Counter Markets
  - d) Long-term Markets
11. What is the main function of financial intermediaries?
- a) Connecting savers and borrowers.
  - b) Regulating the finance industry.
  - c) Acting as a fail-safe during financial crises, such as the Great Recession.
  - d) Facilitating investment in major corporations.
12. Which of the following is not an example of a common financial intermediary?
- a) A commercial bank.
  - b) The Federal Reserve
  - c) The stock market
  - d) The bond market
13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?
- a) The federal government is indirectly involved because it regulates financial intermediaries.
  - b) Financial intermediaries do not deal directly with borrower-spenders.
  - c) Financial intermediaries do not deal directly with saver-lenders.
  - d) Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
14. Which of the following statements about financial markets is not true?
- a) Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.
  - b) Sometimes intermediaries invest in the financial markets.
  - c) Financial markets are associated with "direct" finance.
  - d) When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.

15. Which one of the following is not a financial intermediary?

- a) A money market mutual fund
- b) A steel manufacturing plant
- c) A property and casualty insurance company
- d) A commercial bank

### **Answers for Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

### **Further Readings**

#### **Text Books:**

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2. Indian Financial System By M.Y Khan, Tata Mcgraw Hill, India





## Unit 12: Financial Market

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions. Banks provide packages of financial services which individuals find too costly to search out, produce and monitor by them. Commercial banking offers a wide variety of services to small, medium and large-scale business units. The role of banking is more prominent in the open economy.

*“A bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits.” – Benhams*

A central bank is the essential wellspring of cash supply in an economy through the flow of currency. It guarantees the accessibility of cash for meeting the exchange needs of an economy and encouraging different financial exercises, for example, creation, dissemination, and utilization.

Notwithstanding, for this reason, the central bank needs to rely on the reserves of commercial banks. These reserves of commercial banks are the optional wellspring of money supply in an economy. The main function of a commercial bank is the creation of credit.

Credit creation isolates a bank from other monetary establishments. In basic terms, credit creation is the development of reserves. Furthermore, banks can extend their demand deposits as numerous of their money holds since demand deposits fill in as the important medium of trade.

## **12.1 Commercial Banks**

The Indian financial sector has considerably widened and deepened, thereby lending strong support to capital accumulation and overall economic growth. The commercial banks in India constitute the single-most important component of the Indian financial system in bringing about the bulk of financial intermediation process in the country. A significant part of this impressive record of financial development in India is attributable to the crucial role played by banks in the financial intermediation process. In India the financial sector comprises the banking system (i.e. commercial and cooperative banks), financial institutions (which include term lending institutions, i.e. IDBI, NABARD, ICICI, IRBI, IFCI, EXIM Bank and NHB at the all-India level and SFCs and SIDCs at the state level, besides investment institutions, i.e. UTI, LIC and GIC and other institutions including DICGC and ECGC), non-banking financial intermediaries and the capital market.

### **Evolution of Commercial Banking**

The evolution of banking which lasted for centuries until two types of modern banking developed in the industrially advanced economies in the late nineteenth century was an integral part of the expansion of capitalism. The techniques of banking developed in the 17th century facilitated the industrial and territorial expansion that began about the same time. Banking systems evolved to meet the demands of the constituents, vested interests are regulations governing their establishment. The British system evolved around the central banking system with a central bank and clearing banks with a large network of offices regulated by the central bank while the German one evolved out of an identification of interests of finance, industry and government to

provide multiple services to the constituents. The US system however was set apart by the dominance of the unit banks, the role played by an active interbank market in deposits and reserves and the cooperative lending practices. It also features wholesale banking, which was the source of several innovative practices such as rollover credit or flexi rate lending.

### **Structure of Indian Commercial Banks**

Having established the pivotal role performed by the banking system in the Indian financial sector and by implication, in the overall financial intermediation process, thus supporting the real sector of the economy. The strong points of the financial system are its ability to mobilize savings, its vast geographical and functional reach and institutional diversity.

The commercial banking structure in India consists of: Scheduled Commercial Banks and Unscheduled Banks. Scheduled commercial banks constitute those banks, which have been

included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI includes only those banks in this schedule, which satisfy the criteria laid down vide section 42 (6) (a) of the Act. Indian banks can be broadly classified into nationalized banks/ public sector banks, private banks and foreign banks. The Indian banks include 27 public sector banks excluding 196 Regional Rural Banks (RRBs).

### **Asset Structure of Commercial Banks**

Assets structure will reflect the deployment of sources of funds of commercial banks. The main source of funds of commercial banks is deposits. The other sources of funds are borrowings from other banks, capital, reserves and surplus. The deposits of commercial banks are from savings

deposits, current account deposits and term deposits. These deposits constitute 80 per cent of the total sources of funds. Out of the total deposits, term deposits constitute 50 per cent. Borrowings are around 5 per cent of the total liabilities of the commercial banks. These sources are deployed by the commercial banks mainly on its financial assets i.e, loans and advances which constitute 48.6 per cent of the total assets of the banks. The investments is another important component of the assets of commercial banks which is around 40 per cent of the total assets of the banks during the year 2005. This is because of pre-emptions like SLR and CRR requirements in the banking sector. The investments in commercial banks have increased also because of surplus liquidity in Indian banks during this period due to reduction of SLR and CRR to 25 and 4.5 respectively during that period and less demand for loans and advances from credit-worthy customers. This scenario is changing in India due to increasing demand in credit from industrial, agriculture sector and also the growth of FMCG market.

The assets structure of the banks is governed by certain principles, like liquidity, profitability, shiftability and risklessness. The other factors which influence the assets structure of commercial banks are nature of money market, economic growth of the country, policies and vision of the governments. In the countries like India, China, Russia, North Korea and Brazil there is a boom in the growth of the economy hence naturally there will be heavy demand for the credit. Now let us examine each of the important assets of the commercial bank.

**1. Cash in hand and balances with RBI.** From the point of the liquidity in the commercial banks cash in hand is a very important asset but it is idle and it will not fetch any earnings to the banks. Cash in commercial banks depends upon various factors like uncertainty in the economy due to wars, famine, internal disturbance, the growth of banking system, network of branches, networking of banks, automation in banks and so on. The cash reserve requirements in the commercial banks was more during pre-reform period it was 15 per cent during the year 1994-95. Gradually RBI reduced it to 4 per cent based on the requirements of credit and it is now 5 per cent on Net Demand and Time Liabilities.

**2. Money at Call and Short Notice.** It is second line of defense of the commercial banks in cases of emergencies. If the call money market is well developed the commercial banks can lend their surplus funds in the call market for a day or up to 14 days it is called call market or overnight market without keeping their surplus money idle. It can also lend for short period, where the borrower has to return the money borrowed from the banks when short notice is given by the banks. This is becoming a good business in the money market and constitutes around 4 per cent of the total assets of the commercial banks. The banks instead of keeping the money idle lend their surplus funds for short periods in the call market.

**3. Investments.** Investments constitute one of the important assets of the bank next to loans and advances. A bank makes investments for the purpose of earning profits. First, it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject

to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity.

**4. Loans and Advances.** The commercial banking industry in India has been playing a very important role in intermediating between the economic units, which have surpluses and deficits in their current budgets. By mobilizing financial surpluses in the economy and by channeling these resources into various sectors and segments of the economy, they are guiding the pattern of utilisation of a large proportion of the economy. The Government of India which owns a large segment of the industry, and the RBI, which is the central banking authority of the country, have been persuading the commercial banks to deploy larger and larger volumes of financial resources into certain identified priority sectors, for the purpose of accelerating the growth of these sectors. The total advances of commercial banks include bills purchased and discounted, cash credits, overdrafts, loans, unsecured loans, and priority sector advances. The component of loans and advances in the total assets of commercial banks is 48 to 50 per cent – in fact still growing in India. The management of this asset is a very important aspect in the banking sector. The non-performing assets in banks is increasing. In addition to this banks are exposed to various risks such as credit risk, liquidity risk, market risk and operational risk.

**5. Fixed Assets and other assets.** The component of fixed assets and other assets do not form an important aspect in the funds of commercial banks since deals are more in financial assets than real assets.

### **Factors affecting Banking Systems Growth**

While provision of payment services involving the transfer of ownership of bank deposits from one account to another, provision of deposit facilities and advance credit by means of overdrafts and loans, by the discounting of bills and by trade finance constitutes the ordinary business of banking, there has been a sea change in the business of banking in the last forty years as exemplified by the rise of wholesale banking, liability management, international banking, multiple currency loans, rollover credits, securities lending collateralised mortgages note issuance facilities, interest rate and currency options and financial futures.

*Example:*

Credit cards

Debit cards

Automated teller machines

E-cash and on-line banking

Banks globally have undergone fundamental changes because of the ongoing revolution in information technology and communications. The winds of change are reshaping the nature of banking and financial markets. The demand for new types of services as well as the need to step up earnings through fee income is the major factor. On the other hand, technological advances by reducing costs give individuals and business firms direct access to markets reducing the need for banks to offer certain services. Technological advances and subsequent innovations have also led to the creation of new markets in terms of future options, secondary mortgage markets expanding the range of portfolio strategies open to financial intermediaries.

The changes in competitive conditions since 1990s with banks as a leading partner of financial services industry have transformed banks (especially large international ones) into new financial firms. Among the important factors behind changes in competitive conditions are the internationalization of banking and financial markets. The opening up of financial markets, the supply of cross-border financial services and the impact of the entry of foreign commercial and investment banks are the important features of the process. Other factors are the continuous process of deregulation, partly as a consequence of the globalization of the markets and partly as a middle through process. The sources of change of banking industry, mergers and amalgamations of banks, integration of markets by exchanges, growth of financial information business and internet.

## **12.2 Functions of Commercial Banks**

Prof. Syers, defined banks as “institutions whose debt – usually referred to as ‘bank deposits’ – are commonly accepted in final settlement of other people’s debts”. According to Banking Regulation Act of 1949, “Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise”. From the above definitions we can analyze that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

**1. Receiving deposits from the public.** The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity.

**2. Giving loans and advances.** The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and silver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and foreign banks, the other commercial banks also started giving loans and advances not only to their

traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.

**3. Use of cheque system and credit cards.** The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

**4. Credit creation.** Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

**5. Financing foreign trade.** The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

**6. Transfer of funds.** Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transferring funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.

**7. Agency functions.** The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers.

**8. Miscellaneous functions.** The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc. advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. The Ghosh Committee recommended that "a bank's investment portfolio should be bifurcated into two parts, namely, 'permanent investment' and 'current investment'. The committee recommended that banks should make necessary provision for the depreciation in the value of current investment and there is no need to provide for permanent investment. RBI has also advised the banks to classify the existing investment in approved securities into two categories. Initially from the accounting year 1992-93, banks should not keep more than 70% of their investment in permanent category, and 30% of the portfolio as current investments to facilitate valuing all the investments on fully 'marked to market' basis. Guidelines were laid down for transfer of approved securities from 'current' to 'permanent' and 'vice versa' in 1992. These guidelines ensure that latent losses are provided for at the time of such transfer. In 1993 the entire investment portfolio of banks other than investments classified as 'permanent' has to be classified into six categories for the purpose of valuation. The valuation will be done for each category of investments. While net depreciation has to be provided by debit to the profit and loss account, net gains have to be ignored. Permanent investments can be carried at book value. Premium will have to be amortized over the life of the investment but discount cannot be recognized as income.

## Transformation Services

Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process. Firstly, liability, asset and size transformation consist of mobilization funds and their allocation (provision of large loans on the basis of numerous small deposits). Secondly, maturity transformation by offering the savers, the relatively short-term claim on liquid deposits they prefer and providing borrowers long-term

loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. Commercial banks by effectively appraising credit requests can channel funds into productive uses.

### **Transformation Services and Risks**

Banks incur risks while undertaking transformation services. In the past three decades, banks abroad assumed new roles and accepted new forms of financial intermediation by undertaking currency and interest rate swaps and of dealing in financial futures, options and forward agreements. These new instruments reflect considerable flexibility in responding to market situations and adjusting continually assets and liabilities both on and off-balance sheet, while enhancing profitability.

### **12.3 Risk Management**

Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management. In the words of Alan Greenspan, former Chairman of the Federal Reserve Board of US (Conference at Federal Reserve Bank of Chicago, May 12, 1994), "traditional banking can be viewed at an elemental level as simply the measurement, management and acceptance of risk" and banking involves understanding, processing and using massive amounts of information regarding the credit risks, market risks and other risks inherent in a vast array of products and services, many of which do not involve traditional lending, deposit taking and payment services. Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks. To some extent, these risks could be managed through sound business practices and the others through a combination of product design and pricing. In the past banks concentrated on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that for given liquidity level, the return was the maximum.

**Overall Risk of a Bank:** A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.

**Types of Risk:** Banks have to manage four types of risk to earn profits for maximizing shareholder wealth. These are credit risk, interest rate risk, liquidity risk and operational risk. In addition there is a systematic risk arising due to various disruptions in the working of a major bank, which in notime could spread to other banks or the whole financial system. Credit risk arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by an increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of the borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally, operational risk arises out of an inability to control operating expenses, especially non-interest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardize the banks prospects to survive. Empirical analysis reveals that banks risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks maturity gaps, the duration and interest elasticity of its assets and liabilities and the ability of the management to measure and control the exposure.

**Interest Sensitive Assets Notes:** These risks are a part of either assets or liabilities or both of a bank them. Assets are managed through money market instruments such as interbank lending, treasury bills and repos. Shortening the maturity of these assets makes them interest sensitive. Shifting liabilities such as interbank borrowing, issue of CDs while shortening the maturity of the liability side of the balance sheet makes liabilities more interest-sensitive and increases the risk of the bank's portfolio.

**Credit Risk:** The assets of a bank whether a loan or investment carries credit risk. Credit risk is the risk of losing money when loans default. Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans. Banks can raise their credit standards to avoid high risk loans. Guarantees and collaterals can reduce risk. After the loan is made, compliance can be ensured by monitoring the behaviour of the borrower which reduces risk. Credit risk can be transferred by selling standardized loans. Loans portfolio can be

diversified by making loans to a variety of firms whose returns are not perfectly and positively correlated.

**RBI Guidelines:** RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk. Banks are also expected to evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

**Interest Rate Risk:** Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both. On-balance sheet adjustment involves changes in banks portfolio of assets and liabilities, as interest rates change. When medium or long-term loans are funded by short-term deposits, a rise in the rate of interest will increase the cost of funds but the earnings on the assets will not, thereby reducing the margin or spread on the assets. The problem could be resolved by adopting adjustable interest rate on loans on the asset side of the balance sheet and increasing the maturity pattern of deposits on the liability side of balance sheet. These decisions relating to banks portfolio of assets and liabilities represent balance sheet adjustments. The interest rate risk position can also be adjusted by the bank by making off-balance sheet adjustments which involve the use of various non-traditional financial instruments referred to as derivatives such as futures, options, swaps or creation of synthetic loans through use of futures.

**Liquidity Risk:** Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank. The mismatch between short-term liabilities and long-term assets creates a severe funding problem as the liabilities mature. Again, if the duration of assets exceeds the duration of liabilities, the ability to realize liquidity from the assets of the bank is reduced. Liquidity needs are increasingly met by deposit and non-deposit sources of funds paying market rates of interest.

Banks have decreased the quantity of liquid assets they hold for the purpose of deposits withdrawal and loan demand. Liability management has replaced asset management as a method to fund liquidity needs. The effect of replacement of asset management by liability management would be enhancement of credit risk since liquid assets have been replaced by loans. The replacement of short-term assets by long-term assets would also require an increase in gross rates of return, since upward sloping yield curves require higher rate of return on long-term assets than on short-term assets.

**Foreign Exchange Risk:** Foreign exchange risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur. An open foreign exchange position implies a foreign exchange risk. When a bank owns an uncovered claim in foreign currency, it is said to be long and when it has uncovered liability in foreign currency, it is said to be short. There are several techniques available to hedge or cover exposure to foreign exchange risk. These techniques help in minimize the impact of unfavourable potential outcomes. Forward contracts, money market alternative, foreign currency futures, currency swaps and foreign currency options are used to cover exposure to foreign exchange risk.

**Treasury Functions:** To take advantage of the opportunities provided by development of new financial markets and the internationalization of banking while managing risk has led to the growth of treasury function within bank. The role of new treasury department is to manage a wide range of short-term assets and liabilities. The dealers employed in treasury department are constantly trading in wholesale deposits, interbank deposits, certificates of deposit, foreign exchange, repurchase agreements, securities, financial futures and options. Apart from trading in short-term assets and liabilities, the treasury department monitors the bank's position with respect to earnings and risks due to maturity gaps and interest rate or foreign currency exposures. The treasury department usually reports to a high-level treasury or asset and liability management committee. The committee after considering the entire balance sheet of the bank as well as off-balance sheet liabilities decides the treasury policy.

**Monitoring Risks:** To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed. A maturity profile shows all assets and all liabilities by maturities to enable the calculation of mismatches within each period. Rate-of-interest ladder classifies all assets and liabilities by repricing dates and allows the calculation of rate of interest risk for each period. Duration presents the interest exposure.

## 12.4 Asset and Liability Management

Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals. Frozen lending was offset by increasing flexibility by making new loans against the provision of tradable assets which could be sold before expiry, in case of need. Against a background of rapid growth in the banking business, integrated approach to managing all assets and all liabilities evolved as balance sheets became more complex and as the volatility of interest rates and exchange rates increased. In the eighties, the rescheduling of debt of developing countries on account of their serious payments difficulties involved conversion of short-term and medium term assets into long-term and became frozen.

Banks abroad met the problem by raising long-term funds including capital liabilities. In the process, banks could meet the rise in capital adequacy norms stipulated by bank supervisors. Banks shifted their focus from growth to profitability and asset quality. Banks also started lending against negotiable assets and to the packaging for resale of conventional bank loans. Borrowers were encouraged to raise funds directly through issue of negotiable short-term paper by providing guarantees, standbys and backup facilities. Banks benefited from fee income without expanding balance sheet which would worsen capital ratios. Of course, off-balance sheet contingent liabilities went up.

There was a deliberate attempt to extend asset liability management beyond the range of on-balance sheet assets and liabilities which arises from the bank acting as principal in direct transactions with borrowers and lenders of money. Asset and liability management has helped to bring about securitisation of banking blurring the distinction between commercial banking and investment banking.

## 12.5 RBI Guidelines for Risk Management

Consequent to the liberalization of domestic market in India, the volatility in interest/exchange rates would be transmitted to the financial sector as a whole. To address these risks, banks have to undertake a comprehensive Asset Liability Management (ALM) strategy. The objectives of ALM are to control volatility of net interest income and net economic value of a bank. RBI issued guidelines on 21.10.1999 for risk management in banks which broadly cover credit, market and operational risks. Earlier, guidelines were issued on 10.2.1999 on asset-liability management system which covered management of liquidity and interest rate risks. Together they are purported to serve as benchmark to banks.

**Notes Credit Risk:** Banks should put in place the loan policy covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive credit ratings system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions. Proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. Portfolio quality should be evaluated on an ongoing basis rather than near about balance sheet date. Risk evaluation should be on the basis of total exposure, credit and investment decisions combined. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. A suitable framework to provide a centralized overview of the aggregate exposure on other banks is to be evolved. The banks should also develop an internal matrix that reckons the counter party and country risk.

**Liquidity Risk:** Banks should put in place prudential limits on interbank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments and swapped funds. Liquidity profile should be evaluated under bank specific and market crisis scenarios. Contingency plans should be prepared to measure the ability to withstand sudden adverse swings in liquidity conditions.

**Interest Rate Risk:** A time-frame should be fixed for moving over to value at risk (VAR) and duration approaches for measurement of interest rate risk.

**Market Risk:** Explicit capital cushion based on international standards should be provided for the market risks to which banks are exposed.

**Operational Risk:** In view of the phenomenal increase in the volume of financial transactions, proper systems for measurement, monitoring and control of operational risk should be set up. Suitable methodologies for estimating and maintaining economic capital should be developed.

The design of the risk management should be oriented towards the banks own requirements dictated by the size and complexity of business risk philosophy, market perception and the existing level of



capital. Banks can evolve their own systems compatible with the type and size of operations as well as risk perception. It is neither possible nor necessary to adopt uniform risk management system in all banks on account of the diversity and varying size of balance sheet items. The success of ALM depends on the effective existence of (1) information and policies, and (2) risk management system. There should be asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimize the volatility in its earnings, liquidity and equity to changes in market conditions. The successful pursuit of the objective would manifest in stable net interest margins, optimal earnings, adequate liquidity and effective control of financial risk. For this purpose the strong ALCO must be aware of policies which would address asset liability management goals and risk limits and by information that relates directly to its asset liability position.

## 12.6 Risk Management Systems

Measurement, control and monitoring of risk will help banks to attain the objective. Techniques such as gap, duration and value at risk are suggested to analyse risk. Strengthening of information technology in commercial banks is a prerequisite to implement effectively A.I.M system. The role of a broad-based ALCO in advising boards of banks is of significance.

**Financial Services:** Commercial banks provide securities related services. Commercial banks in India have set up subsidiaries to provide capital market related services, advice on portfolio management or investment counseling. In US, the Glass-Steagall Act of 1933 restricts the nature of services provided by commercial banks. In US, they may offer discount brokerage services but not general-purpose brokerage services. US banks facilitate mergers and acquisitions and in trading in currencies and US Government securities.

The Glass-Steagall Banking Act prohibits commercial banks from owning a firm dealing in securities. The Act has been challenged by banks offering money market mutual funds and other investment services. US Federal Reserve Board in January, 1997 issued a proposal that would allow bank holding companies and their securities industry affiliates to offer one stop shopping for their customers. Commercial banks in US in 1990s have become very active in the management and distribution of mutual funds, managing more than 10 per cent of the assets of all mutual funds. In India, several commercial banks such as Bank of India, Canara Bank, Indian Bank and State Bank of India have set up subsidiaries under the guidelines issued by the Reserve Bank in 1987, followed by guidelines laid down by the Ministry of Finance in 1991.

**Fiduciary Services:** In US, banks manage employee pension and profit-sharing programs that do not show up on banks balance sheet. In US, banks operate separate trust departments which manage the funds of others for a fee under the guidance of a trust agreement. The assets held in trust do not show up on banks balance sheet because they do not own the assets held in trust.

## 12.7 Nature of Primary Reserve in Commercial Banks

The term primary reserve is an analytical term used commonly in banking to refer to absolutely non-earning liquid assets held by a commercial bank. The aggregate of cash holdings by bank with itself and with the central bank and other commercial banks is designated as the primary reserve. It consists of cash in hand, the balance with RBI and demand deposits with other banks. A major function of primary reserve is to maintain liquidity in the bank with a view to protecting

it against illiquidity crises. It enables the bank to satisfy the depositors' claims immediately to perform its expected crisis. The primary reserve plays the role of first day-to-day business needs but to comply with the obligation imposed on it by law. The primary reserve may be divided into:

1. Legal Reserve
2. Working Reserve

**The legal reserve** represents that portion of the primary reserve, which the law requires a bank to maintain. The reserves are computed on the basis of the average deposits outstanding on the bank's books over a short period (one or two weeks). Since the bank is a dealer in public money and attracts public deposits on the premise that the deposits on the premises that the depositors will get back their money on demand, the government has the responsibility to ensure sufficient liquidity in the banking system so that the depositors' claims are met in full as promised. The law prescribes the minimum percentage of deposits, which a commercial bank has to carry with the central bank. By changing the reserve requirements, the central bank can regulate the magnitude of credit. In order to curb inflationary trends, banks may raise the reserve requirements and restrict the lending and investment activities of banks. Similarly the legal reserve weapon may be used along with

other control techniques to take out economy from the possibility of depression, which is another undesired situation to keep the nation on growth track.

The regulatory function of legal reserve involves three steps by the government of the central banking authority:

1. Defines those particular types of assets which can be counted towards the legal reserve requirements. According to RBI the two types of assets- Cash in hand and balance with RBI are considered eligible for legal reserve purpose.
2. Regulates the rupee volume of the legal reserve maintainable by banks. In India, this is the main function of the RBI.
3. Requires banks to hold legal reserves equal to at least some stated fraction of their deposit liabilities.

**Statutory Provisions Regarding Cash Holdings:** The RBI Act, 1935 empowered RBI to require scheduled banks to keep with it not less than 5 percent of their demand liabilities and 2 percent of their time liabilities. RBI announces its CRR policy for the year such that the banks can cope up with the maintaining of adequate Cash Reserve Ratios to prevent illiquidity.

### **Working Reserve - Nature and Functions**

Commercial Banks have to carry cash reserves in excess of the legal minimum reserve to meet the depositors' claims, satisfy the credit needs of the community and provide protection against unforeseen withdrawals. This excess cash reserves held by the commercial banks to fulfill day today business requirements is designated as working reserve. This consists of:

1. Cash in their own vaults.
2. Demand deposits with other banks
3. Excess reserve with the central bank.

The principal function of the working reserve is to take care of both regular and exceptional requirements. Since they have to meet the obligatory demands of human, predicting about their requirements is very difficult and that's why determining working reserve determining is complicated. How much of total deposit liabilities should be held in the form of working reserves is a basic problem which confronts a commercial bank. A commercial bank has to trade off between liquidity and profit. In order to determine the proper size of the working reserve a banker should consider all those variables, which affect the quantum and nature of money inflows, and cheques are collected. The various factors, which generally affect are:

1. Banking habit of the people
2. Nature of Business conditions
3. Seasonal factors
4. Existence of clearing house arrangements
5. Cash reserves held by other Banks
6. Structure of Deposits
7. Size of Deposit Accounts
8. Ownership of deposit accounts
9. Size of secondary Reserve
10. Location of Bank
11. availability and cost of borrowings
12. Ownership of deposit account
13. Banks inclination and ability to adjust working reserve position.

## **12.8 Cash Management in a Commercial Bank**

An efficient utilization of cash is essential for the successful survival of a bank. A bank receives money from customers in various deposit accounts and pays cash to depositors and demand cheques or demand drafts or bank orders etc. The basic issues involved in cash management in a bank are:

1. The management has to keep the cash balance at the lowest possible level in order to avoid the loss of opportunity income.
2. A low cash level will mean a greater risk of running out of cash and higher cost of replenishment.

Prudence in the management of cash lies in striking a balance between the two factors. The banks have to compile data weekly about:

1. Cash receipts from the customers
2. Cash receipts by way of remittances
3. Routine cash payments to customers.

4. Payments in the form of remittances to the head office
5. The amount of cash receipts utilized for the purpose of making everyday.

Cash Management system should be effective to increase profitability and liquidity of any bank. The bank managers should compile periodically information relating to cash receipts, cash payments and similar other information (weekly) and submit to the head office. The head office should analyze the data and determine the optimal cash levels for huge withdrawals and determine cash inventory levels by scientific inventory management techniques. They can be applied to determine optimal cash levels for each bank and if followed that would improve the profitability of a bank.

### 12.9 Nature of Secondary Reserve in Commercial Banks

A commercial bank generally relies on highly liquid earning assets to meet its expected and unexpected financial needs because it can't afford to hold a larger proportion of funds in the vault for the reasons stated earlier. The aggregate of highly liquid earning assets is designated as the secondary reserve in banking circles. The principal objective of holding the secondary reserve is to impart adequate liquidity to funds without adversely affecting the profitability of a bank. The bank must have such assets which are highly liquid and at the same time generate some yield on them. Call loans to brokers or bankers which may be terminated at any time at a very short notice may be regarded as highly liquid assets. Keeping above requirements of high liquidity, yield and shiftability, the following types of assets may be grouped in the category of secondary reserve:

1. Call loans to stock brokers and commercial banks.
2. Short term loans to commercial banks.
3. Short term loans secured against self liquidating assets or blue chips.
4. Investment in treasury bills.
5. Promissory notes of short period maturity.
6. Discounting of usance bills eligible for rediscounting from the RBI.
7. Short period debentures of companies.

### 12.10 Functions of Secondary Reserve in Commercial Banks

The principal function of the secondary reserve is to replenish the primary reserve, while its subsidiary function is to earn a moderate income. Since it is very difficult to estimate correctly the working reserve requirements because the bank deals with human beings who are motivated by a variety of factors, a banker would like to keep a little more cash in the vault than is absolutely necessary to avoid an illiquid crisis. Secondary reserve helps a banker to trade off successfully between liquidity and profitability. Where a bank has a surplus in the primary reserve because of heavy cash inflows, it is invested in secondary reserve assets so that it may be drawn conveniently. Moreover the bank can earn some yield rather than earning nothing or a less yield.

### Factors Influencing the Level of Secondary Reserve in Commercial Banks

The factors can be classified into External factors and Local factors:

#### **External Factors**

1. **General state of Economy:** If the level of business activity is expected to increase, which means more demand for business loans the banker can keep large proportion of loans in secondary reserve to meet the requirements.
2. **Political conditions:** When there are uncertain political conditions in the country, banks generally lose public confidence and consequently there is a run on the banks. In such conditions to meet the heavy customers banks have to invest in secondary reserves more and release conveniently.
3. **Taxation policy** of the government may affect the size and composition of the secondary reserve. A bank may be tempted to invest more in government securities if the government decides to exempt them from the levy of tax because this investment will not only strengthen the liquidity position of the bank and also profitability.
4. **Monetary policy:** A banker has to understand the monetary policies announced by the central bank and expected to be followed at the same time liquidity and profitability are also balanced.

#### **Local Factors**

Character of the local economy- A banker must be familiar with the characteristics of the economy in which he is operating because the character and magnitude of deposits and loans is affected by them. Indian economy is dominated by agriculture and its requirements are highly vulnerable therefore because banks receive large deposits after the harvest season, while withdrawals take place throughout the year. Similarly the banks in industrial locality must familiarize with the industrial requirements pattern and accordingly invest the surplus in secondary reserves. A large number of internal factors such as deposit structures, ownership of

deposit accounts, average size of bank accounts, access to money market, nature of bank loan, maturities and diversification of investment portfolio are such other factors influence regarding the size of secondary reserves of a bank. Banks can apply statistical methods to analyse the various demand supply requirements of money and accordingly determine the structure its secondary reserve portfolio to maintain liquidity and profitability.

### 12.11 Management of Loans in a Commercial Bank

Lending is the most important function commercial banks. At they aim at lending results in maximum return and their survival depends on high they can do it with in the frame work of central bank regulations and guidelines along with the social responsibility for the economy development as expected by the society. The important characteristics of commercial bank loans are:

1. The bulk of the loans in India are provided to trade and industries.
2. As the banks look at liquidity they give maximum proportion of loans of less than year type which are short term nature.
3. Commercial banks in India demand sound security like goods, financial assets, gold, and hypothecation. Unsecured credit loans are given to firms with a sound financial position and stable earning records.

Lending is the most profitable business of a commercial bank but at the same time it is highly risky. A banker is supposed to do the lending business on the sound principles of safety, liquidity and profitability. Banks should diversify their risk of lending by evolving to a right portfolio. It should not be merely defensive but provide for earning for increasing average rate of return on fund. The principle of maturity diversification allows the loan portfolio is staggered over different maturity periods so that a certain amount of loans mature at regular intervals of timeperiods so that the realizations can be utilized to meet the investors obligations. The funds can be invested in securities of diversified nature to earn reasonable returns.

Banks should check well into the purpose of loan an applicant seeks and track whether the loan is applied. This is important for productive purpose and the banks social obligations are also satisfied. An advance made to for non productive and speculative purposes is subject to high risk of recovery. A banker should avoid making loans against wasteful expenditure on social functions. The banker should examine whether the credit granted is not for a purpose other than that is sought. A bank has the social obligation of meeting the diverse credit needs of the society ranging from personal needs to small businesses to large industrial business needs. It can not afford to lend the funds of its depositors indiscriminately and incur losses. The loan policy should be carefully structured to maintain uniformity and standardization of lending policies. There is always a risk of misunderstanding and misinterpretation of the policy. In general, the loan policy in a bank largely influenced by the following factors:

1. **Capital position:** A bank having strong capital base can follow a liberal lending policy.
2. **Earning Requirements:** Profit making and required rate of return becomes the basis while structuring lending policy.
3. **Deposit variability:** Large variation is found between the urban banks and rural banks regarding demand and of supply of money. Banks expecting a rising tendency can go for liberal credit policy.
4. **State of local economy and National economy:** Banks have to understand the local needs and national needs due to variation in seasonality, commercial activity or agricultural needs.
5. **Monetary policy of the Central bank:** RBI announces the lending policy of term loans and interest rates range focusing on sectoral growth for prosperity and to put a check on inflationary movements affecting the common man and welfare of the economy. Fiscal disciplinary measures are to be followed by the banks and need to follow the directives of the central banks.
6. Term lending policy of a commercial bank is usually based on industrial activity and sectoral growth needs. Banks have to commit large funds to long term loans to industry. Commercial banks generally seek the assistance of banks like NABARD, IDBI etc. while granting collaborative lending to commercial purposes with respect to term loans. The commercial banks thus play an important role in the growth of an economy by mobilizing funds from small investors to business and play a critical role in the transformation of the nation to a greater and powerful economy. *Task* Prepare a project feasibility proposal as per the guidelines of a merchant Banker by selecting an entrepreneurial activity.

## Summary

The importance of Commercial banks and their contribution are discussed. An attempt is made to provide the effect of RBI banking regulations, demand supply theory of money, interest and profitability of banks are explained. The risk management practices observed by banks are discussed. The management of primary and secondary reserves, loan policy formulation and issues involved are discussed. There is also discussion on the financial institutions, which offer a variety of specialized to traditional services to the business and act as mediators and agents of transfer of funds to create wealth to the society at some charge for the service, which would be their source of revenue. They have the obligation of creating a qualitative Financial System and should cooperate with the regulatory bodies engaged with various measures to discipline the economic system.

## Keywords

**Credit or loan:** Credit or loan refers to sum of money along with interest payable.

**Finance:** Finance is monetary resources comprising debt and ownership funds of the state, company or person.

**Financial Institutions:** Financial Institutions are business organizations that act as mobilizers and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the society.

**Financial System:** Financial System is concerned about money, credit and finance.

**Money:** Money refers to the current medium of exchange or means of payment.

## Review Questions

1. What is the role of commercial banking in developing the economy?
2. Explain about the functions of commercial banks.
3. Write about the regulating policies RBI with respect to commercial banks.
4. What are the various factors influencing the level of secondary reserve in commercial banks?

## Self Assessment

1. In a market-oriented financial system, specialized .....including banks, financial markets and market intermediaries cater to the different financial needs.
2. In a .....financial system, savings are largely transferred directly from those who generate them to those wishing to use them by the intermediation of banks.
3. ....consists of provision of banking services by a single institution.
4. A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the .....of the value.
5. ....arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise.
6. Liquidity risk refers to the bank's ability to meet its .....obligations to depositors and borrowers.
7. ....risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.
8. ....is the link between financial markets and bank's profitability.
9. A capital shortage of a bank indicates that it should change, among others, its .....policies.
10. .... indicates how well a bank's programmes can be sustained and the capital sum serves as a cushion against temporary losses.
11. Market discipline according to .....is a lever to strengthen the safety and soundness of the banking system.
12. ....is the most profitable business of a commercial bank but at the same time it is highly risky.

13. Term lending policy of a commercial bank is usually based on industrial activity and .....needs.
14. A bank has the social obligation of meeting the diverse ..... needs of the society ranging from personal needs to small businesses to large industrial business needs.
15. .... reserve helps a banker to trade off successfully between liquidity and profitability.

### **Answers for Self-Assessment**

1. financial institutions
2. bank-oriented
3. Unit banking
4. standard deviation
5. Credit risk
6. cash
7. Foreign exchange
8. Bank capital
9. Operating
10. Return on bank capital
11. BCBS
12. Lending
13. sectoral growth
14. credit
15. Secondary

### **Further Readings**

#### **Text Books:**

1. Financial Institutions and Markets by L.M Bhole and Jitendra Mahakud, TataMcgraw Hill, India

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## Unit 13: Derivative Market

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### Objectives

After this lecture, you would be able to

- To study the financial system of an economy.
- To evaluate the nature and scope of financial system.
- To explore the nature and meaning of money.
- To study the type and importance of money
- To understand the financial intermediaries in economy
- To evaluate the type and role of financial intermediaries.
- To analyse the equilibrium condition of financial sector.
- To evaluate the functions of financial sector.

### Introduction

The economic development of any Country depends upon the existence of a well-organized financial system. When the system functions properly, it channelizes funds from savers to investors. By increasing productivity, the financial system helps super economic growth and raise the standard of living. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it is mobilization of savings or their efficient, effective and equitable allocation

for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Financial system is a concept derived from the wide concept of finance. The financial system is a system that allows the transfer of money between savers and investors. It plays an important role in global, national, regional, institutional and individual areas. This states the healthy and soundness of financial status from global to individual.

### **13.1 Meaning of Financial System:**

The term financial system is a set of interrelated activities or services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, capital formation and growth. In simple, financial system refers to all the securities, intermediaries and markets that exist to make transfers from savers to borrowers possible.

#### **Definitions:**

1. In the words of Dr.S.Gurusamy, in his book Financial Services and Systems defined the term financial system as "a set of complex and closely interconnected financial institutions, markets, instruments, services, practices and transactions."
2. Prof.S.B.Gupta defines the financial system as "a set of institutional arrangements through which financial surpluses available in the economy are mobilized".
3. Van Horne has defined the financial system as "the purpose of financial markets to allocate savings efficiently in an economy to ultimate users withers for investment in real assets or for consumption".
4. According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and permit portfolio adjustment in the composition of the existing wealth".

### **13.2 Features/Characteristics/Role of Financial System:**

1. It plays a vital role in the economic development of a country.
2. It encourages both savings and investments.
3. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
4. It links both savers and investors.
5. It helps in mobilizing and allocating the savings efficiently and effectively.
6. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation. So, financial system helps in capital formation.
7. It helps in bringing investments.
8. It facilitates expansion of financial markets.
9. It helps in allocation of funds.
10. It is a set of inter-related activities or services.
11. It creates a bridge between investors and companies.
12. It helps in fiscal discipline and control of the economy.
13. It brings accountability for investors.
14. It helps to monitor corporate performance.
15. It provides a mechanism for managing uncertainty and controlling risk.
16. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.
17. It allows transfer of money between savers and borrowers.
18. It is applicable at global, regional and firm level.
19. It includes financial institutions, markets, instruments, services, practices and transactions.
20. The main objective is to formulate capital, investment and profit generation.

### **13.3 Objectives of Financial System:**

The primary objectives of a financial system are concerned to formulate capital, facilitate investment and profit generation. These objectives are also the significance or importance of



financial system in an economy. The major and primary objectives of a financial system are as follows:

1. To mobilize the Savings: The financial system begins its operations by the mobilizing of savings from the small saving community. It collects the funds by offering different schemes which attract the investors' i.e., savers to fund their savings in different institutions, services, securities etc.
2. To distribute the savings for the industrial investment: The purpose of mobilizing the fund from the saving community is to invest them in different industries. Thereby it meets the fund requirement of industrial sector. Hence it helps in the growth of industrial sector.
3. To stimulate capital formation: The objective of supporting the industries is not ended with sanctioning of fund to them. Further, it makes them to formulate the capital out of their earnings for the further capital requirement and industrial investment.
4. To accelerate the pace of economic growth: The ultimate aim of the financial institutions is to support the process of economic growth of a nation. Directing the saving fund to the industrial capital need, motivating them for capital formation support the acceleration of the process of economic growth.

### **13.4 Functions of Financial System:**

The following are the functions performed by the financial system of a nation. These are the aggregate functions performed by the sub classes of financial system viz. financial markets, financial institutions and financial services.

1. **Provision of Liquidity:** The provision of liquidity is one of the primary functions of financial system. It states the ability of meeting the obligations as and when they are required. In other words, it states the ability of converting the assets into liquid cash without any loss.
2. **Mobilization of savings:** Savings are done by millions of people. But amount saved are of no use unless they are mobilized into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, mutual funds bonds or equity shares. It is the function of financial institutions, a sub division of financial system to mobilize the savings from the saver or investment group.
3. **Small Savings to big investment:** Financial system acts as an intermediary in transforming the mobilized fund of savings to the big investments. It channelizes small savings fund received from the savings group to the industries to investments.
4. **Maturity Transformation function:** It is also one of the intermediary functions of financial system. The financial institutions receive the saving fund from the depositors for a particular tenure and lend the same fund to the required people on term basis.
5. **Risk Transformation function:** The financial system also does a function of risk transformation. The small savers are usually risk averse, who doesn't want to invest their small saving fund in the risky ventures. Hence the financial institutions take the responsibility of transforming their risk in investing their funds in profitable and safe venture by bearing the risk.
6. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced. The payment mechanism is now being increasingly made through electronic means.
7. **Pooling of funds:** A financial system provides a mechanism for pooling of funds to invest in large scale enterprises.
8. **Monitor Corporate performance:** A financial system not only helps in selecting the projects to be funded but also motivates the various stakeholders of the financial system to monitor the performance of the investment.
9. **Provide price related information:** Financial markets provide information which enables the investors to make an informed decision about whether to buy, sell or hold a financial asset. This information dissemination facilitates valuation of financial assets.
10. **Information function:** Financial markets disseminate information for enabling participants to develop informed opinion about investment, disinvestment, reinvestment or holding a particular asset.
11. **Transfer function:** A financial system provides a mechanism for the transfer of resources across geographic boundaries.
12. **Reformatory function:** A financial system, undertakes the functions of developing, introducing innovative financial assets/instruments. Services and practices and restructuring the existing assets, services etc., to cater to the emerging needs of borrowers and investors. I.e. financial engineering and reengineering.

**13. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

### **13.5 Types of financial system:**

The Indian financial system can be broadly classified into two types i.e.

**Formal (organized) financial system:** This is also known as organized financial system because it comes under the purview of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), and regulatory bodies. Formal financial system consists of four sub-systems. These are:

- Financial Institutions.
- Financial Markets.
- Financial Instruments.
- Financial Services.

**Informal (unorganized) financial system:** The informal financial system consists of individual money lenders, groups of persons operating as associations, partnership firms consisting of local brokers' pawn brokers and non-banking financial intermediaries such as finance, investment and chit fund companies. These people have a system and they have their own rules on how they should function in their day-to-day activities.

### **13.6 Money:**

As barter system was an inconvenient method of exchange, people were compelled to select some commodity which was most commonly accepted in that area as a medium of exchange. Thus, a large variety of goods came to be used as money; gradually the most attractive metals, like gold, silver, etc., were adopted as money almost everywhere.

Money has now taken the place of all these commodities. Later coins were replaced or supplemented by paper currency for the reasons of economy and convenience. The bank cheques, drafts and promissory notes came into use in addition of currency to serve as the most important type of money. However, today each country has its own monetary system and the money of one is not usually acceptable outside its borders.

In fact, this is one of the reasons which makes international trade different from internal trade. Money was not invented overnight. The development of money was rather slow. It is the result of a process of evolution through several hundred years.

The different types of money indicate the different stages of the development of money. Wheat, corn, tobacco, skins, beads, gold, etc. Even live animals served as a medium of exchange at different times in different parts of the world. Rulers in all lands found that making coins is a profitable business and took it into their own hands.

### **13.7 Meaning and Definitions of Money:**

The word "money" is believed to originate from a temple of 'Juno', located on Capitoline, one of Rome's seven hills. In the ancient world Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located.

The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn or instruct) or the Greek word "moneres" (alone, unique).

Now-a-days everybody recognizes money but usually does not know how to define money. Money has been defined differently by different economists. While some economist like WALKER has defined money in terms of the functions, while others like KEYNES, COLE, ROBERTSON, etc., have emphasized on the general acceptability aspect of it.

To serve as money, the definition of money should be comprehensive enough to cover all the essential functions that money performs in the economy. Before we arrive at the most suitable definition, it is essential to study a few definitions of money as given by some eminent economists.

#### **Definitions of Money:**

Money is one such concept which is very difficult to be restricted to some well-defined set of words. It is very easy to understand but difficult to define. Still, a large number of economists have given variety of definitions, some definitions are too extensive while others are too narrow. Various

economists like Prof. Walker, Robertson, Seligman, etc., have used different characteristics for defining it.

According to Prof. Walker, "Money is what money does". It is associated with the functions performed/roles played by money.

However, a suitable definition must be comprehensive and must emphasise not only on the important functions of money but also on its basic characteristics, namely general acceptability. Looking from this criterion, we find Crowther's definition to be the most suitable.

"Anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and that at the same time, acts as a measure and as a store of value." – Crowther

This definition covers all the three important functions of money and also stresses its basic characteristic, namely general acceptability.

#### **Legal Tender Money and fiduciary Money:**

Legal tender money is issued by the monetary authority of a country. It has legal sanction of the Government. Every individual is bound to accept legal tender money in exchange for goods and services, and in the discharge of debts.

#### **Legal tender money is of two kinds:**

(a) Limited legal tender, and

(b) Unlimited legal tender.

Fiduciary optional money is non-legal tender money as it is generally accepted by the people in final payments. It comprises credit instruments like cheques, drafts, bills of exchange, etc. Acceptance of optional money depends upon the will of a person.

### **13.8 Stages in the Evolution of Money:**

#### **(i) Animal Money:**

In ancient India, Go-Dhan (cow wealth) was accepted as form of money. Similarly, in the fourth century B.C., the Roman State had officially recognized cow and sheep as money to collect fine and taxes.

#### **(ii) Commodity Money:**

The second stage in the evolution of money is the introduction of commodity money. Commodity money is that money whose value comes from a commodity, out of which it is made. The commodities that were used as medium of exchange included cowrie shells, bows and arrows, gold, silver, food grains, large stones, decorated belts, cigarettes, copper, etc. However, the commodity money had various drawbacks such as there could be no standardization of value for money, lacks the property of portability and indivisibility. Therefore this form of money became an unsuitable medium of exchange.

#### **(iii) Coinage:**

The next step is coinage. This is just like a commodity money but the commodity is the metal that the money is made of. Thus, it can be seen that commodity money is of two types i.e., metallic and non-metallic.

When the use of money was not so very extensive, copper could do the job but when the number of transactions increased gradually, silver and then gold was used as a main metal for money and coins of small denominations were prepared either of copper or of silver.

Metallic money at one stage were used as full bodied money, i.e., the full value was equal to the intrinsic value of the metal.

Non-metallic commodity money was used on a large scale in our early days of civilization.

#### **(iv) Paper Money:**

The next important stage in the evolution of money is the paper money which replaced the metallic money. The transfer of sum of money in terms of metallic money was both inconvenient and risky. Therefore, written documents were used as temporary substitutes for money. Any person could deposit money with a wealthy merchant or a goldsmith and get a receipt for the deposit.

These receipts and documents were not actual money but temporary substitutes of money. This marked the development of paper money. These paper notes gradually took the form of currency notes.

#### **(v) Bank Money:**

As the volume of transactions increased, paper money started becoming inconvenient because of time involved in its counting and space required for its safe-keeping. This led to the introduction of bank money (or credit money).

Bank money implies demand deposits with banks which are withdraw able through cheques, drafts, etc. Cheques are widely accepted these days particularly for business transactions. Debit and credit cards also fall under this category.

**Characteristics of Money:**

**1. General Acceptability:**

Money is accepted by all as a medium of exchange. Thus, it has general acceptability. No one denies to accept money as a medium of exchange. People do not hesitate to accept it as standard of payment.

**2. Measure of Value:**

Value of any good or service can easily be measured in terms of money. It is accepted as a measure of value.

**3. Active Agent:**

Money is an active agent of an economic system. In modern economy, money is required in every commercial process. Process of production cannot start without the participation of money.

**4. Liquid Assets:**

Money is highly liquid asset. It can easily be converted in goods and services. Debt, stock and bills, etc., are the other liquid assets but the liquidity of money is highest than the other liquid assets. One has to first get to convert other liquid assets into money, then it can be converted in desired goods or services, while money can directly be converted.

**5. Money is a Means and not an End:**

The word money is means to acquire things desired. Money itself cannot be used to satisfy. It is indirectly used to get any goods or services to satisfy human wants.

**6. Voluntary Acceptability:**

Money is voluntarily accepted by people. There is no requirement to get legal approval. People always wish to hold money.

**7. Government Control:**

Reserve Bank of India and Govt, of India have an authority to issue currency which is accepted as a form of money in India. No other authority can issue currency notes. Thus, the government keeps control over the money supply in the country.

**Classification of Money:**

Money assumes so many forms in real life that it is difficult to identify what constitutes money and what not. Different economists have classified money in different forms.

**The more important classifications of money are as follows:**

**(i) Actual Money and Money of Account:**

Actual money is that which actually circulates in the economy. It is used as a medium of exchange for goods and services in a country. For example, paper notes of different denominations and coins in actual circulation in India constitute the actual money. Money of account is that form of money in terms of which the accounts of a country are maintained and transactions made.

For example, rupee is the money of account in India. Generally, actual money and money of account are the same for a country; however, sometimes actual money may be different from the money of account. For example, rupee and paise is the money of account in India. In real practice, however, one paisa coin is nowhere visible.

**(ii) Commodity Money and Representative Money:**

Commodity money is made up of a certain metal and its face value is equal to its intrinsic value. It is also referred to as full-bodied money. Representative money, on the other hand, is generally made either of cheap metals or paper notes. The intrinsic value of the representative money is less than its face value. Currency notes and coins are good examples of representative money in India. Representative money may or may not be converted into full-bodied money.

**(iii) Money and Near-Money:**

Money is anything that possesses 100 per cent liquidity. Liquidity is the quality of being immediately and always exchangeable in full value for money. Near-money refers to those objects which can be held with little loss of liquidity. For example, National Savings Deposits, Building Society Deposits and other similar deposits are not money because they are not generally acceptable in paying debt; these, however, could be easily and quickly exchanged for money without any loss or with minimum loss.

**(iv) Metallic Money and Paper Money:**

This classification is based upon the content of a unit of money. Money made of some metal like gold and silver is called metallic money. On the other hand, money made of paper, such as currency notes, is called paper money.

**Metallic money is sub-classified into:**

(a) Standard Money, and

(b) Token Money.

Standard money is one whose intrinsic value is equal to its face value. It is made up of some precious metal and has free coinage. Token money is that form of money whose face value is higher than its intrinsic value. Indian rupee coin is an example of token money. Paper money comprises bank notes and government notes which circulate without difficulty.

**Paper money is classified into following parts:**

(a) Representative paper money, which is 100 per cent backed and is fully redeemable in some precious metal.

(b) Convertible paper money, which can be converted into standard coins at the option of the holder. It is not fully backed by precious metals.

(c) Inconvertible paper money, which cannot be converted into full-bodied money. Indian one rupee note is a good example of inconvertible paper money.

(d) Fiat money, which is issued by the government of the country under emergency conditions. It does not have any backing of reserve.

**(v) Credit Money:**

It is also known as bank money. This consists of deposits of the people held with the banks, which are payable on demand by the depositors. Cheques, drafts, bills of exchange, etc., are examples of credit money.

## 13.9 Modern Forms of Money:

### 1. Currency:

The currency is a country's unit of exchange issued by their government or central bank whose value is the basis for trade. Currency includes both metallic money (coins) and paper money that is in public circulation.

**(a) Metallic Money:**

Metallic money refers to the coins which are used for small transactions. Coins are most often issued by the government. Examples of coins are 50 paise coins, and 1, 2, 5 and 10 rupee coins.

**(b) Paper Money:**

It refers to paper notes and used for large transactions. Each currency note carries the legend, 'I promise to pay the bearer the sum of 50/100 rupees' depending on the value of note. The currency notes are duly signed by the Governor of RBI.

Simply, the meaning of legend is that it can be converted into other notes or coins of equal value. Examples of currency notes are 1, 2, 5, 10, 20, 50, 100, 500 and 2000 rupee notes.

### 2. Deposit Money or Bank Money:

It refers to money deposited by people in the bank on the basis of which cheques can be drawn. Customers of the bank deposit coins and currency notes in the bank for safe-keeping, money transferring and also to get interest on the deposited money.

This money is recorded as credit to the account of the bank's customer which can be withdrawn by him on his/her wish by cheques. Cheques are widely accepted these days because transfer of money through cheques is convenient.

### 3. Legal Tender Money (Force Tender):

Legal tender money is the currency which has got legal sanction or approval by the government. It means that the individual is bound to accept it in exchange for goods and services; it cannot be refused in settlement of payments of any kind.

Both coins and currency notes are legal tender. They have the backing of government. They serve as money on the fiat (order) of the government. But a person can legally refuse to accept payment through cheques because there is no guarantee that a cheque will be honored by the bank in case of insufficient deposits with it.

Currency is the most common form of legal tender. It is anything which when offered in payment extinguishes the debt. Thus, personal cheques, credit cards, debit cards and similar non-cash methods of payment are not usually legal tenders.

Coins and notes are usually defined as a legal tender. The Indian Rupee is also legal tender in Bhutan but Bhutanese Ngultrum is not legal tender in India.

### 4. Near Money:

It is a term used for those which are not cash but highly liquid assets and can easily be converted into cash on short notice such as bank deposits and treasury bills. It does not function as a medium of exchange in everyday purchases of goods and services.

### 5. Electronic Money:

Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) involves computer networks to perform financial transactions electronically. Electronic Funds Transfer (EFT) and direct deposit are examples of electronic money.

The financial institutions transfer the money from one bank account to another by means of computers and communication links. A country wide computer network would monitor the credits and debits of all individuals, firms, and government as transactions take place in the economy.

It exchange funds every day without the physical movement of any paper money. This would eliminate the use of cheques and reduce the need for currency.

#### **6. Fiat Money:**

Fiat money is any money whose value is determined by legal means. The term fiat currency and fiat money relate to types of currency or money whose usefulness results not from any intrinsic value or guarantee that it can be converted into gold or another currency but from a government's order (fiat) that it must be accepted as a means of payment.

A distinction between money and currency may be made here. The term 'currency' includes only metallic coins and paper notes which are legal tender and are in actual circulation in the country.

The term 'money' however includes not only currency in circulation but also credit instruments. In other words, we may say that all currency is money but all money is not currency.

### **13.10 Importance of Money:**

Money plays a significant role in modern economy. It has an active role in economic activities.

**Importance of money in an economy can be discussed as below:**

#### **1. Money and Production:**

Money helps in various ways in the process of production. Money can help producers to decide, plan, execute and manage the production activities. Moreover, the existence of money helps the producers to assess the quality and quantity of demand of a consumer.

#### **2. Money and Consumption:**

Money has a great importance in consumption. Consumers with the help of the money can easily decide, what they want and how much. They have a ready command over the goods and services. Moreover, they can postpone their demands, if required.

#### **3. Money and Distribution:**

Money has made it possible to distribute the reward accurately and conveniently among the various factors of production. The reward can be distributed in terms of wages, rent, interest and profit in the form of money.

#### **4. Removal of the Difficulties of Barter:**

There were some difficulties attached to the barter system of exchange, i.e., lack of double coincidence of wants, problem of measurement of value, problem of future payment, etc. Invention of money has overcome all the difficulties of barter system. There is no need to find double coincidence of wants and value can be measured easily in terms of money.

#### **5. Money and Capital Formation:**

Money is essential to facilitate capital formation. Savings of people can be mobilized in the form of money and these mobilized savings can be invested in more profitable ventures. Financial institutions are the part of this process. They mobilize the savings and channelize them in productive process.

#### **6. Money and Public Finance:**

Public finance deals with the income and expenditure of the government. Government receives its income in the form of money through taxes and other means and make expenditures in development and administrative processes.

#### **7. External Trade:**

Money has facilitated trade not only inside the country but also outside countries. With the use of money, goods and services can easily and rapidly be exchanged. Though in external trade foreign currencies are used in receipts and payments but they are exchanged with the help of domestic currencies.

#### **8. Money and Economic Development:**

Supply of money in a country affects its economic development. If the money supply is more, then it may lead to inflationary situation in the economy which may hamper growth. Similarly, if the supply of money is lesser than what is required then there will be shortage of liquidity which will lead to lesser investments and hence lesser employment.

#### **Value of Money:**

The value of money means all is related with its exchange value. Apart from exchange value of money it has no other independent value. In other words, the money is always related with its exchange value. As we know the eye whether of human person or animal does not have its own light, similarly the eye can see only with either by artificial or natural light. In the same way, the value of money can be judged or perceived only when it is related with its power of purchase.

In the words of Crowther "The value of money is what it will buy." In other words the value of money depends on its purchasing power. In this connection the other definition of Robertson may also be referred. As per this definition – **"The value of money means the amount or things in general which will be given in exchange for a unit of money."**

In this way the value of the money depends on its purchasing power either of a commodity or other services. It is also evident that the value of money and value of commodity has opposite relationship. This means when there is an increase in the value of commodity, the value of money will decrease.

**The above discussion may be made clear by an example:**

Suppose in a particular situation by one unit of money 5 oranges or 1 kg of sugar can be purchased. This means that the one unit of money is equivalent to 5 oranges or one kg of sugar. Now the value of any or all things take and increasing position then the value of money will certainly decrease.

In other words, if 1 kg of sugar was available for Rs. 2 only where when the value of sugar is available for Rs. 3, that it can be presumed that the initial power of Rs. 2 did not remain so much that 1 kg of sugar can be purchased with old value. This means that in case of increase the value of money will be to the diminishing power of purchase. So, it is proved that there is opposite relationship between the power of money and the commodity.

Now the significant question arise that when the differences between the value of commodity and the value of services appear different, then in what way the base value can be judged because of the fact the difference between the retail price and the wholesale price.

**The solution of such problem has been found out on the following three consecutions:**

**(1) Wholesale Value:**

Whatever value becomes prevalent in the wholesale market is usually taken as wholesale value. So, the wholesale value is easy to be found out because the value of money usually is displayed on this very base. This is called the wholesale value of the money.

**(2) Retail Value:**

The value prevalent in the retail market is called as retail value. But the retail value may be perceived separately on different places. This means the retail value will remain constant. The calculation of the retail value is always different from one place to another and as such the base of retail price is difficult in comparison to wholesale price.

**(3) Labour Value:**

In order to make payment the money among the labourers the value prevalent in such a market is usually called the value of labour. Now the value of labour will never be constant and it will also vary from place to place. So, it cannot be accepted as bases of value.

**Evils of Money:**

Money is not an unmixed blessing. It is said that money is a good servant but a bad master.

**Several evils of money are said to be:**

**(i) Economic Instability:**

Several economists are of the opinion that money is responsible for economic instability in capitalist economies. In the absence of money, saving was equal to investment. Those who saved also invested. But in a monetized economy, saving is done by certain people and investment by some other people. Hence, saving and investment need not be equal. When saving in an economy exceeds investment, then national income, output and employment decrease and economy falls into depression.

On the other hand, when investment exceeds saving, then national income, output and employment increase and that leads to prosperity. But if the process of money creation and investment continues beyond the point of full employment, inflationary pressures will be created. Thus inequality between saving and investment are known to be main cause of economic fluctuations.

The main evil of money lies in its liability of being over-issued in the case of inconvertible paper money. The over-issue of money may lead to hyper-inflation. Excessive rise in prices brings suffering to the consuming public and fixed income earners. It encourages speculation and inhibits productive enterprises. It adversely affects distribution of income and wealth in the community so that the gulf between the rich and poor increases.

**(ii) Economic Inequalities:**

Money is a very convenience tool for accumulating wealth and of the exploitation of the poor by the rich. It has created an increasing gulf between the 'haves' and the 'have-nots'. The misery and degradation of the poor is, thus, in no small measure due to the existence of money.

**(iii) Moral Depravity:**

Money has weakened the moral fiber of man. The evils to be found in the affluent society are only too obvious. The rich monopolizes all the social evils like corruption, the wine and the woman. In this case, money has proved to be a soul-killing weapon.

**(iv) Medium of Exploitation:**

Prominent socialist like Marx and Lenin condemned money but it helps the rich to exploit the poor. When the communists came to power in Russia, they tried to abolish money. But they soon realized that to run a modern economy without money was impossible. All economic activity has to be based on monetary calculations. Accordingly, money is fully and firmly established in all Socialist States. Money performs several functions like facilitating optimum allocation of the country's resources, functions as a medium of exchange and a measure of value, guides economic activity and is essential for facilitating distribution of national income.

**13.11 Meaning of Financial Intermediaries (FIs):**

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

**FIs are divided into:**

- (a) Commercial banks; and
- (b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities which they define as "all liabilities and outstanding equities of non-financial spending units." They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non-financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the latter's primary securities. The purchase of primary securities by surplus income units is called direct finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

**Process of Intermediation:**

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a



reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

### **13.12 Roles of Financial Intermediaries:**

#### *1. Role in the Modern Financial System:*

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

**They have the following economic effects:**

#### **(i) Reduce Hoarding:**

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

#### **(ii) Help the Household Sector:**

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

#### **(iii) Help the Business Sector:**

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

#### **(iv) Help the State and Local Government:**

FIs help the state and local bodies financially by purchasing their bonds.

#### **(v) Help the Central Government:**

Similarly, they buy and sell central government securities and thus they help the central government.

#### **(vi) Lenders and FIs both Earn:**

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

#### **(vii) Spread of Risks:**

FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

**(viii) Creation of New Assets and Liabilities:**

All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

**(ix) Provide Liquidity:**

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

**(x) Help in Lowering Interest Rates:**

Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

**(xi) Low Interest Rates Benefit both Savers and Investors:**

When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

**(xii) Bring Stability in the Capital Market:**

FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

**(xiii) Benefit to the Economy:**

FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

### **13.13 Functions of the Financial Sector**

Although they are often thought of as recent phenomena, financial and payment systems have evolved over several thousand years. The manner in which transactions occur has changed remarkably over that time, but the underlying objectives have not. The economic functions performed by the first modern banks of Renaissance Italy, for instance, still apply today. At least four core functions can be identified. The financial sector should provide the following services:

**Value exchange:** a way of making payments.

**Intermediation:** a way of transferring resources between savers and borrowers.

**Risk transfer:** a means for pricing and allocating certain risks.

**Liquidity:** a means of converting assets into cash without undue loss of value.

These are all valuable tools for a community to have. The modern economy could not have developed without the financial sector also developing these capabilities. Moreover, these core functions require the financial sector to have certain supporting capabilities, such as the ability to screen and monitor borrowers. In principle, each of these functions could be performed by individuals. But there are efficiency benefits from having institutions perform them, particularly in addressing some of the informational asymmetries that arise in financial transactions.

The provision of these core functions can overlap and interact in important ways. For example, some financial products, such as deposits, combine value exchange, intermediation, risk transfer and liquidity services. With these interactions in mind, each core function is considered in more detail below.

### Value exchange

A safe and efficient payment system is essential to support the day-to-day business of the Australian economy. There are approximately 43 million transactions in Australia every day, including cash and non-cash payments as well as transactions in financial assets. With so many payments, even relatively small inefficiencies can have significant implications for the broader economy and the living standards of Australians.

In this regard, the payment system has progressed a long way since the early Australian colonies, where the predominant means of exchange for many years was rum (Shann 1930). Today, we enjoy access to a range of convenient payment options, including cash, card and internet transfer. While future innovations are by nature uncertain, it is possible to identify some desirable qualities of an efficient payment system. It should be:

**Timely:** while not all transactions are urgent, the possibility of giving recipients timely access to funds is useful.

**Accessible:** everyone who needs to make and receive payments should have ready access to the payments system.

**Easy to integrate with other processes:** this includes the reconciliation and recording of information by the parties involved (which should also be timely and accessible).

**Easy to use:** this is not only an issue of convenience but also of minimising errors.

**Safe and reliable:** end users of a payments system need to be confident that the system is secure; that is, that their confidential information is protected. They also need to have confidence that the system will be available when needed.

**Affordable and transparent:** users can make well-informed choices about payment methods according to their cost and convenience.

Of course, there can be tensions between these objectives. For instance, making a payments system fully accessible and easy to use absorbs resources that might increase its cost.

### Intermediation

The financial sector plays an important role in the functioning of the economy through intermediation. Simply put, the financial sector sits between savers and borrowers: it takes funds from savers (for example, through deposits) and lends them to those who wish to borrow, be they households, businesses or governments.

Intermediation can take on many forms beyond the traditional banking service of taking deposits and making loans. For example, investment banks intermediate between investors and bond issuers. Brokers perform a similar function in connecting the buyers and sellers of equities. The common thread is that a financial institution stands between the counterparties to a transaction. Depending on the nature of the transaction, a number of supplementary functions may be required to intermediate between savers and borrowers, including:

**Pooling resources:** for example, a bank can combine a number of small deposits to make a large loan.

**Asset transformation:** financial intermediaries provide a link between the financial products that firms want to issue and the ones investors want to buy (Freixas and Rochet 2008). This includes issuing securities to savers at short maturities, while making loans to borrowers at long maturities – a process known as maturity transformation.

**Risk assessment and information processing:** financial intermediaries have expertise in screening potential borrowers to identify profitable lending opportunities, taking into account the risks that these entail (Diamond 1984).

**Monitoring borrowers:** financial institutions take steps to limit the misuse of savers' assets. This function is critical to the decision by savers to lend their money in the first place, and hence for facilitating investment in the economy.

**Accurate accounting:** together with a legal system that enforces property rights, prudent measurement is vital in enabling depositors, shareholders and investors to be paid what they are entitled to.

Effective intermediation requires a number of the qualities listed above in the context of an efficient payments system; it should be accessible and reliable, for instance. If the financial system is working well, it allocates funds to their most productive use. This benefits society by expanding the productive capacity of the economy, hence raising living standards.

#### **Risk transfer**

A well-functioning financial system also facilitates the pricing and allocation of certain risks. As these risks include the possibility that a borrower will default on their obligation (credit risk), that an asset's value will fluctuate (market risk), or that an income stream will be required for longer than expected (longevity risk). Financial contracts may also alter the financial implications of physical risks, by providing insurance against flood or fire damage to property, for example (insurance risk), or against legal liability and similar costs (operational risk). Many of the subsidiary capabilities implied by the intermediation function are also necessary for effective risk pricing and allocation, particularly the ability to assess risk and monitor borrowers.

The financial sector should allow individuals to tailor their exposure to risk to suit their preferences. A younger person, for instance, may have more scope to adjust to a sharp fall in the value of their assets than an older person, who would have less time to build up assets to fund their retirement. Given this, a younger person may choose to invest in a riskier portfolio of assets, with the prospect of higher returns.

Importantly, the role of the financial sector is not to remove risk entirely. Rather, it should facilitate the transfer of risks to those best placed to manage them. It cannot remove many of the risks within the economy, which must ultimately be borne by individuals either as holders of real and financial assets, or as taxpayers. Moreover, it is not the goal of the financial sector necessarily to minimise risk. The socially optimal amount of risk is almost certainly not the minimum feasible level, given the importance of risk-taking to innovation and entrepreneurship. Of course, the characteristics of the financial system can shape the extent of risk-taking in important ways.

#### **Liquidity**

The financial sector provides liquidity. If the financial system is working well, individuals, businesses, and governments are able to convert their assets into cash at short notice, without undue loss of value. The provision of liquidity is useful to individuals for meeting unexpected obligations. It is also critical to society at large. Access to liquidity allows businesses to deploy their capital in ways that increase the productive capacity of the economy. Without it, households and businesses would be forced to hold larger sums of cash to protect against unforeseen events. The result would be fewer resources for investment and the provision of fewer goods and services to consume.

Given various imperfections in the financial system, it is not optimal for the private financial sector to be the sole provider of liquidity (Holmström and Tirole 1998). Indeed, the central bank can also play an important role. In the Australian context, the Reserve Bank is the supplier of funds that can be lent or borrowed in the overnight market. From day to day, the Reserve Bank's goal is to manage supply to meet the system's demand for cash at the price – the interest rate – set by the Reserve Bank Board.

On occasion, there may be a sudden flight to liquid assets in response to acute uncertainty about the value of financial assets. One example of this occurred in many economies during the crisis of 2008 (although there are many others scattered throughout history). In these circumstances, the central bank's role is to supply the necessary liquidity to ensure the smooth functioning of the system. The provision of liquidity support by the central bank to an individual institution – as the lender of last resort – is a related, but separate form of intervention which central banks can make; this complex and important role has been discussed at length elsewhere (Goodhart 1988).

#### **The Characteristics of Finance**

Each of the four core functions that were introduced in the preceding section are vital to economic progress. But these functions are not generally ends in themselves. Put another way, the financial sector is an intermediate sector. Its activities are mainly directed at promoting efficiency in other sectors. This implies that the resources used in finance are a cost to society, because they cannot be used for one of the end purposes that members of society desire. It is therefore important that these financial services be provided in the most efficient way that is still consistent with the desired levels of safety and service.

The financial sector is, however, a critical link in the functioning of the economy: every economic interaction has a financial component, such as a payment. The spillovers to the real economy from dysfunction or operational failure in the financial and payments systems can be severe. Moreover, these spillovers can add to 'moral hazard', whereby financial institutions take risks under the

assumption that the resulting costs would be, at least partly, borne by others (for example, their creditors or society at large). The potential for undue risk-taking is exacerbated by the problem of asymmetric information, where the party ultimately bearing the risk is not fully aware of it.

In addition, the core functions of financial intermediaries make them vulnerable to a change in customer and investor confidence, more so than for most firms. In particular: Because they undertake maturity transformation, financial intermediaries hold long-term assets while being subject to short-term obligations. This exposes them to the possibility of runs.

In intermediating between savers and borrowers, financial institutions tend to be highly leveraged relative to other companies. As a consequence, depositors and other creditors have a relatively small capital buffer against unexpected losses, which can provide a strong incentive to withdraw their funds during periods of stress.

The interlinkages between financial firms are greater than in most industries. This can be useful for allocating resources and risks. But it also means that shocks to one institution can be propagated across institutions and borders, often rapidly, as was demonstrated during the financial crisis.

The critical role of the financial sector and its inherent vulnerabilities suggest that it should be subject to more regulation than most other industries. (Although market discipline has a role to play, past experience has shown its limitations.) Even so, it is important to recognise the limits of what regulation can achieve. The financial sector is an information-intensive industry, so the financial system can change rapidly in response to technological change. As a result, regulations may be circumvented or become outdated very quickly, and will often produce unintended consequences. This does not remove the need for a good deal of regulation. But it does point to the importance of effective supervision – especially during the boom times – rather than reliance on inflexible rules.

## Summary

The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets,

instruments, services, practices, and transactions. India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors. In a number of sectors Government plays the role of regulator. RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms. The commercial banking sector comprises of public sector banks, private banks and foreign banks. The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector. India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level. All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance. State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate. Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI. RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).

## Keywords

*Commercial Paper:* Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

*Deposits:* Are sums of money placed with a financial institution, for credit to a customer's account.

*Intangible Asset:* By contrast, represents legal claims to some future benefit.

*Loan:* Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

*Tangible Asset:* Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

*Treasury Bills:* Are government securities that have a maturity period of up to one year.

**Review Questions**

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups." Comment.
5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

**Self Assessment:**

1. .... allocates saving efficiently in an economy to ultimate users either for investment in real assets or for consumption
  - a. Economic system
  - b. Banking system
  - c. Financial system
  - d. Market system
2. — — — — represent claims for the payment of a sum of money sometimes in the future and/or a periodic payment in the form of interest or dividend.
  - a. physical asset
  - b. fixed asset
  - c. financial asset
  - d. none of these
3. Financial derivatives include
  - a. Stocks
  - b. Bonds
  - c. Futures
  - d. None of the above
4. Which of the following is the regulator of Money market?
  - a) Reserve Bank of India
  - b) Government of India
  - c) Telecom Regularity Authority
  - d) Insurance Regularity Department
5. What is Call Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
6. What is Notice Money?
  - a) It is an overnight loan in the Money Market
  - b) It is loan of above 1 day to 14 days in the money market
  - c) It is loan of above 14 day to 364 days in the money market
  - d) It is an amount charged on ISD
7. What is Term Money?
  - a) It is an overnight loan in the Money Market

- b) It is loan of above 1 day to 14 days in the money market  
 c) It is loan of above 14 day to 364 days in the money market  
 d) It is a loan provided on certain terms and conditions by Bank to its customer
8. Which of the following is not related with Money Market?  
 a) Treasury Bills  
 b) Commercial Bills  
 c) Certificates of Deposit  
 d) Shares
9. Which of the following is related with Money Market?  
 a) Treasury Bills  
 b) Commercial money  
 c) Cheque  
 d) Shares
10. The financial Market where debt and stocks are traded and maturity period is more than a year is classified as:  
 a) Shorter term Markets  
 b) Capital Markets  
 c) Counter Markets  
 d) Long-term Markets
11. What is the main function of financial intermediaries?  
 a. Connecting savers and borrowers.  
 b. Regulating the finance industry.  
 c. Acting as a fail-safe during financial crises, such as the Great Recession.  
 d. Facilitating investment in major corporations.
12. Which of the following is not an example of a common financial intermediary?  
 a. A commercial bank.  
 b. The Federal Reserve  
 c. The stock market  
 d. The bond market
13. Which of the following best describes why financial intermediaries are associated with "indirect" finance?  
 a. The federal government is indirectly involved because it regulates financial intermediaries.  
 b. Financial intermediaries do not deal directly with borrower-spenders.  
 c. Financial intermediaries do not deal directly with saver-lenders.  
 d. Financial intermediaries are firms which accept the savings of individuals and invest them in financial assets issued by other firms.
14. Which of the following statements about financial markets is not true?  
 a. Commercial paper represents a short-term component of the financial markets while a corporate bond represents a long-term component.  
 b. Sometimes intermediaries invest in the financial markets.  
 c. Financial markets are associated with "direct" finance.  
 d. When a bank extends a loan directly to a small business, this involves "direct" finance through the financial markets.
15. Which one of the following is not a financial intermediary?  
 a. A money market mutual fund  
 b. A steel manufacturing plant  
 c. A property and casualty insurance company  
 d. A commercial bank

### **Answers: Self-Assessment**

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (c)  | 3. (c)  | 4. (a)  | 5. (a)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (c) |
| 11. (a) | 12. (b) | 13. (d) | 14. (d) | 15. (b) |

### **Further Readings**

#### **Text Books:**

1. Financial Institutions and Markets by L.M Bhole and Jitendra Mahakud, TataMcgraw Hill, India

**References:**

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## Unit14:Insurance Market

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### Objectives

After this lecture, you would be able

- To explore the concept and origin of cooperative bank in India.
- To evaluate the growth of cooperative bank in India.
- To explore the objectives and features of cooperative banks in India.
- To evaluate the types and functions of cooperative banks in India.

### Introduction

The co-operative banks are government backed financial institutions that work on the principle of co-operation, self-help and mutual help. The co-operative banks are mainly set up to provide access to credit in rural areas. This empowers and secures the poor and the low-income groups. Co-operative banks offer basic banking functions and services in rural, urban and semi-urban areas, where banking facilities are scarce. Unlike commercial banks whose sole purpose is profit making, co-operative banks help encourage rural business and the agricultural sector and work towards growth. In India, co-operative banks play a crucial role in rural financing, with funding of areas under agriculture, livestock, milk, personal finance, self-employment, setting up of small-scale units among the few focus points for both urban and rural cooperative banks.

They provide a much-needed alternative to the age-old exploitative practice of people approaching the village moneylender, most often getting into a debt-trap that they struggle to pull themselves out of. The cooperative banking system came into being with the aim to promote saving and investment habits among people, especially in rural parts of the country.

## 14.1 Meaning of Cooperative Bank

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. People belonging to the same local or professional community having a common interest often establish it. It is formed to promote the upliftment of financially weaker sections of the society and to protect them from the clutches of moneylenders who provide loans at an unreasonably high-interest rate to the needy. The co-operative structure is designed on the principles of cooperation, mutual help, democratic decision making and open membership. It follows the principle of 'one shareholder, one vote' and 'no profit, no loss'.

Cooperatives Banks are **registered under the Cooperative Societies Act, 1912**. These are **regulated by the Reserve Bank of India and National Bank for Agriculture and Rural Development (NABARD) under the Banking Regulation Act, 1949 and Banking Laws (Application to Cooperative Societies) Act, 1965**.

Cooperative banks differ from commercial banks on the grounds of organisation, governance, interest rates, and the scope of functioning, objectives and values. Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the cooperative banks are founded by collecting funds through shares, accept deposits and grant loans.

**The cooperative banks differ from joint stock banks in the following manner:**

- (i) Cooperative banks issue shares of unlimited liability, while the joint stock banks issue shares of limited liability.
- (ii) In a cooperative bank, one shareholder has one vote whatever the number of shares he may hold. In a joint stock bank, the voting right of a shareholder is determined by the number of shares he possesses.
- (iii) Cooperative banks are generally concerned with the rural credit and provide financial assistance for agricultural and rural activities. Joint stock companies are primarily concerned with the credit requirements of trade and industry.
- (iv) Cooperative banking in India is federal in structure. Primary credit societies are at the lowest rung. Then, there are central cooperative banks at the district level and state cooperative banks at the state level. Joint stock banks do not have such a federal structure.
- (v) Cooperative credit societies are located in the villages spread over entire country. Joint stock banks and their branches mainly concentrate in the urban areas, particularly in the big cities

### **History of Cooperative Banking in India:**

The genesis of the cooperative movement and its implementation in a modern technical sense can be traced after the Industrial Revolution in England during the period of 18th and 19th century. The idea of Hermann Schulze and Friedrich Wilhelm Raiffeisen during the economic meltdown to provide easy credit to small businesses and poor sections of the society took shape as cooperative banks of today across the world.

### **Pre-independence period (prior to 1947)**

British India replicated this model and based on the recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901), the Co-operative Credit Societies Act, 1904 was passed. It tried to deal with the problems of rural indebtedness and consequent conditions of farmers in the country. The Act promoted the establishment of credit cooperative societies which led to the formation of first urban co-operative credit society, registered on October 1904 at Kanjeeपुरam now in Tamil Nadu State. It marked the beginning of the institutionalization of the Cooperative Banking system in India. But there were certain defects in the Act which restricted the reach of the expected benefits of cooperatives. The Act only permitted the registration of credit societies, and there was no provision for the protection of non-credit societies or federal societies. These shortcomings were recognised by the Government and to remedy it; more comprehensive legislation was introduced, known as the Cooperative Societies Act of 1912. It recognized the formation and organisation of non-credit societies and the central co-operative federations.

In 1919, after the end of the first world war under the Treaty of Versailles, 1919, the Montague Chelmsford Reforms were introduced in India under which Cooperation becomes a transferred subject which was to be administered by the States. The need for separate acts for effective implementation and to widen the reach of the cooperative banks was felt by the States. The Bombay

Provincial Government was the first to pass its own act which was known as Bombay Provincial Cooperative Societies Act, 1925. Other state governments like Madras, Bengal, Bihar and Punjab followed the Bombay Act and passed their own legislation in the following years.

In 1942, the British Government enacted the Multi-Unit Cooperative Societies Act, 1942, the ambit of which covered societies whose operations are extended to more than one state. The Act provided for the regulation of affairs of such society by the provisions of cooperative societies act of the state where the principal business of the society is located.

### **Post-independence period (after 1947)**

After independence, the movement of cooperative societies maintained its pace even after facing several hardships during that phase and continued to be part of the economic development of the country.

The First Five Year Plan recognized the importance of cooperatives in the implementation of development plans, particularly targeting the farmers and weaker section of the society. In 1954, Government of India appointed a committee called **All India Rural Credit Survey Committee** to remedy the problem of rural credit and other financial issues of the rural community. It recommended a well defined institutional framework for cooperative organizations, particularly for meeting the needs of rural India. The recommendations of the committee were recognized and were put into effect under the Second Five Year Plan.

The Second Five Year Plan recommended expanding the scope of cooperative activities to other fields with special emphasis on the warehousing sector.

The Third Five Year Plan emphasized on training personnel for the cooperative sector and to increase the reach of the cooperative movement.

The Fourth Five Year Plan recommended the consolidation of a cooperative system for effective functioning.

The Fifth Five Year Plan recommended the establishment of Farmers Service Societies. The Sixth Five Year Plan developed a point programme for a cooperative society to bring economic development and for expanding the scope of cooperative societies.

The Seventh Five Year Plan also focussed on expansion and growth of the scope of cooperative societies so as to achieve greater employment and decrease poverty in the country.

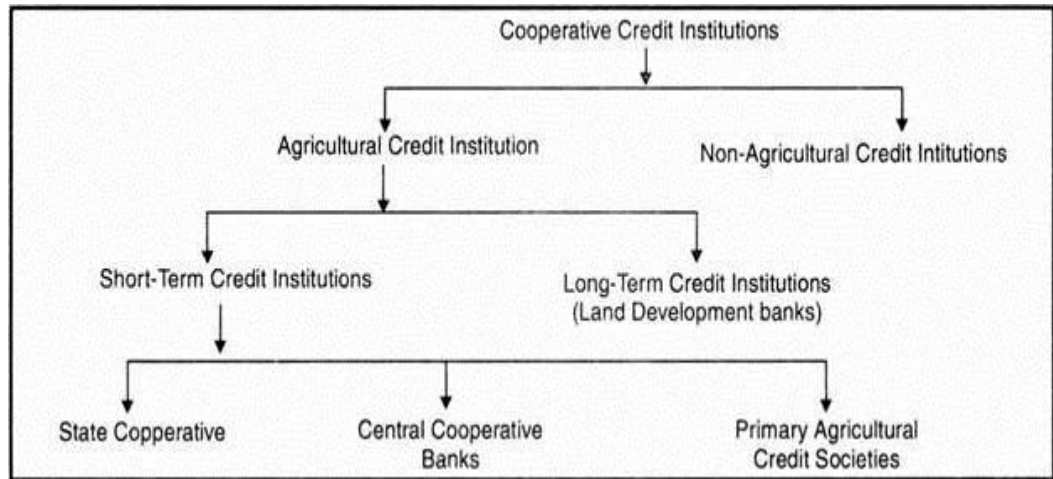
## **14.2 Structure of Cooperative Banking:**

There are different types of cooperative credit institutions working in India. These institutions can be classified into two broad categories- agricultural and non-agricultural. Agricultural credit institutions dominate the entire cooperative credit structure.

Agricultural credit institutions are further divided into short-term agricultural credit institutions and long-term agricultural credit institutions.

The short-term agricultural credit institutions which cater to the short-term financial needs of agriculturists have three-tier federal structure- (a) at the apex, there is the state cooperative bank in each state; (b) at the district level, there are central cooperative banks; (c) at the village level, there are primary agricultural credit societies.

Long-term agricultural credit is provided by the land development banks. The whole structure of cooperative credit institutions is shown in the chart given.



### Short-Term Rural Cooperative Credit Structure:

In rural India, there exists a 3-tier short-term rural cooperative structure. Tier-I includes state cooperative banks (SCBs) at the state level; Tier-II includes central cooperative banks (CCBs) at the district level; and Tier- III includes primary agricultural credit societies (PACSs).

In 19 states, there exists a 3-tier short-term cooperative credit structure, comprising SCBs, CCBs and PACSs. And in 12 states, there exists a 2-tier short-term cooperative structure. In the north-eastern states, including Sikkim, the structure is 2-tier, comprising only SCBs and PACSs.

#### 1. State Cooperative Banks (SCBs):

##### Functions and Organisation:

State cooperative banks are the apex institutions in the three-tier cooperative credit structure, operating at the state level. Every state has a state cooperative bank.

State cooperative banks occupy a unique position in the cooperative credit structure because of their three important functions:

- They provide a link through which the Reserve Bank of India provides credit to the cooperatives and thus participates in the rural finance,
- They function as balancing centers for the central cooperative banks by making available the surplus funds of some central cooperative banks. The central cooperative banks are not permitted to borrow or lend among themselves,
- They finance, control and supervise the central cooperative banks, and, through them, the primary credit societies.

*Capital:* State cooperative banks obtain their working capital from own funds, deposits, borrowings and other sources:

- Own funds include share capital and various types of reserves. Major portion of the share capital is raised from member cooperative societies and the central cooperative banks, and the rest is contributed by the state government. Individual contribution to the share capital is very small;
- The main source of deposits is also the cooperative societies and central cooperative banks. The remaining deposits come from individuals, local bodies and others.
- Borrowings of the state cooperative banks are mainly from the Reserve Bank and the remaining from state governments and others.

*Loans and Advances:* State cooperative banks are mainly interested in providing loans and advances to the cooperative societies. More than 98 per cent loans are granted to these societies of which about 75 per cent are for the short-period. Mostly the loans are given for agricultural purposes. The number of state cooperative banks rose from 15 in 1950-51 to 21 in 1960-61 and to 28 in 1991-92. The loans advanced by these banks increased from Rs. 42 crore in 1950-51 to Rs. 260 crore in 1960-61, and further to Rs. 7685 crore in 1991-92.

## 2. Central Cooperative Banks (CCBs):

**Functions and Organisation:** Central cooperative banks are in the middle of the three-tier cooperative credit structure. Central cooperative banks are of two types:

- (a) There can be cooperative banking unions whose membership is open only to cooperative societies. Such cooperative banking unions exist in Haryana, Punjab, Rajasthan, Orissa and Kerala.
- (b) There can be mixed central cooperative banks whose membership is open to both individuals and cooperative societies. The central cooperative banks in the remaining states are of this type. The main function of the central cooperative banks is to provide loans to the primary cooperative societies. However, some loans are also given to individuals and others.

**Capital:** The central cooperative banks raise their working capital from own funds, deposits, borrowings and other sources. In the own funds, the major portion consists of share capital contributed by cooperative societies and the state government, and the rest is made up of reserves.

Deposits largely come from individuals and cooperative societies. Some deposits are received from local bodies and others. Deposit mobilisation by the central cooperative banks varies from state to state.

For example, it is much higher in Gujarat, Punjab, Maharashtra, and Himachal Pradesh, but very low in Assam, Bihar, West Bengal and Orissa. Borrowings are mostly from the Reserve Bank and apex banks.

**Loans and Advances:** The number of central cooperative banks in 1991-92 was 361 and the total amount of loans advanced by them in 1991-92 stood at Rs. 14226 crore. About 98 per cent loans are received by the cooperative societies and about 75 per cent loans are short-term. Mostly the loans are given for agricultural purpose.

About 80 per cent loans given to the cooperative societies are unsecured and the remaining loans are given against the securities such as merchandise, agricultural produce, immovable property, government and other securities etc.

**Problem of Overdues:** The most distressing feature of the functioning of the central cooperative banks is heavy and increasing overdue loans. In 1997-98, the percentage of overdues to demand at the central cooperative level was 34. According to the Review of the Cooperative Movement in India, 1974-76, by the Reserve Bank of India, the main causes of these overdues are:

- (a) Natural calamities such as floods, draughts, etc., affecting the repaying capacity of the borrowers;
- (b) Inadequate and inefficient supervision exercised by the banks;
- (c) The poor quality and management of societies and banks;
- (d) Absence of linking of credit with marketing;
- (e) Reluctance to coercive measures; and
- (f) Where coercive measures were taken, the inability of the machinery to promptly execute the decrees.

For the rehabilitation of the weak Central cooperative banks, the Central Sector Plan Scheme has been formulated under which semi financial help is given to write off the bad debts, losses and irrecoverable overdues against small and marginal farmers.

## 3. Primary Agricultural Credit Societies (PACs):

**Functions and Organisation:**

Primary agricultural credit society forms the base in the three-tier cooperative credit structure. It is a village-level institution which directly deals with the rural people. It encourages savings among the agriculturists, accepts deposits from them, gives loans to the needy borrowers and collects repayments. It serves as the last link between the ultimate borrowers, i.e., the rural people, on the one hand, and the higher agencies, i.e., Central cooperative bank, state cooperative bank, and the Reserve Bank of India, on the other hand. A primary agricultural credit society may be started with 10 or more persons of a village. The membership fee is nominal so that even the poorest agriculturist can become a member. The members of the society have unlimited liability which

means that each member undertakes full responsibility of the entire loss of the society in case of its failure. The management of the society is under the control of an elected body.

**Capital:**The working capital of the primary credit societies comes from their own funds, deposits, borrowings and other sources. Own funds comprise of share capital, membership fee and reserve funds. Deposits are received from both members and non-members. Borrowings are mainly from central cooperative banks.

In fact, the borrowings form the chief source of working capital of the societies. Normally, people do not deposit their savings with the cooperative societies because of poverty, low saving habits, and non-availability of better assets to the savers in term of rate of return and riskiness from these societies.

**Coverage:**In 1999-2000 there were 88 thousand primary agricultural societies covering more than 96 per cent rural areas. The membership of these societies was 8.68 crore. During the past few decades, the Reserve Bank in collaboration with State governments, has been taking various measures to reorganise the viable primary credit societies and to amalgamate non-viable societies with large-sized multipurpose societies.

This work of reorganisation of primary societies into strong and viable units has been completed in almost all the states except Gujrat, Maharashtra, and Jammu and Kashmir. It is because of reorganisation that the number of primary societies which increased from 105 thousand in 1950-51 to 212 thousand in 1960-61, declined to 92 thousand in 1999-2000.

**Loans Advanced:**The loans advanced by the primary credit societies have been Showing 3 Continuously increasing trend. They rose from Rs. 23 crore in 1950-51 to Rs. 202 crore in 1960-61 and further to Rs. 13600 crore in 1999-2000.

Only the members of the societies are entitled to get loans from them. Most of the loans are short-term loans and are for agricultural purposes. Low interest rates are charged on the loans.

The societies are expected to increase amounts of loans to the weaker sections of the rural community, particularly the small and marginal farmers. There, however, exists a serious problem of overdue loans of the societies which have increased from Rs. 6 crores in 1950-51 to Rs. 44 crore in 1960-61 and to Rs. 2875 crore in 1991-92.

### **14.3 Land Development Banks (LDBs) or Cooperative Agricultural and Rural Development Banks (CARDs):**

Besides short-term credit, the agriculturists also need long-term credit for making permanent improvements in land, for repaying old debts, for purchasing agricultural machinery and other implements. Traditionally, the long-term requirements of agriculturists were mainly met by money lenders and some other agencies. But this source of credit was found defective and has been responsible for the exploitation of farmers. Cooperative banks and commercial banks by their very nature are not in a position to provide long-term loans because their deposits are mainly demand (short-term) deposits. Thus, there was a great need for a specialised institution for supplying long-term credit to agriculturists. The establishment of land development banks now known as cooperative and rural development banks (CARDs) is an effort in this direction.

**Structure:**The land development banks are registered as cooperative societies, but with limited liability. These banks have two-tier structure:

- (a) At the state level, there are state or central land development banks, now known as state cooperative agricultural and rural development banks (SCARDs) generally one for each state. They were previously known as central land mortgage banks,
- (b) At the local level, there are branches of the state land development banks or SCARDs and primary land development banks now known as primary cooperative agricultural and rural development banks (PCARDs).

In some states, there are no primary land development banks, but the branches of the state land development bank. In Madhya Pradesh, the state cooperative bank itself functions as the state land development bank. In other states like Andhra Pradesh, Kerala and Maharashtra, there are more than one state land development banks.

Similarly, the primary land development banks also vary organisationally in different states. At the national level, the land development banks have also formed a union, called All-India Land Development Banks' Union.

**Capital:** Land development banks raise their funds from share capital, reserves, deposits, loans and advances, and debentures. Debentures form the biggest source of finance. The debentures are issued by the state land development banks. They carry fixed interest, have maturity varying from 20 to 25 years, and are guaranteed by the state government. These debentures are subscribed by the co-operative banks, commercial banks, the State Bank of India and the Reserve Bank of India. Besides the ordinary debentures, the land development banks also float rural debentures for the period upto 7 years. These debentures are subscribed by farmers, panchayats, and the Reserve Bank. The Reserve Bank substantially contributes to the finance of land development banks by extending funds to the state governments for contributing to the share capital of these banks and by subscribing to ordinary and rural debentures.

**Growth:** In India, the first cooperative land mortgage bank was organised in Punjab in 1920. But the effective beginning was made in Madras with the establishment of a central land development bank in 1929. Later on other states also established such institutions. The number of state cooperative agricultural and rural development banks (SCARDBs) which was 5 in 1950-51, rose to 20 in 2013. The number of primary cooperative agricultural and rural development banks (PCARDBs) was 697 in 2013.

**Loans and Advances:** The land development banks or SCARDBs provide long-term loans to the agriculturists-

- (a) for redemption of old debt,
- (b) for improvement of land and methods of cultivation,
- (c) purchasing costly machinery, and
- (d) in special cases, for purchasing land.

These banks grant loans against the mortgage of land and the period of loan varies from 15 to 30 years. In 1999-2000, the loans sanctioned by these banks were Rs.2520 crore and the amount of loans outstanding was Rs. 11670 crore. The amount of loans outstanding at the end-March 2012 was Rs. 19400 crore by SCARDBs and Rs.12000 crore by PCARDBs.

#### 14.4 Defects of Land Development Banks:

Although numerically the land development banks have grown over the years, they have not been able to make much progress in providing long-term finance to the farmer. The following are the factors responsible for the unsatisfactory performance of land development banks:

**i. Uneven Growth:** There has been uneven growth of land development banks. These have shown some progress in the states like Andhra Pradesh, Tamil Nadu, Karnataka, Maharashtra, Gujrat. Other states have made very little progress. About half of the states have no land development bank.

**ii. Problem of Overdues:** The major problem faced by the land development banks is the existence of heavy overdues. Moreover, the overdues are continuously rising over the years. In 1991-92, the percentage of the overdues of the land development banks has been put between 42 to 44 per cent. Faulty loaning policies, inadequate supervision, over-utilisation of loans, ineffective measures for recovery, willful defaulters, etc. are the main causes of unsatisfactory level of overdues. In view of the seriousness of the problem, the state governments have been advised to draw up and implement time-bound programmes for special recovery drives.

**iii. Lack of Trained Staff:** In spite of quantitative growth of the land development banks, they have not shown much qualitative improvements in the field of granting loans largely due to inadequate technical and supervisory staff. Necessary changes in the legislation of cooperative institutions are also required if the lending activities are to be diversified for non-traditional developmental purposes and on the basis of non-landed security.

**iv. Other Defects:** Other defects of the land development banks can be summarised below:

- (a) These banks charge very high interest rates on the loans provided by them.
- (b) There is much delay and red-tapism in the granting of loans,
- (c) Second loan is not advanced unless the first is not repaid.
- (d) Installments and the period of loans are not fixed on the basis of the repaying capacity of the borrowers.
- (e) The procedure of receiving a loan from these banks is so complicated that the agriculturist is forced to seek help from the money lender,

(f) Weaker sections of the rural society such as landless labourers, village artisans and marginal farmers, are generally unable to secure loans from these banks for their productive activities simply because they do not have land or adequate security to offer against loans.

(g) Mostly loans are given for the repayment of old loans and for development purposes.

**v. Report of Rural Credit Survey:** The Report of the Committee of Direction of All-India Rural Credit Survey has pointed out the unsatisfactory performance of the land mortgage banks (now called the land development banks) in the following manner:

(a) These banks raise inadequate funds in a manner ill-rated to demand and usually lend them in a manner uncoordinated with development;

(b) They act as if prior debts and not production had claim on its attention; and

(c) They reach only the large cultivator and reach him late.

## 14.5 Advantages of Cooperative

The cooperative banking system has to play a critical role in promoting rural finance and is specially suited to Indian conditions. Various advantages of cooperative credit institutions are given below:

**I. Alternative Credit Source:** The main objective of cooperative credit movement is to provide an effective alternative to the traditional defective credit system of the village money lender. The cooperative banks tend to protect the rural population from the clutches of money lenders. The money lenders have so far dominated the rural areas and have been exploiting the poor people by charging very high rates of interest and manipulating accounts.

**II. Cheap Rural Credit:** Cooperative credit system has cheapened the rural credit both directly as well as indirectly:

(a) Directly, because the cooperative societies charge comparatively low interest rates, and

(b) Indirectly, because the presence of cooperative societies as an alternative agency has broken money lender's monopoly, thereby enforcing him to reduce the rate of interest.

**III. Productive Borrowing:** An important benefit of cooperative credit system is to bring a change in the nature of loans. Previously the cultivators used to borrow for consumption and other unproductive purposes. But, now, they mostly borrow for productive purposes. Cooperative societies discourage unproductive borrowing.

**IV. Encouragement to Saving and Investment:** Cooperative credit movement has encouraged saving and investment by developing the habits of thrift among the agriculturists. Instead of hoarding money the rural people tend to deposit their savings in the cooperative or other banking institutions.

**V. Improvement in Farming Methods:** Cooperative societies have also greatly helped in the introduction of better agricultural methods. Cooperative credit is available for purchasing improved seeds, chemical fertilizers, modern implements, etc. The marketing and processing societies have helped the members to purchase their inputs cheaply and sell their produce at good prices.

**VI. Role of Cooperative Banks before 1969:** Till the nationalisation of major commercial banks in 1969, cooperative societies were practically the only institutional sources of rural credit. Commercial banks and other financial institutions hardly provided any credit for agricultural and other rural activities. Cooperative credit to the agriculturists as a percentage of total agricultural credit increased from 3.1 per cent in 1951-52 to 15.5 per cent in 1961-62 and further to 22.7 per cent in 1970-71. On the other hand, the agricultural credit provided by the commercial banks as a percentage of total agricultural credit remained almost negligible and fell from 0.9 per cent in 1951-52 to 0.6 per cent in 1961-62 and then rose to 4 per cent in 1970-71.

**VII. Role of Cooperative Banks after 1969:** After the nationalisation of commercial banks in 1969, the government has adopted a multi-agency approach. Under this approach, both cooperative banks and commercial banks (including regional rural banks) are being developed to finance the rural sector. But, this new approach also recognised the prime role to be played by the cooperative credit institutions in financing rural areas because of the following reasons:

(a) Co-operative credit societies are best suited to the socio-economic conditions of the Indian villages.

(b) A vast network of the cooperative credit societies has been built over the years throughout the length and breadth of the country. This network can neither be duplicated nor be surpassed easily.



- (c) The cooperative institutions have developed intimate knowledge of the local conditions and problems of rural areas.

**VIII. Suitable Federal Structure of Cooperative Banking System:** Cooperative banking system has a federal structure with-

- (a) primary agricultural credit societies at the village level,
- (b) higher financing agencies in the form of central cooperative and state cooperative banks,
- (c) land development banks for providing long-term credit for agriculture. Such a banking structure is essential and particularly suited for effectively meeting the financial requirements of the vast rural areas of the country.

Considering the great importance of cooperative banks, particularly in the rural areas, it is not surprising that every committee or commission, that has examined the working of the cooperative banking system in India, has expressed the common view that "cooperation remains the best hope of rural India." Various committees, commissions and individual studies that have reviewed the working of the cooperative banking system in India have pointed out a number of weaknesses of the system and have made suggestions to improve the system.

## 14.6 Major weaknesses are given below:

**I. General Weaknesses of Primary Credit Societies:** Organisational and financial limitations of the primary credit societies considerably reduce their ability to provide adequate credit to the rural population. The All India Rural Credit Review Committee pointed out the following weaknesses of the primary credit societies:

- (a) Cooperative credit still constitutes a small proportion of the total borrowings of the farmers,
- (b) Needs of tenants and small farmers are not fully met.
- (c) More primary credit societies are financially weak and are unable to meet the production-oriented credit needs,
- (d) Overdues are increasing alarmingly at all levels,
- (e) Primary credit societies have not been able to provide adequate and timely credit to the borrowing farmers.

**II. Inadequate Coverage:** Despite the fact that the cooperatives have now covered almost all the rural areas of the country, its rural household membership is only about 45 per cent. Thus, 55 per cent of rural households are still not covered under the cooperative credit system. In fact, the borrowing membership of the primary credit societies is significantly low and is restricted to a few states like Maharashtra, Gujrat, Punjab, Haryana, Tamil Nadu and to relatively rich land owners.

**Criteria of determining borrowing membership include:**

- (a) Borrowing members as a proportion of rural households,
- (b) The average amount of loan issued per borrowing member, and
- (c) The proportion of loans going to weaker sections.

**The banking Commission 1972 has brought out the following reasons for the low borrowing membership cooperative societies:**

- (a) Inability of the people to provide the prescribed security;
- (b) Lack of up-to-date land records;
- (c) Ineligibility of certain purposes for loans;
- (d) Inadequacy of prescribed credit limits;
- (e) Onerous conditions prescribed for loans such as share capital contribution at 10 or 20 per cent of loans outstanding and compulsory saving deposits; and
- (f) Default of members to repay loans.

**III. Inefficient Societies:** In spite of the fact that the primary agricultural credit societies in most of the states have been reorganised into viable units, their loaning business has not improved. As the Seventh Plan has observed that out of 94089 primary agricultural credit societies in the country in 1982-83, only 66000 societies had full time paid secretaries. About 34000 societies were running at loss.

**IV. Problem of Overdues:** A serious problem of the cooperative credit is the overdue loans of the cooperative institutions which have been continuously increasing over the years. In 1991-92, percentage of overdues to demand at the level of land development banks was 57, at the level of central cooperative banks was 41 and at the level of primary agricultural credit societies was 39. The overdues in the short-term credit structure are most alarming in North-Eastern States. In the long-term loaning sector, the problem of overdues has almost crippled the land development banks in 9 states, viz., Maharashtra, Gujarat, Madhya Pradesh, Bihar, Karnataka, Assam, West Bengal, Orissa

and Tamil Nadu. Large amounts of overdues restrict the recycling of the funds and adversely affect the lending and borrowing capacity of the cooperative societies.

**The Banking Commission 1972 pointed out the following reasons for the overdue loans:**

- (a) Indifferent management or mismanagement of primary societies;
- (b) Unsound lending policies resulting in over-lending or lending unrelated to actual needs, diversions of loans for other purposes;
- (c) Vested interests and group politics in societies and willful defaulters;
- (d) Inadequate supervision over the use of loans and poor recovery efforts;
- (e) Lack of adequate control of central cooperative banks over primary societies;
- (f) Lack of proper links between credit and marketing institutions;
- (g) Failure to take quick action against willful defaulters; and
- (h) Uncertain agricultural prices.

**V. Regional Disparities:** There have been large regional disparities in the distribution of cooperative credit. According to the Seventh Plan, the eight states of Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab and Rajasthan account for about 80 per cent of the total credit disbursed. The per hectare short-term credit disbursed varied from Rs. 4 in Assam to Rs. 718 in Kerala.

**VI. Benefits to Big Land Owners:** Most of the benefits from the cooperatives have been covered by the big land owners because of their strong socio-economic position. For instance, in 1984-85 the farmers having holdings less than two hectares got only 38.8 per cent of the total loans granted by the primary agricultural credit societies, whereas the land owners with holdings of more than 2 hectare received 55 per cent. The share of the poorest rural population (i.e. tenants, share croppers and landless labours) was only 6.2 per cent.

**VII. Lack of Other Facilities:** Besides the provision of adequate and timely credit, the small and marginal farmers also need other facilities in the form of supply of inputs (i.e., better seeds, fertilisers, pesticides, etc), extension and marketing services. These facilities will enable them to utilise the borrowed credit in a proper way. Therefore, the credit societies should be reorganised into multi-purposes cooperatives. Strengthening the cooperative credit movement has been the Reserve Bank of India's special responsibility ever since its establishment in 1935.

### **14.7 The measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country:**

**1. Agricultural Credit Department:** The Reserve Bank has a separate Agricultural Credit Department whose functions are:

- (i) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the central and state governments, state cooperative banks and other banking organisations; and
- (ii) To coordinate the operations of the Reserve Bank in connection with agricultural credit and relations with the state cooperative banks and other institutions engaged in the business of agricultural credit.

**2. All-India Rural Credit Survey:** The Reserve Bank's real role in the cooperative credit movement started with the appointment of All-India Rural Credit Survey Committee in 1951. The objective of this Committee was to study the problems of rural credit and explore possibilities of expanding agricultural credit through cooperative credit system. The committee submitted its report in December 1954 which highlighted the vital importance of cooperative rural credit. The Committee found that while private credit agencies, i.e., money lenders and traders supply 70 per cent of the rural credit, the cooperative societies provided only 3 per cent of the total borrowed amount. The Committee observed that the rural credit in India fell short of the right quantity, was not of right type, did not serve the right purpose, and often fail to go to the right people. Regarding the future of cooperative credit movement the committee said, "cooperation had failed, but cooperation must succeed."

**3. Integrated Scheme of Rural Credit:** For the success of cooperative credit movement, the Survey Committee suggested an integrated scheme of rural credit based on the following fundamental principles-

- (a) state partnership in cooperative credit institutions;
- (b) full coordination between credit and other agricultural activities, particularly, marketing and processing; and

- (c) administration through adequately trained and efficient personnel, responsive to the needs of the rural population.

**4. Provision of Finance:** In pursuance of the recommendations of the Survey Committee and the later committees like the Committee on Cooperative Credit (1960), the Reserve Bank has activity helped the cooperative system to expand rural credit. The Reserve Bank does not provide finance directly to the agriculturists, but only through cooperative sector. The Reserve Bank provides financial assistance for meeting short-term, medium-term and long-term rural needs.

**The needs are explained as under:**

**(i) Short-Term Finance:** The Reserve Bank provides short-term finance to the state cooperative banks in two ways-

- (a) through loans and advances;
- (b) through rediscounting facility.

The financial assistance is given for seasonal agricultural operations and for marketing of crops.

In 1950-51, the Reserve Bank sanctioned short-term credit of Rs. 7.6 crore. This amount increased to Rs. 147 crore in 1960-61 and to Rs. 1090 crore in 1981-82.

**(ii) Medium-Term Finance:** The Reserve Bank provides medium-term loans to state cooperative banks generally for 3 to 5 years. These loans are provided for-

- (a) land improvements like bunding, digging of wells and water channels;
- (b) repair of wells and other irrigational schemes;
- (c) purchase of livestock, implements and machinery;
- (d) construction of farm houses and cattle sheds.

The Reserve Bank also provides medium-term loans in scarcity affected areas. Over the years, the amount of medium-term loans sanctioned by the Reserve Bank has considerably increased from Rs. 27 lakh in 1954-55 to Rs. 24 crore in 1970-71 and to Rs. 110 crore in 1981-82.

**(iii) Long-Term Finance:** The Reserve Bank provides long-term financial assistance for a maximum period of 20 years for agriculture in three ways-

- (a) It subscribes a portion of debentures issued by the land development banks.
- (b) It grants long term loans to such banks,
- (c) It grants loans to state governments for subscribing to the share capital of cooperative credit institutions. The total long-term loans sanctioned by the Reserve Bank were Rs. 212 crore in 1981-82.

**5. Setting Up of Funds:** To meet its financial obligations, the Reserve Bank set up two national funds in 1956, i.e., the National Agricultural Credit (Long-Term Operations) Funds, and the National Agricultural Credit (Stabilisation) Fund. The Purpose of the Long-Term Operations Funds was-

- (a) to make long-term loans available to state governments to enable them to subscribe the share capital of cooperative credit institutions;
- (b) to make medium-term loans to state cooperative banks for agricultural purposes;
- (c) to make long-term loans to the central land mortgage banks against the guarantee of the state government; and
- (d) to purchase debentures of central land mortgage banks against the guarantee of state government. The Stabilisation Fund helps the state cooperative banks to convert their short-term loans into medium-term loans in cases of draught, famine or other calamities.

**6. Strengthening of Cooperative Banking Structure:** With a view to strengthen cooperative banking structure and promote cooperative credit, the Reserve Bank undertakes the following measures:

- (i) It pays special attention towards rehabilitating and revitalising the weaker cooperative units.
- (ii) It makes arrangements for maintaining the flow of cooperative credit by involving commercial banks to finance the primary agricultural societies.
- (iii) It makes efforts in improving the lending policies and operational efficiency of cooperative credit institutions.
- (iv) It provides financial accommodation to cooperative credit institutions.
- (v) It conducts special training courses at the Cooperative Bankers' Training Colleges for the personnel of state, central and urban banks.

## Summary

A cooperative bank is an institution of finance that is owned and operated by its members, who are also the bank's customers. It is frequently founded by persons who share a mutual interest and belong to the very same regional or professional group. It was established to promote the

development of economically deprived members of the community and to keep them from the claws of lenders who supply needy people with loans at unnecessarily high-interest rates. Cooperation, mutual aid, democratic decision-making, and open membership are the guiding principles of the cooperative structure. It operates on the 'one shareholder, one vote' and 'no profit, no loss' principles. Organization, governance, interest rates, the scope of operations, objectives, and values distinguish cooperative banks from commercial banks.

Cooperative banks play an integral part in the implementation of development plans and are important for the effective functioning of the banking system in India. India is termed as an underbanked country, and after so many scams, it is need of the hour to take necessary measures to remedy the lacuna and to boost the confidence and trust of the public in the banking system.

Cooperative banks are essential to the smooth running of India's banking sector and play a major role in the process of development goals. In India, cooperative banks have become an important component of the country's financial inclusion story. Since their inception, they have set numerous milestones and assisted ordinary rural Indians in feeling empowered and secure. The plot has had its own share of procedural flaws and difficulties, with diverse areas of procedural flaws and woes.

### Keywords

**Co-operative bank:** A co-operative bank is a small-sized, financial entity, where its members are the owners and customers of the Bank.

**Loan:** A loan is a form of debt incurred by an individual or other entity.

**Capital:** capital is the money that a bank has obtained from its shareholders and other investors and any profit that it has made and not paid out.

**Rural Credit:** any kind of loan or financial assistance that is taken by the people residing in the rural areas for the purpose of agriculture or setting up small businesses.

**Fund:** a collection of different people's money collected & managed by high market professionals.

### Review Questions

1. Write and explain the Structure of Cooperative Banking.
2. What are the Challenges Faced by the Cooperative Banks? Explain.
3. Critically explain the Cooperative Agricultural and Rural Development Banks.
4. Explain the measures undertaken by the Reserve Bank to develop cooperative banking system and to promote cooperative finance in the country

### Self-Assessment

1. Co-operative banks which work at a metropolitan level are called as?
  - a) District Central Co-operative Bank
  - b) State Co-operative Bank
  - c) Primary Urban Co-operative Bank
  - d) Primary Agricultural Credit Societies
2. Which one of the apex bodies regulates the cooperative banks in India?
  - a) NABARD
  - b) RBI
  - c) Sponsor Banks
  - d) Both A and B
3. All banks registered under the
  - a) Banking Regulation Act 1949
  - b) The Bankers' Books Evidence Act-1891
  - c) Cooperative Societies Act, 1912

- d) Both (A) and (C)
4. Who manages the registration and management activities of Urban co-operative banks?
- RBI
  - NABARD
  - RCS
  - None of the above
5. Which of these are at the lowest rung of Rural Cooperative banking structure in India?
- State Cooperative Banks
  - District Central Cooperative Banks
  - Primary Agricultural Credit Societies
  - None of the above
6. Who regulates the functioning of District Cooperative Banks in India?
- State Government
  - SBI
  - State Cooperative Banks
  - None
7. Which was the first Cooperative Bank established in India?
- Bharat Cooperative Bank Limited
  - Kangra Central Co-operative Bank Limited
  - Anyonya Co-operative Bank Limited
  - Abhyudaya Co-operative Limited
8. Which of these is a Cooperative Bank in India?
- Cosmos Bank
  - SVC Bank
  - Janata Sahakari Bank
  - All of the above
9. Which is the largest cooperative bank of India presently?
- Saraswat Bank
  - NSB Bank
  - Apna Sahakari Bank L
  - None of above
10. Which of the following organizational structure is followed by Co-operatives in India?
- Federal Structure:
  - Unitary Structure
  - Centralized Structure
  - Decentralized Structure
11. DCCBs
- District Central Cooperative Banks
  - Director of Central Cooperative Banks
  - Danish Credit Cooperative Banks
  - Dane Creative Cooperative Banks
12. Co-operative banks which work at a metropolitan level are called as?
- District Central Co-operative Bank
  - State Co-operative Bank
  - Primary Urban Co-operative Bank

- d. Primary Agricultural Credit Societies
13. All banks registered under the \_\_\_\_\_ are considered co-operative banks.
- Banking Regulation Act 1949
  - The Bankers' Books Evidence Act-1891
  - Cooperative Societies Act, 1912
  - Both (A) and (C)
14. Besides banks, the other formal major source of cheap credit in rural areas, are:
- money lenders
  - zamindars
  - the cooperative societies
  - friends and relatives
15. ....is the vertex of the pyramidal structure in a State for the provision of short and medium term credit to agriculturists on cooperative basis.
- District Central Cooperative Banks
  - Primary Agricultural Credit Societies
  - State Cooperative Banks
  - All the above Answer

### Answers for Self-Assessment

- |         |         |         |         |         |
|---------|---------|---------|---------|---------|
| 1. (c)  | 2. (b)  | 3. (c)  | 4. (c)  | 5. (c)  |
| 6. (b)  | 7. (c)  | 8. (d)  | 9. (a)  | 10. (a) |
| 11. (a) | 12. (a) | 13. (c) | 14. (c) | 15. (c) |

### Further Readings

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