BLOCK IV:
MONEY AND COMMERCIAL BANKS

UNIT-1

MEANING AND FUNCTION OF MONEY

Unit Structure:

1.1 Introduction

Initially, money came into use for removing the inconveniences of the barter system. As a common medium of exchange, money has been playing a vital role in economy, production, marketing, industry, and trade and business right from individual level to international level. That is why understanding money and its management is very important both from the individual and organizational level. This will help the individuals, businessman, industry or organization to take their financial, marketing and economic decisions. On the other hand in modern time banking places a significant role in the economic development of all countries of the world. With the help of organize banking system the savings of general public as well as business can be mobilized and channelized into productive purpose. Hence, banking is known as life blood of business. The modern banks perform multifarious activities and service for business, industries and individual. Keeping in view the importance of money and commercial banks, the present unit aims at discussing some important issues related to money and commercial bank.

1.2 Objectives

After going through this unit you will be able to:

- *define* Money and Bank,
- *understand* the characteristic of money,
- *describe* the types and functions of money,
- *explain* Money supply and factors affecting money supply,
- *elaborate* the functions of modern commercial bank.

1.3 Meaning and Definition of Money

Anything which is generally acceptable in payment for goods, services and debts are known as money. Money is anything that serves as a medium of exchange. A medium of exchange is anything that is widely accepted as a means of payment.

Different economist have defined money is different ways.

According to Walker, "Money can be defined as anything that is generally acceptable as a medium of exchange and at the same time acts a measure and store of value." The author in this definition highlights three important functions of money i.e., medium of exchange, measure of value and store of value.

According to Thomas, "Money is a commodity chosen by common consent to be a measure of value and a means of value and a means of exchange between all the others commodities." The author highlights the generally acceptability, medium of exchange, measures and means of value as important elements of money.

According to Kent, "Money is anything which is commonly used and generally accepted as a medium of exchange or as a standard of value." The author in this definition highlights generally acceptability, medium of exchange and standard of value as main characteristic of money.

The definitions mentioned in the above discussion highlights the following important points.

- Money is generally accepted as it is chosen by common consent.
- Money is a medium of exchange as the commodities and services can be exchanged in terms of money.

- Money is measure of value. The value of commodities and services are measured in terms of money.
- Money is a store of value because the value of commodities and service can be stored in the form of money.

STOP TO CONSIDER

Approaches to Definition of Money

There are *four approaches* to the definition of money viz.

i) *Traditional approach*: According to this approach money is regarded only as a medium of exchange.

ii) *Monetarist approach*: According to this approach money is a temporary abode of purchasing power. Money can act as a temporary abode of purchasing power, if it is kept in form of cash, demand deposits or any other assets which is close to currency.

iii) *Liquidity approach*: As per this approach money include currency, demand deposits, time deposits, saving bank deposits, shares and bonds.

iv) *Central bank approach*: According to this approach money includes currency, bank credit, time deposits, credit from non-banking financial institutions and credit from unorganized agencies.

1.4 Characteristics of Money

The following are the prime characteristic of money-

(i) General Acceptability: A commodity is known as money if it is generally acceptable as a medium of exchange. Thus to be money a commodity must have universal acceptability.

(ii) Divisibility: Divisibility is an important characteristic of money. Money must be easily divisible into small parts and thus it facilitates small transactions.

(iii) Limited Supply: Another important characteristic of money is that its supply is limited. Any material which is freely available cannot be termed as money.

(iv) Portability: Money must be portable one so that it can be transferred easily from one place to another at a lot. Portability of paper money is very high.

(v) Durability: Money must be highly durable so that it should not perish away soon.

(vi) Cognizability: A good money must have the quality of cognizability, i.e, it must be easily recognized.

(vii) Homogeneity: Various units of money must be homogeneous in quality. There should not be any difference between the various units of money coins and paper money are always homogeneous.

1.5 Types of Money

Different types of money are discussed below:

1. *Legal Tender Money*: The money which is legally tendered by certain authority is known as legal tender money. As it is tendered legally thus it cannot be refused by anybody. Legal tender money may be two types- unlimited legal tender money and limited legal tender money. The type of money which is legal tender for unlimited amount is known as unlimited legal tender money e.g Rupee in India and the dollar of U.S.A. Again those type of money which legal tender only upto a certain limited amount is known as limited legal tender.

2. *Standard Money*: Standard Money is a kind of unlimited legal tender money whose face value is equal to its intrinsic or content value.

3. *Bank Money*: Bank Money includes all deposit and credit created by banks including overdrafts. This bank money can be easily used for making payments through cheques as these deposits are chequable. Deposit money is really a kind of guarantee given by banks to offer cash money. This type of money is different from money proper and is created in the account book of banks. In modern times bank money has become the most important form of money. Bank money is a very convenient form of money for making large payments.

4. *Token Money*: Token money is a type of money whose face value is greater than its content value. As token money is legally tendered

and as it is convenient to use thus people, in general, accept the token for their daily transactions.

5. *Commodity Money*: Commodity money includes all those commodities which were generally accepted by the people as money. In the primary stage of monetary economy, human being started to use some commodities as money. Commodity money was full-bodied money. For example, during the colonial period, 1 rupee coin was made of silver metal and its monetary value was equal to its commodity value. The commodities which were commonly used as commodity money include cows, precious stone and metals like gold, silver, copper etc.
6. *Paper Money*: Paper money is a kind of legal tender money which is made of paper. Most of the countries of the world are now using paper money.
7. *Money of Account*: Money of account acts as unit of account. In every country there must be unit of account for keeping accounts and also for making all transactions. Normally the money of account and legal tender money is same. The Rupee in India and Dollar in USA are taken as both legal tender money and money of account.

Stop to Consider

Near Money

Near money refers to all those assets which posses many of the characteristic of money, have high degree of liquidity and can inexpensively be converted into money of course near money cannot be directly use for making transactions. This money must first be converted into money before spending. Different types of near money are bill of exchange, bonds, equity shares, Time deposits and Savings deposits with commercial banks and other banks, bankers' acceptances etc.

1.6 Functions of Money

Money performs five important functions which are described below:

(i) **Money as Medium of Exchange**: The most important function of money is to serve as a medium of exchange. As a medium of exchange, money removes all the difficulties of barter system. There is no necessity for a double coincidence of wants in a money economy. The man with the cow, who wants to purchase a horse, need not hunt for a horse seller, who wants to own a cow. He can sell his cow in the market for money and then purchase a horse with the money thus obtained. Money units are of all denominations and it is easy to make fractional purchases, which is not possible under most cases of barter.

(ii) **Money as a standard measure of value**: When money serves as a medium of exchange, it incidentally measures the values of things for which it is exchanged. Money serves as a unit of account. In a money economy, it is easy to compare the value of different commodities and services. The values are in proportion to their respective prices. Expression of values in prices enables us to add them and have a definite idea of person's or a community's wealth.

(iii) **Money as a standard of deferred payment**: One of the important functions of money is that it must serve as a standard of deferred payment. Deferred payment means those payments which are to be made at sometime in the future. The use of money as a common medium of exchange allows some transactions to be settled in the future date.

(iv) **Money as a store of value**: Money serves as a store of value or, more correctly, it enables a person to keep a portion of his assets in liquid. Liquid assets are those which can be used for any purpose at any time. Therefore, this function of money enables the owner of the asset to store it in the form of money and thus, solves the problem of storage of the commodity or asset itself.

(v) **Money as a means of transferring value**: Value of asset can be transferred from one another or to any institution or to any place by transferring money. Money facilitates buying and selling of goods not only in domestic country but also in other parts of the world. Thus money functions as a transfer of value.

1.7 Money Supply

Money supply implies total stock of money held by the public in spendable form. Here public means individuals as well as business organization in the economy excluding central govt., the central bank and the commercial banks. Money supply has two concepts, one is stock concept and another is flow concept. Money supply as per stock concept at a particular moment of time is the stock of money held by the public at that moment of time. It implies the total currency notes, coins and demand deposits held by the public with the bank. According to flow concept , the money supply over the period of time can be known by multiplying a given stock of money held by the public by the velocity of circulation of money, which can be expressed according to *fisher's* equation as given below-

PT=MV,

Where M refers to the stock of money held by the public and V refers to the velocity of circulation of money

> **Stop to Consider**
>
> Till 1967-68, the Reserve Bank of India (RBI) used to adopt only the narrow measure of money supply (M) defined as the sum of currency and demand deposits, both held by the public. From 1967-68 it started publishing additionally broader measure of money supply, called aggregate monetary resources (AMR). It was defined emphirically as money narrowly defined plus the time deposits of banks held by the public. From April, 1977, the RBI has adopted four alternative definitions of money supply, labeled as M_1, M_2, M_3 and M_4.
>
> M or M_1=C + DD + OD
>
> $M_2 = M_1$ + savings deposits with post office savings banks.
>
> AMR or M3 = M1 + net time deposits of banks.
>
> $M_4 = M_3$ + total deposits with the Post Office Savings Organisation (excluding National Saving Certificates.)
>
> In the above definitions, C =currency held by public,
>
> DD = net demand deposits of banks,
>
> OD = 'other deposits' of the RBI which include demand deposits of quasi-government institutions (like the IDBI), foreign central banks and governments, the IMF and the World Bank etc.
>
> Source: Paul, R.R.(2001). *Money, Banking and International Trade (3rd ed)*. New Delhi: Kalyani Publishers

1.8 Factors influencing Money Supply

There are many factors which influence the supply of money. These influencing factors are discussed under the following points:

1. **Volume of Transactions:** According to the change in physical volume of trade as well as transaction in economy, the supply of currency/money may change. If the supply of currency is more than its requirement, it leads to the creation of inflationary pressures. On the other hand, if the money supply is less than its requirements, it creates deflationary trends.

2. **Nature of Trade:** Both the nature of wholesale trade and retail trade, determine the proportion of currency of different denomination. In case of wholesale trade, the notes of higher denomination are required, on the other hand in case of the retail trade; larger proportion of notes and coins of lower denominations is required.

3. **Method of Payment:** The method of payment is another influencing factor which determines the currency/money supply. In case of more cash transactions, greater proportion of currency/money supply is required. On the other hand in case of more transactions through cheques less currency/money supply is required.

4. **The Price level:** Another factor influencing the supply of money is Price level. In case of higher the price level, larger amount of currency is needed. On the other hand in case of low price level, smaller amount of currency is required for carrying out the given amount of transactions.

5. **Banking habits:** The confidence of public in commercial banks and their level of banking habits will influence the money supply. If the public has confidence in the bank money and has banking habits, the currency requirements will be less. But, if the people have less banking habits, the transactions will be conducted in cash and hence more currency is required.

Check Your Progress

1. Money serves as a unit of ________.
2. ……….. is a type of money whose face value is greater than its content value
3. ……… means those payments which are to be made at sometime in the future.
4. A commodity is known as ……….. if it is generally acceptable as a medium of exchange.
5. What is money Supply?
6. What are the factors affecting Money Supply?
7. Note down the different types of Money

1.9 Definition of Bank

According to Oxford English Dictionary, bank is defined as an establishment for custody of money received from or on behalf of its customers. The meaning of the bank can be understood more clearly from its definition as given below-

a) ***According to Banking Regulation Act 1949***, Under section 5 (1)(c), banking company means any company which transacts the business of banking in India.

b) ***Sir John Paget***, who is known as the father of banking, defines banker in his book "Law of Banking" as "that no person or body corporate or otherwise can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheque and (iv) collect cheques crossed and uncrossed for his customers."

c) ***According to Indian Companies Act, 1956***, "Bank is every company accepting deposits of money subject to withdrawn by cheque, drafts or others".

From the above definitions we can draw the following points:

(i) As a noun, bank is called an establishment, an institution, a firm, a corporate body etc.

(ii) As a verb, bank or banking is defined as dealing in money, instrument of credit creation, means of accepting or lending money etc.

(iii) As an individual bank or banker can be defined as a person, as a company, as a body corporate etc.

There are two distinctive features of a banking institution. These are:

(i) Acceptance of chequable demand deposits

(ii) Advancing of loan and credits.

1.10 Functions of Modern Commercial Banks

The function of modern bank can be understood from the statement given by Prof. R.S.Sayers, which say that 'Ordinary banking business consists of changing cash for bank deposits and bank deposits for cash: transferring bank deposits from one person or corporation to another, giving bank deposits in exchange for bills of exchange, government bonds, the second promises of businessman to repay and so forth."

From the above statement the functions of bank can be classified as shown below:

A. Main or Primary Function

B. Secondary or Subsidiary Function

C. Modern Function

(A). **Main or Primary Function**: "Banking in the traditional form is concerned with acceptance of deposits of money from the customers, the lending of the surplus of deposited money to suitable customers who wish to borrow, and transmission of funds. The primary functions of banking are:

(i) Acceptance of Deposits

(ii) Advancing of Loans

(iii) Use of cheque system and

(i) Acceptance of Deposits: Acceptance of deposit is an important primary function of a bank. The main purpose of accepting deposit is to mobilize savings from the people of the society.

(ii) Advancing of loans: The bank keep a certain amount of accepting deposit as cash reserve, thereafter, remaining amount of deposit is paid as loan to the needy person. Of course, the bank always satisfies itself about it credit worthiness before giving advances.

(iii) Use of cheque system: It is an important and unique function of bank. Bank introduces various kinds of cheques to settle debt of the modern business transactions. Cheque is a most convenient, inexpensive and developed credit instrument in modern time.

(B) **Secondary or subsidiary function**: In addition to above primary function, under section 6 of the Indian Banking Regulation Act 1949, a bank is allowed to perform some other functions. These functions are known as secondary functions. These secondary functions can be classified into two categories.These are:

(i) Agency services

(ii) General utility service

(i) Agency services: The relationship between the banker and customer is like a principal and agent. The main purpose of doing some agency service by a bank to provide necessary facilities to customers. Bank collects cheques, dividends, bills or promissory notes on behalf of his customers. Banks also acts as trustee, attorney, executor, correspondent or a representative. Various agency services provided by banks are:

(a) Remittances of fund: Remittance of funds is one of the agency function done by the modern bank. There are many branch offices of bank throughout the country. By virtue of these branches, bank provides the facilities of remittance of funds from one place to another on behalf of its customers. These funds are remitted through bank drafts, mail transfers or telegraphic transfers. Bank charge a minimum fees from its customer to provide such service.

(b) Executes payment: Bank executes payments on behalf of its customer for bills, cheques, bill of exchange, drafts, promissory notes, interest, dividend, rents, and subscriptions, insurance premium, bill of lading, railway receipt, warrants etc.

(c) Purchasing and selling of securities: Another important agency function of bank is purchasing and selling of foreign exchange including foreign banks notes, securities and investments of all kinds, such as shares, debentures, stock, bonds and obligations.

(d) Acting as trustee and executor: Bank acts as trustee and executor for its customer. Banks can preserve the "Wills" of its customers and can execute the same after the death of the customer.

ii) General utility services: In addition to the above, banks also perform some others functions known as general utility services. Some important general utility services are:

(i) Safe deposit lockers: It is a unique facility. Under the facility, bank provides one or more locker boxes to the customers on hire or payment of a charge. There are two keys to open the locker box. One is with bank and another is with customer. The locker box can be opened if the two keys are used, the customers can keep their valuable documents and to her goods with the locker.

(ii) Safe custody of valuable articles: Under this facility, the customer can hand over some valuable articles such as negotiable instruments, securities, jewellery, documents of title, wills, deed-boxes etc to banks. The customer may hand over these valuable articles either openly or in a sealed cover or box.

(iii) Issue of travellers' cheque and letter of credits etc.: A travellers' cheques is a printed cheque of a particular denomination. Travellers or other persons can carry travellers cheques instead of money. The advantage of traveler cheque is that it is convenient and has limited risk than the cash. A bank may issue travelers cheque at the request of the customer after cheque, the customer is to sign on this cheque, which is to be counter signed by the banker. When the payment is made, then the customer is to sign in the presence of the person who accepts the traveller's cheque.

(iv) Supply information and advice on financial matters to customers: The bank also provides necessary advice on financial matters to the customers. There are various data and information with the bank such as economic, market, price, supply, demand, credit etc. related to industry, trade, and commerce. Some banks also publish these data and information help the customers in taking their different financial and monetary decisions.

(v) Underwriting of capital issue and loans: Banks act as underwriter of capital issue and loans of Government bodies and companies. The general public can purchase the debenture, share of private companies, if these are unwritten by banks because public have good faith on banks.

(vi) Foreign exchange business: The Reserve Bank of India provides licenses to different banks for dealing in foreign exchange business. Commercial banks provide short-term finance to exporter at the pre-shipment and post-shipment stages. Moreover, these banks provide long term finances to the exporters and importers.

(vii) Credit creation: Credit creation is an important function of modern bank.

(viii) Acting as a referee: By this service, bank enables the customers to obtain reliable and speedy information about the general standing of people with whom they have to do the business transaction. When a seller intends to sell his goods to an unknown buyer he may do so only after knowing the financing standing of the buyers.

3. Modern Function: At present banks are able to provide some new services by virtue of introducing computerized equipments in the day to day activities of banks. The following modern functions are discussed below:

(i) SWIFT message: At present, remittances of funds can be done by the method of SWIFT message. The full meaning of SWIFT is *Society for Worldwide Inter Bank Financial Tele-communication*. The Transfer of funds from one country to another can be affected by SWIFT message.

(ii) ATM: Automated Teller Machine works like a computer. In order to provide ATM service, each customer is given an ATM card. The ATM card holder can withdraw and deposit cash at any time-day and night. After inserting the ATM card into the terminal, he is to enter his identification code. Thereafter, the machine will perform the deposit, withdraw or any other instruction as per given by the card holder.

(iii) Issue of Credit Card: A credit card is an instrument which provides instantaneous credit facilities to its holders to avail of a variety of goods and services at merchant outlets. Credit cards are issued by the banks to persons with income above certain minimum level.

(iv) Cheque card: A cheque card is a document issued by a bank guaranteeing to a payee, that any cheque up to a certain amount will be honoured at any branch of the issuing bank or any other bank having mutual arrangement.

(v) Gift cheque: Banks also issue gift cheques. This gift cheque are artistically designed in attractive folders and covers. The purchaser of a gift cheque need not be an account holder with that bank or any other bank to avail of this service. This gift cheque is collectable at par at all offices of the issuing bank in India.

(vi) Merchant banking: Merchant banking involves giving advisory service and assistance to entrepreneurs setting up new industrial units and for expanding and diversifying production to existing industrial units.

(vii) Debit card: Bank also provides debit card to the account holder. The main purpose of issuing debit card is to transfer money electronically from one bank account to another when making a purchase. Of course, no overdraft facility is given to debit card.

(viii) Electronic Funds Transfer Systems (EFTS): This is electronic process of transferring fund. By this process salary, dividend etc. are transferred from the account of one person to the account of another person. This is a very safe and convenience process of transferring and handling money.

(ix) Mobile Banking Services: Mobile Banking service can be defined as "Anywhere Banking". Under this service, customers now do not need access to a computer terminal to access their banks, they could do so on the go when they are waiting for their loans to the work place, why they are travelling on, when are waiting for their orders to come through ina restaurant by using their mobile handset, developing one of the following four channels:

(a) IVR (Interactive Voice Response): This service operates through pre-specified numbers that banks advertise to their customers. Customers make a call at IVR number and are usually greeted by a store electronic message followed by a menu of different options.

(b) SMS (Short Messaging Service): This service uses the popular text-messaging standard to enable mobile application based banking. The way this works is that the customer requests for information by sending an SMS containing a service command to a pre-specified number. The bank responds with a reply SMS containing the specific information.

(c) WAP (Wireless Access Protocol): WAP uses a concept similar to that used in internal banking. Banks maintain WAP sites which customer's access using a WAP compatible browser on their mobile phones.WAP sites offer familiar form based interface and could also implement security quite effectively. Once customer log into their banks' WAP site through their WAP/GPRS enabled mobile phone, all you need to do is enter your customer ID and net banking IPIN.

(d) Internet banking: Internet banking is system of online banking from home or anywhere. Internet banking provides. "Anywhere", "anytime" banking access to one's account as well as to the public information updated by the bank on its website. Majority commercial banks have introduced internet banking facilities.

Check Your Progress

1. Define Bank?
2. Note down the functions of a Modern Commercial Bank.
3. Write short notes on : RTGS, Internet Banking, Mobile Banking Service, Debit Card

1.11 Summing Up

1. Anything which is generally acceptable in payment for goods, services and debts are known as money. Money is anything that serves as a medium of exchange.
2. Different characteristics of money are – i) General acceptability, ii) divisibility, iii) limited supply, iv) Portability v) durability, vi) Cognazability and vii) homogeneity
3. Different types of money are- i) legal tender money ii) standard money, iii) bank money, iv) token money, v) Commodity money, vi) Paper money and vii) Money of accounts
4. Money performs five important functions, such as- i) Medium of Exchange, ii) Standard measure of value, iii) standard of deferred payment, iv) Money as a store of value, v) means of transferring value
5. Money supply implies total stock of money held by the public in spendable form.

6. Money supply has to two concepts, one is stock concept and another is flow concept.

7. The currency component of the money supply, i.e, coins and notes, is influenced by a number of factors, such as i) Volume of transactions, ii) Nature of Trade, iii) Method of payment, iv) Price level, v) Banking habits

8. Bank can be defined as an establishment which makes to individuals and organizations such Advances of money or other means of payment as may be required by them and safely made to which individuals and organization entrust money when not required by them for use.

1.12 Model Questions

1. What do you understand by term Money?
2. Give a definition of Money?
3. Explain the various characteristic of money?
4. Discuss different types of money?
5. "Money is that Money does"-in light of this statement describe the various function of money?
6. What is money supply?
7. What are the various components of money supply?
8. What is the importance of money?
9. Define Bank?
10. What are the characteristic of bank?
11. Describe the primary functions of bank?
12. Discuss the secondary functions of bank?
13. What are the emerging/modern functions of bank?

1.13 References and Suggested Readings

1. Mithani, D.M.(2010). *"Money, Banking, International Trade and Public Finance"*; New Delhi Himalaya Publishing House.

2. Hajela,T.M.(2009). *"Money, Banking and Public Finance"*; ANE Books New Delhi.

3. Jhingan, M.L.(2014), *"Money, Banking and International Trade and Public Finance"*; New Delhi Vrinda Publications Pvt. Ltd.

******

Unit-2
Credit Creation

Unit Structure:

2.1 Introduction:

The creation of credit is a unique and important function of commercial banks and this function distinguishes banks from the non banking institutions. That is the reason why banks are called the manufacturer of credit. According to Horace White "Bank is a manufacturer of credit and machine for facilitating exchanges. Just as the central bank is responsible for ensuring the supply of money in the economy, similarly commercial bank performs the function of credit creation. This unit aims at discussing the various aspect of credit creation.

2.2 Objectives

After going through this unit you will be able to:

- understand the meaning and concept of credit creation,
- describe the role of commercial banks in credit creation,
- explain various methods of credit creation,
- elucidated techniques and mechanism of credit creation.

- Identity various advantages of credit creation
- Describe various limitation of credit creation

2.3 Meaning and Concept of Credit Creation

Commercial banks accept deposits and advance loans. In the process of advancing loans, the bank creates deposits. Before discussing the meaning of creation of credit, we should have a clear concept on deposit of bank, because the process of creating credit is based on deposit system of bank. In this regard, it is to be mentioned that there are two ways of mobilising deposits.

These are:

(i) Primary or passive deposit: A bank accepts cash from the customer and opens a deposit in his name. This is a primary deposit. This does not mean credit creation. These deposits simply convert currency money into deposit money. However, these deposits form the basis for the creation of credit.

(ii) Derivative or secondary deposits: A bank grants loans and advances and instead of giving cash to the borrower, opens a deposit account in his name. This is the secondary or derivative deposit. Every loan creates a deposit. *The creation of a derivative deposit means the creation of credit.*

We also need to understand the following concepts, in order to have a better understanding of the concept of credit creation.

i) Cash Reserve Ratio: CRR is the percentage of total deposits which the banks must hold in cash reserves for meeting the depositors' demand for cash

ii) Excess reserve: The reserves over and above the cash reserves are the excess reserves. These reserves are used for loans and credit creation.

iii) Credit multiplier: A bank can create multiple times credit, out of a certain amount of cash in its deposits. In the process of multiple credit creation, the total amount of derivative deposits that a bank creates is a multiple of the initial cash reserves

Bank creates deposits in the process of their lending operation. When a customer deposits money in the bank, it opens a deposit account in the name of the customer and credits the amount in his account. After keeping a certain portion of the deposit as CRR , the bank advance loans to other customers. While advancing the loans the bank again creates a account in the name of the borrower and credits the same amount in the borrower's account. Here, a single deposit account, after keeping aside a small amount as CRR has created another deposit account. This process continues and repeats in all the banks or in the banking system as a whole. *This process is called the credit creation*. The process of credit creation increases the asset and liabilities in the entire banking system. Let us try to understand the same with the help of the following example.

1. Customers(A) deposits Rs 1000 in the bank, the bank opens an account in his name and credits Rs 1000 to customers(A) account
2. After keeping aside the required CRR(for eg:10%) , the bank advance Rs 900 to Customer (B) as loan. While advancing loan , the bank opens a account in the name of borrower and credits the amount(Rs 900) in his account. So the bank has an additional deposit of Rs 900 which is created out of the deposit from customer A.
3. The bank again after keeping aside the required CRR (say 10%) out of the Rs 900 deposit, lends Rs 810 to customer (C). While advancing loan, the bank opens an account in the name of customer (C) and credits the amount (Rs 810) in his account. The bank has an addition deposit of Rs 810 . (Total 900+810)
4. This process continues and hence the credit is multiplied number of times by the bank from a single deposit of Rs 1000 from Customer (A) as mention in this example. This leads to the credit creation and increase in the asset and liability of banks and the banking system.

2.4 Role of Commercial Banks in Credit Creation

Commercial banks play a crucial role in credit creation within the economy. Credit creation refers to the process by which banks extend loans or create deposits, leading to an increase in the money supply. This process is also known as *the multiplier effect*. This is how commercial banks play a role in fostering credit creation:

- **Accepting Deposits:** Commercial banks attract funds from the public by accepting deposits, which can be in the form of savings, fixed deposits, or current accounts.
- **Reserve Requirements:** Central banks set reserve requirements, which are the minimum amounts of reserves that commercial banks must hold with their deposits. The reserve requirements act as a limit on the amount of money that banks can create.
- **Loan Creation:** In the dynamic process of loan creation, a commercial bank, upon receiving a deposit, is mandated to retain only a portion of it as reserves, while the remaining funds become a catalyst for extending loans. This lending activity sets in motion a chain reaction, generating new deposits and thereby amplifying the overall money supply within the economy. The extent of this monetary expansion is determined by the reciprocal of the reserve requirement, signifying the multiple by which the initial deposit can be magnified through the loan creation process. For instance, if the reserve requirement is set at 10%, the bank has the potential to create loans up to 10 times the value of the original deposit, illustrating the transformative impact of the credit creation mechanism.
- **Multiplier Effect:** The multiplier effect is a powerful phenomenon in the area of credit creation. When commercial banks extend loans, the impact goes beyond the initial transaction. For instance, when a bank provides a loan to a borrower, the borrowed money is typically spent or invested. If the recipient of the funds deposits them into another bank, that bank can then utilize a fraction of this new deposit to make additional loans. This cycle repeats as the newly created deposits find their way into the banking system, leading to successive rounds of lending and deposit creation. This repetitive procedure results in a multiplier effect, wherein the total money supply in the economy becomes significantly larger than the initial deposit. Essentially, one initial deposit sets off a chain reaction of lending and deposit creation, amplifying the overall impact on the money supply.
- **Interest Rates:** Commercial banks charge interest on loans, and the interest earned contributes to their revenue. The interest rate set by the central bank influences the cost of borrowing for

commercial banks and, consequently, their lending rates. Changes in interest rates can impact the level of credit creation.

- **Creditworthiness Assessment:** Banks play a crucial role in assessing the creditworthiness of borrowers. They evaluate the financial health and capacity of individuals and businesses to repay loans. This helps maintain the stability of the banking system and ensures responsible lending practices.
- **Economic Impact:** Credit creation by commercial banks has a significant impact on economic activity. It stimulates investment, consumption, and overall economic growth. However, excessive or imprudent lending can lead to financial instability, as seen in cases of banking crises.

STOP TO CONSIDER

Credit creation depends upon the ratio of cash reserves to deposits. The credit or the deposit multiplier is: $k = \frac{1}{r}$; where k is the credit multiplier and r is the cash-reserve ratio. Thus, credit multiplier is the reciprocal of cash reserve ratio. If cash-reserve ratio is 20% then

$K = \frac{1}{r} = \frac{1}{.2} = 5$

The higher the cash-reserve ratio, the lower will be the credit multiplier; the lower the cash reserve ratio, the higher will be the credit multiplier.

2.5 Methods or Ways of Credit Creation

Credit creation by commercial banks occurs through several methods or mechanisms. The following are the primary ways in which credit is created:

- **Fractional Reserve System:** The Fractional Reserve System is a fundamental aspect of commercial banking, dictating that banks are obligated to maintain only a portion of their deposits in reserve, allowing them to lend out the remaining funds. For example, consider a scenario where a bank faces a reserve requirement of 10%. In this case, the bank can extend loans equivalent to 90% of the total deposits it receives. For instance, if customers deposit Rs 100, the bank is mandated to hold Rs 10 in reserves and can utilize the remaining Rs 90 for lending purposes, thereby amplifying its capacity to stimulate economic activities through credit creation.

Top of Form

- **Deposit and Loan Relationship:** When a bank receives a deposit, it retains a portion of it as reserves and lends the remaining amount. The borrower, in turn, uses the loaned amount, which may end up in another bank as a deposit. The process continues, creating a cycle of deposits and loans, leading to an overall increase in the money supply.
- **Multiplier Effect:** The multiplier effect, a pivotal aspect of credit creation, amplifies the money supply as commercial banks engage in lending. For instance, when a customer makes an initial deposit, a fraction is held in reserve, and the remainder is lent out. This process repeats as the borrowed amount is deposited in the same or another bank, allowing for further lending. With each repetition, new deposits are created, contributing to a cumulative expansion of the overall money supply. The extent of this expansion is influenced by the reciprocal of the reserve requirement set by central banks, showcasing the compounding impact of credit creation on the economy.
- **Open Market Operations:** Central banks conduct open market operations by buying or selling government securities. When central banks purchase securities, they inject money into the banking system, providing commercial banks with additional funds that can be used for lending and credit creation.
- **Discount Rate:** The central bank sets a discount rate, which is the interest rate at which commercial banks can borrow from the central bank. By adjusting the discount rate, the central bank can influence the cost of borrowing for commercial banks, affecting their willingness to lend and the overall level of credit creation.
- **Interest Rates:** Commercial banks charge interest on the loans they extend. The interest earned is a source of revenue for banks and influences their profitability. Changes in interest rates, influenced by central bank policies or market forces, impact the level of credit creation by affecting the cost of borrowing.
- **Creditworthiness Assessment:** Before extending credit, banks assess the creditworthiness of borrowers. This involves evaluating the financial stability, repayment capacity, and credit history of

individuals and businesses. Prudent lending practices help ensure that loans are repaid, contributing to a stable banking system.

- **Government Policies:** Government policies, including fiscal and monetary policies, can impact credit creation. For example, government spending and taxation policies can influence the overall level of economic activity, affecting the demand for credit.
- **Liquidity Preferences:** The willingness of individuals and businesses to hold deposits in banks, rather than in cash, influences the amount of money available for lending. If there is a preference for holding money in banks, it can contribute to higher levels of credit creation.

Stop to Consider

The process of credit creation can be analyzed in two ways: (a) credit creation by a single bank; and (b) credit creation by the banking system as a whole. In the single bank system, only one bank operates and all the cash deposits and cheques are to be made with this bank alone. In the real world, there are many banks in existence comprising multiple banking systems. Whereas a single bank cannot lend beyond the amount of excess reserves, the banking system as a whole can do what a single bank cannot do. The banking system can grant loans many times the excess reserves of cash created for it. When an individual bank creates derivative deposits, it loses cash to other banks; the loss of deposit of one bank is the gain of deposit by some other bank. This transfer of cash within the banking system creates, in turn, primary deposits and increases the possibility for a further creation of derivative deposits by the banks receiving cash. This process of the banking system to increase credit many times more than the initial excess reserves is called multiple credit creation.

Check Your Progress

1. What is Credit Creation?
2. What are Primary or Passive deposits?.
3. What is Derivative or Secondary Deposit?

4. Write short note on: Cash Reserve Ratio, Multiplier Effect.
5. Note down the different methods or ways of credit creation.
6. Discuss the role played by Commercial Bank in credit creation.

2.6 Techniques or Mechanism of Credit Creation

The process of credit creation involves various techniques and mechanisms employed by commercial banks to extend credit and increase the money supply. Below are several essential techniques and mechanisms:

Top of Form

- **Deposit and Loan Relationship:** When a bank receives a deposit, it retains a portion as reserves and lends out the rest. The borrower, in turn, uses the loan for various purposes, and the money often finds its way back into the banking system as a new deposit. This cycle continues, leading to a multiplier effect on the initial deposit.
- **Multiple Deposit Creation:** The initial deposit creates multiple rounds of lending and re-depositing in the banking system. As each new deposit becomes the basis for additional loans, the total money supply expands, contributing to credit creation.
- **Credit Expansion through Loans:** Banks extend credit by providing loans to individuals, businesses, and other entities. These loans contribute to economic activity by financing investments, purchases, and other financial transactions.
- **Central Bank Operations:** Central banks influence credit creation through open market operations, where they buy or sell government securities. By injecting or withdrawing money from the banking system, central banks impact the level of reserves available to commercial banks, influencing their capacity for credit creation.
- **Discount Rate:** The discount rate, set by the central bank, represents the interest rate at which commercial banks can borrow funds directly from the central bank. Changes in the discount rate influence the cost of borrowing for commercial banks, affecting their willingness to extend credit.

- **Interest Rate Policies:** Commercial banks charge interest on loans, and the interest rate is a critical factor in credit creation. Changes in interest rates, influenced by central bank policies or market conditions, impact the demand for loans and the overall level of credit in the economy.
- **Selective Credit Controls:** Central banks may implement selective credit controls to regulate specific types of lending or borrowing. For example, they may impose higher reserve requirements or interest rates on certain types of loans to manage credit creation in specific sectors.
- **Prudent Lending Practices:** Commercial banks employ credit risk assessment and prudent lending practices to ensure that loans are extended to creditworthy borrowers. Assessing the financial health and creditworthiness of borrowers helps mitigate the risk of loan defaults.
- **Government Policies:** Government policies, including fiscal and monetary measures, can influence credit creation. Fiscal policies such as government spending and taxation, along with monetary policies, play a role in shaping the overall economic environment and affecting the demand for credit.

2.7 Advantages of Credit Creation

Credit creation, facilitated by the lending activities of commercial banks, has several advantages that contribute to economic growth and development. The following are the advantages of Credit Creation-

- **Economic Stimulus:** Credit creation provides a means for injecting money into the economy. As banks extend loans to individuals and businesses, they support increased spending, investment, and economic activity, thereby stimulating overall economic growth.
- **Capital Formation:** Credit creation facilitates the accumulation of capital by enabling businesses to access funds for expansion, research, and development. This contributes to increased productivity, job creation, and long-term economic development.
- **Entrepreneurship Support:** Credit enables entrepreneurs to start new businesses or expand existing ones. Access to credit allows

individuals with innovative ideas to bring them to fruition, fostering entrepreneurship and innovation within the economy.

- **Homeownership and Real Estate Development:** Mortgage loans enable individuals to purchase homes, contributing to increased homeownership rates. Additionally, credit creation supports real estate development by providing financing for construction projects, leading to improved housing infrastructure.
- **Consumer Spending:** Consumer loans and credit cards provide individuals with the ability to make purchases beyond their immediate financial means. This boosts consumer spending, which is a significant driver of economic activity, particularly in consumer-oriented economies.
- **Investment in Education:** Credit facilitates investment in education by providing students with loans for tuition and other educational expenses. This enables individuals to acquire the skills and knowledge necessary for personal development and enhances the overall human capital of a society.
- **Smooth Business Operations:** Businesses often face fluctuations in cash flows. Credit allows them to smooth out these fluctuations by providing a financial cushion during lean periods, ensuring that operations can continue without disruption.
- **Infrastructure Development:** Credit is crucial for funding large-scale infrastructure projects such as roads, bridges, and utilities. Governments and private entities often use credit to finance these projects, contributing to economic development and improved living standards.
- **Job Creation:** Increased economic activity resulting from credit creation leads to higher demand for goods and services, which, in turn, creates job opportunities. Businesses that expand or start-ups that emerge due to credit support contribute to employment growth.
- **Enhanced Financial Inclusion:** Credit creation can contribute to financial inclusion by providing access to financial services for individuals and businesses that may not have had access otherwise. This helps in reducing economic disparities and promoting inclusive growth.

- **Investment in Technology:** Credit supports investments in technology and innovation. Businesses can use credit to finance the adoption of new technologies, improving efficiency and competitiveness.
- **Flexible Payment Options:** Credit allows individuals and businesses to make purchases and investments with the flexibility of repaying over time. This flexibility can be especially beneficial during periods of economic uncertainty.

2.8 Limitations of Credit Creation

While credit creation by commercial banks has various advantages, it also comes with certain limitations and risks. These limitations are-

- **Risk of Over-Lending:** If banks engage in excessive lending without proper risk assessment, it can lead to over-lending credit expansion. This may result in a high level of non-performing loans and financial instability.
- **Credit Risk:** There is inherent credit risk associated with lending. Borrowers may default on their loan repayments due to various reasons such as economic downturns, business failures, or individual financial distress. This can lead to losses for the lending institutions.
- **Asset Quality Deterioration:** An increase in credit creation may lead to deterioration in the quality of bank assets. If a significant portion of loans becomes non-performing, it can adversely affect the financial health of banks.
- **Liquidity Concerns:** Banks need to maintain a balance between making loans and ensuring they have sufficient liquidity to meet deposit withdrawals and other obligations. Excessive credit creation without adequate liquidity management can lead to liquidity crises.
- **Interest Rate Risk:** Changes in interest rates can impact the profitability of banks. If interest rates rise significantly, the cost of funds for banks may increase, affecting their net interest margin and overall profitability.
- **Impact on Inflation:** Excessive credit creation can contribute to inflationary pressures by increasing the money supply. This is particularly true if the additional money is not matched by a corresponding increase in goods and services.

- **Boom and Bust Cycles:** Rapid credit expansion can contribute to economic booms, but it may also lead to speculative bubbles. When these bubbles burst, it can result in economic downturns, financial crises, and negative consequences for the banking sector.
- **Regulatory Constraints:** Regulatory authorities impose reserve requirements and other regulations to control credit creation. Banks must comply with these regulations, limiting the extent to which they can create credit.
- **Dependency on Economic Conditions:** Credit creation is closely tied to the economic environment. During economic downturns, banks may become more cautious in lending, leading to a reduction in credit creation. This can exacerbate economic contractions.
- **Systemic Risks:** The interconnectedness of financial institutions can lead to systemic risks. If one major bank faces financial difficulties due to a high level of non-performing loans, it can have a cascading effect on other banks and the broader financial system.
- **Consumer Debt Burden:** High levels of credit creation, especially in the form of consumer loans, can contribute to a significant debt burden on individuals. This can lead to financial stress for households if economic conditions deteriorate.
- **Moral Hazard:** Knowing that they may be bailed out in case of financial difficulties, banks might engage in riskier lending practices, leading to moral hazard. This can contribute to a lack of prudence in credit decision-making.

Check Your Progress

1. Discuss the techniques and mechanism of credit creation.
2. What are the advantages of Credit Creation?
3. Discuss the limitations Credit Creation.

2.9 Summing Up

- Commercial banks, often referred to as “manufacturers of credit” due to their unique ability to create credit, play a crucial role in economic activity through processes like deposit acceptance, reserve management, and the multiplier effect of loan creation; however, responsible lending practices and central bank oversight are essential safeguards against potential financial instability.

- Commercial banks employ a range of tools, including the fractional reserve system, deposit and loan relationships, the multiplier effect, open market operations, discount rates, interest rates, creditworthiness assessments, government policies, and liquidity preferences, to shape the money supply and facilitate credit creation in the economy.
- Credit creation by commercial banks involves fractional reserve banking, initiating lending cycles through deposit and loan relationships, employing central bank influence, prudent creditworthiness assessments, and consideration of government policies and liquidity preferences, highlighting the multifaceted nature of the credit creation process.
- The advantages of credit creation include economic stimulus, capital formation, entrepreneurship support, homeownership promotion, consumer spending stimulation, education investment, infrastructure development, job creation, financial inclusion enhancement, technology investment facilitation, and flexible payment options, showcasing its positive impact on various aspects of economic growth.
- On the other hand, the limitations of credit creation encompass risks such as over-lending, non-performing loans, credit risk, asset quality deterioration, liquidity concerns, susceptibility to interest rate fluctuations, inflationary pressures, contribution to economic cycles, regulatory constraints, dependence on economic conditions, systemic risks, consumer debt burden, and potential moral hazard, underscoring the importance of managing credit creation responsibly to maintain financial stability.

2.10 Model Questions

1. Define the concept of credit creation.
2. Elaborate on the role of Commercial Banks in the process of credit creation.

3. Outline the different methods employed in credit creation.
4. Provide an example to illustrate the mechanism of credit creation.
5. Enumerate the advantages associated with credit creation.
6. Analyze and discuss the limitations inherent in the process of credit creation.

2.11 References and Suggested Readings

Hajela, T. M. (2009). *Money, Banking and Public Finance.* New Delhi: ANE Books.

Jhingan, M. L. (2014). *Money, Banking and International Trade and Public Finance.* New Delhi: Vrinda Publications Pvt. Ltd.

McLeay, R., Radia, A., & Thomas, R. (2014). Money creation in the modern economy. *Bank of England Quarterly Bulletin, Q1.*

Mishkin, F. S., & Eakins, S. G. (2015). *Financial Markets and Institutions.* Pearson.

Mithani, D. M. (2010). *Money, Banking, International Trade and Public Finance.* New Delhi: Himalaya Publishing House.

******

Unit-3
Types of Banks and Banking System, Structure of Commercial Banks in India

Unit Structure:

3.1 Introduction

Banks are the financial institutions which plays a very important role in the economic development of the country. Banks may be defined as an institution engaged in accepting deposits of money from the public and lending to the needy borrowers. According to Sec 5 (1) (b) of the Banking Regulation Act, 1949, "Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques draft, order or otherwise." Over the period of time, various banks have been developed to cater to the requirements of the economy. In this Unit, you will learn about the various Types of Bank, the prevailing Banking System and the structure of Commercial Bank in India.

3.2 Objectives

After studying this unit, you should be able to:

- explain the different types of banks,
- understand the various banking system along with its features,
- describe the structure of Commercial Banks in India.

3.3 Types of Banks

A bank is a financial institution which acts as an intermediary between the lender and the borrower. It accepts deposits of money from the public and creates credit by making advances out of the funds received as deposits. In other words, it mobilises savings and channelise them to investments. In addition to its primary functions, it also provides services such as transfer of funds, remittance, issue of drafts, locker facilities, dealing with foreign exchange, online banking, mobile banking, debit card, credit card, etc. Each type of banks provide a specialised and particular type of banking activity. Banks in India can be classified into the following types-

3.3.1. Central Bank

The central bank occupies a central position in the banking system and acts as the highest financial authority in a country. It is an apex institution which is generally set up by the government of a country to undertake central banking functions. It is an autonomous institution entrusted with the powers of control, supervision of the monetary and banking system of the country. Its primary responsibility is to maintain stability of the national currency and money supply. Besides issuing currency notes, it controls the credit, acts as custodian of foreign exchange reserves and clearing house and also acts as the bankers' bank and banker to the Government. It also ensures that banks and other financial institution do not behave recklessly or fraudulently. In India, Reserve Bank of India function as the central bank was set up in 1935.

3.3.2 Commercial Bank

Commercial banks performs all kinds of ordinary banking business such as accepting deposits, advancing loans, credit creation, agency and general utility functions. It operates on a commercial basis and profit making is their main objective. It occupies a very important place in the banking structure of a country and cater to the needs of short and medium term financial requirements of the economy. Commercial banks may be public sector banks, private sector banks and foreign banks.

Some of the commercial banks in India are:

i. State Bank of India,

ii. Canara Bank,

iii. Allahabad Bank,

iv. United Bank of India,

v. Punjab National Bank,

vi. Union Bank ofIndia,

vii. Bank of India,

viii. HDFC Bank,

ix. ICICI Bank,

x. Axis Bank, etc.

The structure of Commercial Bank is discussed in brief at 3.4

3.3.3 Co-operative Banks.

A Co-operative Bank is a voluntary association of members which operates on the principles of cooperation, self-help and mutual help. Co-operative banks are set up under the Cooperative Societies Act. This bank is also engaged in the ordinary banking business of accepting deposits and advancing loans. However, its main goal is to promote social welfare by providing concessional loans to its members and needy borrowers. Generally, this bank works on no-profit no-loss mechanism and do not pursue to the idea of profit maximisation. This banks primarily focus on granting short term loans to agricultural and other allied activities and serves as one of the important source of rural credit.Their business in the urban areas have increased in recent years due to the increase in the numbers of Primary Cooperative Banks.They are also regulated by Reserve Bank of India and governed by Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1965.

They are organised in Three- tier structure-

i. Tier 1 (State Level) - State cooperative Banks (SCBs)

State cooperative banks are the apex institutions in the Three-tier cooperative credit structure operating in the state level.

ii. Tier 2 (District Level) - Central /District Cooperative Banks (CCBs)

Central cooperative Banks are placed in the middle of the Three –tier cooperative credit structure. These banks operate in the district level and are located in the district headquarters or prominent towns.

iii. Tier 3 (Village Level) - Primary Agriculture Credit Societies (PACS)

Primary Agriculture Credit Societies forms the base in the Three-tier cooperative credit structure operating in a village level. This institution directly deal with the people and provides banking services. It depends on the central cooperative banks and state cooperative banks for its funding requirements.

3.3.4. Development Banks.

Development banks are specialised type of financial institutions which are engaged in providing both fund as well as non-fund based services. They provide medium term as well as long term funds and acts as a catalytic agents in promoting balanced development of the country. These banks mainly focuses in the promotion and development of industry, agriculture and other key sectors in the economy. In other words, they are engaged in the activities for economic development in general and industrial development in particular.

In India, Industrial Finance Corporation of India (IFCI) was the first institution established as the development bank in 1948. Thereafter more development banks have been established both at central level and at the state level. Some of them are as follows.

i. Industrial Development Bank of India (IDBI)

ii. National Bank for Agriculture and Rural Development (NABARD)

iii. Small Industries Development Bank of India (SIDBI)

iv. State Industrial Development Corporations (SIDCs)

v. State Finance Corporation (SFCs)

vi. North Eastern Development Finance Corporation (NEDFi),

vii. Industrial Investment Bank of India (IIB) etc.

3.3.5. Regional Rural Bank (RRBs)

Regional Rural Bank was first setup in 1975 on the recommendation of M. Narasimham committee. The objective was to provide credit and other facilities to small and marginal farmers, agricultural labourers and artisans. These banks are generally based in the rural areas with the aim of taking the banking services into the doorstep of rural poor. The capital of Regional Rural Bank are shared between the Government of India (50%), concerned State Government (15%) and the sponsoring nationalised bank (35%). These banks are scheduled banks and governed by Regional Rural Bank Act, 1976.

However, as per the recommendations of Bhandari Committee (1994-95) and Basu Committee (1995-96) the government made two policy changes-

i. Concessional loans of RRBs has been abolished and RRBs started charging commercial interest rates from its customers

ii. The target clients of rural masses and weaker sections were set free and RRBs started giving loans to all customers.

There are two Regional Rural Banks operating in Assam- Assam Gramin Vikash Bank headquartered at Guwahati and Langpi Dehangi Rural Bank headquartered at Diphu.

3.3.6. Investment Banks

An investment bank is a financial institution that assist individuals, corporations and government in raising capital by underwriting and/ or acting as the client's agent in the issuance of securities. These banks also assist corporations involved in mergers and acquisition and provide certain ancillary services such as market making, trading of derivatives, fixed income securities, foreign exchange, commodities and equities. Investment Bank aims at earning income through charging fees and commissions.

Some of the Investment banks in India are: ICICI Securities Ltd, IDBI Capital Market service Ltd, SBI Capital Markets Ltd, etc.

3.3.7. Exchange Banks

Exchange Banks are the banks which facilitates the foreign exchange transactions. They are specialised in financing the foreign trade and have branches in the foreign countries and other important trade centres.

Exchange bank plays an important role in the growth of a foreign trade of a country. They are primarily engaged in converting the foreign currency into domestic currency, and domestic currency into foreign currency. They finance the foreign trade by discounting, accepting and collecting foreign bill of exchange. They also provide other services such as opening letters of credit, issue of foreign currency draft, traveller's cheque, collecting and supplying information about foreign customers, etc.

Apart from financing the foreign trade, they are also engaged in facilitating the internal trade of the country by advancing loans to traders and discount their bill of exchange.

The Exchange bank also performs ordinary commercial banking functions like accepting deposits, advancing loans, agency services, remittance facility, locker facility, etc.

3.3.8. Export Import Bank of India

The Export and Import Bank is an institution engaged in promotion and development of foreign trade in a country. The Export – Import bank of India (EXIM Bank) was established in 1982. Most of the countries have their own Export and Import bank. The main function of this bank is to provide financial and other required assistance to the exporter and importer of a country. Moreover, this institution also act as the Apex institution in regard to export and import by coordinating other institution engaged in export and import for providing all the necessary services for the growth of international trade.

3.3.9. Payment Banks

Payment bank are newly developed form of banking in India. They are differentiated bank (niche banks) which cater to the needs of certain demographic segments of the population.

The objective of payment bank is to boost the financial inclusion by providing-

- Small savings account
- Payments/ remittance services to migrant labour workforce, low income households, small business, other unorganised sectors and other users.

These banks can carry out most of banking operations but cannot advance loans or issue credit cards. They also provide services such as Internet banking, mobile banking, ATM, debit card.

They are registered under Companies Act, 2013 but are governed by host of legislations such as Banking Regulations Act, 1949; RBI Act, 1934; Foreign Exchange Management Act, 1999; Payment and settlement system act, 2007 and the like.

Currently 6 payment banks are operating in India. They are -

i. Airtel Payment Bank

ii. India Post Payment Bank

iii. Paytm Payment Bank

iv. Jio Payment Bank

v. Fino Payment Bank

vi. NSDL Payment Bank

Check Your Progress

1. When was the Reserve Bank of India set up?
2. What is a Co-operative Bank?
3. Mention the 6 Payment Banks.

3.4 Banking System

The banking system refers to the procedure or manner of undertaking banking business by a bank. The banking system of a bank is determined on the basis of business pattern, volume of operation and the area of operation.

The most common system of banking are-

i. Branch banking.

ii. Unit banking

iii. Group banking

iv. Chain banking

v. Retail banking

vi. Universal banking

vii. Wholesale banking

Let us discuss all the above types of banking system briefly.

3.4.1 Branch banking system

Branch banking is a system of banking where the bank provides banking services through a wide network of branch offices. Under this system of banking, the banks may have branches within and outside the country. This system has made the banking more convenient by removing the geographical barriers. In India, since the introduction of organised banking institutions, branch banking system is being followed.

Features of branch banking are:-

a) There is separation of ownership and management of the banks. Ownership lies with the shareholders and the management lies with the single Board of Directors.

b) Under this system, the bank has a head officethrough which it controls the operation of all the branch offices.

c) The customers of the bank can avail banking services from any of the branch offices.

d) There is a manager for each branches, responsible for managing the affairs of the branches.

e) In the preparation of financial statements, the assets and liabilities of the Head office and the branches are aggregated.

3.4.2 Unit Banking System

Unit banking is a system of banking where an independent isolated bank undertakes banking business/ functions in a particular area to cater the financial needs of particular region. They are confined to particular areas and does not have any branches. They are also called localised bank. These banks maintain and control the entire banking operations on their own. Under this system of banking, the banks usually focus on development of local area and better community services. They provide collection and remittance facilities to its customers by taking the help of other banks.

Following are the features of unit bank:-

a) Legal entity: The bank has a separate legal entity.

b) Unit office: It has only one office. It does not have branches.

c) Particular area: It operates in a particular area, where it is established.

d) Ownership: The ownership may be sole proprietorship, partnership or Joint Stock Company.

e) Scale of operations: It operates in small scale and have small capital. Therefore they are not capable of providing huge loans.

3.4.3 Group Banking System

Group banking is a system of banking where two or more banks come together as a group to provide banking services.These individual banks act as a subsidiary of the holding or parent company. The holding company may be a banking or non-banking institutions.The main purpose of this type of banking is to unify the management of banks and to achieve economies of large-scale operation.

Following are the features of Group Banking system:-

a) The individual banks are controlled by the holding company.

b) Each individual banks have their own separate identity

c) The individual or the participating banks have their own Board of Directors which is responsible to the holding company.

d) The Board of Directors of individual banks are responsible to the depositors for the proper management of the banks.

3.4.4Chain Banking System

Chain Banking is a system of banking when a small group of individuals control two or more banks which are independently chartered. In this system a number of separately incorporated banks are controlled through holding majority of shares in each bank or inter-locking of directorship.

Each bank retains its own separate entity and carries out its operations without the interference of any central organisation. The purpose of chain banking is to maximise profit and goodwill in the market. The banks which entered into chain banking within a community, had less scope of competition from other banks operating in the same area.

Features of Chain banking are:-

a) It offers services to the investors in the form of consistent return and complete control.

b) There is optimum utilization of resources to maximise profit.

c) Due to centralised and unified control it provides quick decision-making.

3.4.5 Retail Banking System

Retail banking is a system of banking which is concerned about the current requirements of the individual customers. It provides financial services to the individual consumers rather than the corporate clients. It is also known as consumer banking or personal banking.In other words, all the services that an individual can avail from a bank falls under the retail banking. For example multiple deposit accounts, credit cards, debit cards, A.T.M, online banking, etc.

Features of Retail banking are:-

a) Retail banks deals with individual customers rather than the corporate clients.

b) Retail banks deals in large number of customers and large volume of transactions having low transaction value.

c) It provides services to wide range of consumers thereby mitigating the risk of non-performing assets.

d) Retail banks provide the services of various deposit accounts, various loans, debit card, credit card, internet banking, mobile banking, etc.

e) With the emergence of internet banking, Retail banks have the luxury of multiple distribution channels.

3.4.6 Universal Banking System

Universal banking is a banking system which offers a set of services under one roof. It carries on the comprehensive financial services comprising of investment banking and commercial banking. In other words, these banks may also be called financial superstore. The services offered are accepting deposits, sale of different financial products, merchant banking, selling of insurance policies, underwriting, book runners, asset under management services, stock broking, money transfer services (RTGS&NEFT), and any other services related to banking.

Features of Universal banking are:-

a) In universal banking system all types of customers are served, such as individuals, corporates, government, etc.

b) In universal banking all types of funds for short, medium and long term are provided.

c) Universal bank provides all types of services such as accepting deposits, advancing loans, credit creation, agency and general utility functions, asset management, merchant banking, bill discounting, fund transfer, etc.

Stop to Consider

In recent years, with the advent of digital banking and the expansion of online service the banking sector in India has witnessed a shift toward technology enabled banking channels. However, branch banking system continues to be a crucial component of the Indian banking landscape.

3.4.7 Wholesale Banking System

Wholesale banking can be described as banking system where the target customers are the large clients, such as banking institutions, non-banking institutions, Government agencies, large corporations, real estate developers. These banking system is opposite to the retail banking system which focuses on individual consumers. Some of the services offered in wholesale banking system are large trade transactions, consultancy, underwriting, working capital financing, mergers and acquisitions.

Following are the features of Wholesale banking system:-

a) Wholesale banking deals with corporate clients rather than individual consumers.
b) It deals with high value transactions with limited number of clients.
c) It provides the services of underwriting, working capital finance, mergers and acquisitions, etc.
d) It has low operational cost but deals in very high risky assets.

Check Your Progress

1. What is Unit Banking?
2. Define Wholesale Banking.

3.5 STRUCTURE OF COMMERCIAL BANK IN INDIA

The Commercial bank in India can be broadly classified as follows:

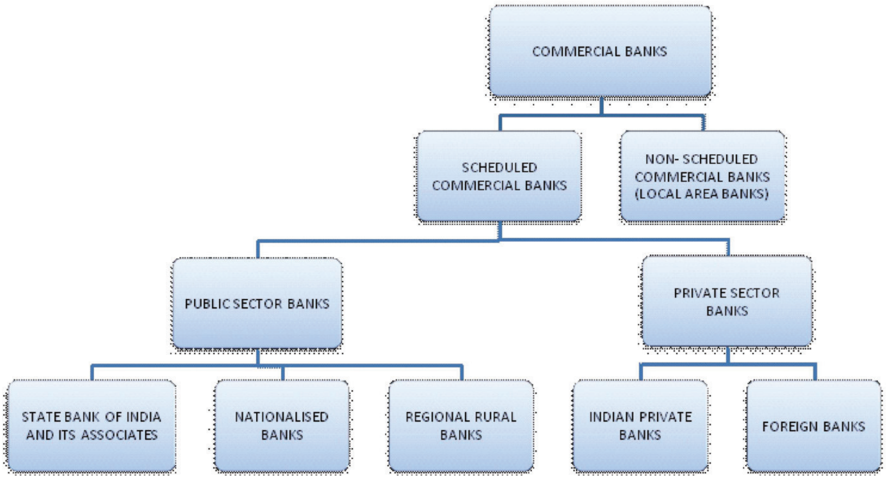


Fig: Structure of Commercial Banks in India

3.5.1 Scheduled Banks: A scheduled bank refers to those banks which are included in the Second Schedule of the Reserve Bank of India Act 1934. The banks that satisfy the criteria under clause 42(6) (a) of this Act. To qualify as a scheduled bank, a bank must satisfy the condition that the paid-up capital and the collected funds of the bank must not be less than Rs.5 lakh. Schedule banks are eligible for loans from Reserve Bank of India at bank rate and are given membership to clearing house.

Scheduled banks are classified into:-

i. Public sector banks

ii. Private sector banks

Let us discuss both the types of public sector banks in details.

3.5.1.1 Public sector banks- Public sector banks are those banks in which the government holds more than 50% ownership. In India, public sector banks are owned and controlled by the government either directly or indirectly through the Reserve bank of India. These banks are also known as 'National banks'.

Public sector banks are further classified into-

3.5.1.1.1 State bank of India and its Associate banks- The state bank of India is the largest public sector bank in India. The State Bank of India earlier had seven subsidiaries. State Bank of Indore was merged with SBI on 26 August, 2010 and State Bank of Saurashtra was merged with SBI on 13 August 2008, leaving only five associate banks. The five associate banks were:

i. State Bank of Hyderabad.

ii. State Bank of Mysore.

iii. State Bank of Patiala.

iv. State Bank of Travancore

v. State Bank of Bikaner and Jaipur.

On 1st October 2017, all these five banks have been merged with SBI, making it the biggest bank in India. At present there are no associate banks of SBI.

3.5.1.1.2. Nationalised Banks- Nationalization of bank means taking over of a bank owned by the private sector into public ownership of a national government by purchasing more than 50% of stake. The main objective of nationalization of the bank was to help achieve balanced regional sectoral and sectional development of the economy by way of making the banking service available to all the section of people and throughout the country, be it rural, urban or semi-urban areas.

- In July 1969, the Government of India nationalised 14 large banks. In April 1980, 6 more banks were nationalised increasing the number of nationalised banks to 20.
- State Bank of India has been merged with State Bank of Saurashtra in 2008, State Bank of Indore in 2009, State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala, State Bank of Travancore and The BharatiyaMahila Bank in 2017.
- Bank of Baroda has been amalgamated with Dena Bank and Vijaya Bank in 2018.
- Punjab National Bank has been merged with Oriental Bank of Commerce and United Bank of India in 2020.

- In 2020, Syndicate Bank was merged with Canara Bank and Union Bank of India was merged with Andhra Bank and Corporation Bank.
- Allahabad Bank was merged with Indian Bank in 2020.

At present there are 12 nationalised banks operating in India after the mergers of Government banks in the year 2020.

3.5.1.1.3. Regional Rural Banks- The Regional Rural Bank was established in October 1975 and added to the Public Sector Banks. Initially five RRBs were set up, two in Uttar Pradesh and one each in Haryana, Rajasthan and West Bengal. At present there are 43 Regional Rural Banks functioning in the country. These banks have been set up with the objective of providing credit and other facilities for agriculture and other productive activities in rural areas. These banks are public sector banks as 50% of their capital is provided by Central government, 15% by the state government concerned and the remaining 35% by the sponsoring public sector commercial banks.

3.5.1.2 Private Sector Banks- Private Sector banks are those banks in which the majority of the stake is held by shareholders of the bank and not by the government. They perform all the commercial banking functions. This segment comprises of:

3.5.1.2.1 Indian private banks: The first private bank in India was IndusInd bank. It is one of the fastest growing private sector banks in India.

The First financial institute in India to receive an "in principle approval" from RBI was the Housing Development Finance Corporation Limited (HDFC), as part of RBI's Liberalisation of the Indian banking Industry. Thus, HDFC bank limited was incorporated as a private bank in January 1995 with its registered office in Mumbai. Some of the private banks operating in India are-

i. HDFC Bank ltd.
ii. ICICI Bank Ltd.
iii. IDBI Bank Ltd.
iv. IndusInd Bank Ltd.
v. Kotak Mahindra Ltd.
vi. Axis Bank Ltd.
vii. Yes Bank Ltd. Etc.

3.5.1.2.2 Foreign Banks- Foreign banks are those banks which are registered or incorporated outside India. They have an office or branches in India. In other words, it can be said that foreign banks are foreign in origin but have a place of business in India. These bank performs almost the same range of functions as being performed by Indian banks. However, they are mostly active players in export and import trade and foreign exchange transactions. Some of the foreign banks are-

i. HSBC Ltd.,

ii. Citibank,

iii. Standard Chartered Bank,

iv. United Overseas Bank Ltd, etc.

3.5.2 Non Schedule Banks- The banks which are not listed in the second schedule of the Reserve Bank of India are called Non-Scheduled banks. These banks are defined in clause (c) of sec 5 of the Banking Regulation Act, 1949 (10 of 1949). The requirements of statutory cash reserve is also applicable to these banks. However, unlike scheduled banks they are not required to keep the reserves with the Reserve bank of India. These banks are deprived from the privileges available to the scheduled banks.

The presence of non-scheduled banks has declined over the years. It has become almost nil now. However, RBI considers the four Local Area Banks as the non-scheduled commercial banks

i. The Costal Area Bank Ltd., Vijayawada.

ii. Capital Local Area Bank Ltd., Phagwara, Navsari.

iii. Krishna BhimaSamrudhi Local Area Bank Ltd., Mehabub Nagar.

iv. Subhadra Local Area Bank Ltd., Kolhapur.

Check Your Progress

1. List two Private Banks.
2. Name the Regional Rural Banks available in Assam.
3. Which is the First financial institute in India to receive an “in principle approval” from RBI?

3.6 Summing Up

- A Bank accept deposits of money from the public and creates credit by making advances out of the funds received as deposits.
- Central Bank is an apex institution which is generally set up by the government of a country to undertake central banking functions. It is an autonomous institution entrusted with the powers of control, supervision of the monetary and banking system of the country.
- Commercial banks performs all kinds of ordinary banking business such as accepting deposits, advancing loans, credit creation, agency and general utility functions. It may be public sector banks, private sector banks and the foreign banks.
- A co-operative Bank is a voluntary association of members which operates on the principle of cooperation, self-help and mutual help. Co-operative banks are set up under the Cooperative Societies Act. They are also regulated by Reserve Bank of India and governed by Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1965.
- Development banks are specialised type of financial institutions which are engaged in providing both fund as well as non-fund based services. They provide medium term as well as long term funds and acts as catalytic agents in promoting balanced development of the country. Industrial Finance Corporation of India (IFCI) was the first institution established as the development bank in 1948.
- The capital of Regional Rural Bank are shared between the Government of India (50 %), concerned State Government (15%) and the sponsoring nationalised bank (35%). These banks are scheduled banks and governed by Regional Rural Bank Act, 1976.
- An investment bank is a financial institution that assist individuals, corporations and government in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. Investment Bank aims at earning income through charging fees and commissions.
- Exchange Banks are the banks which facilitates the foreign exchange transactions. They are specialised in financing the foreign trade and have branches in the foreign countries and other important trade centres. Apart from financing the foreign trade, they are also engaged in facilitating the internal trade of the country by advancing loans to traders and discount their bill of exchange.

- The Export – Import bank of India (EXIM Bank) was established in 1982. The main function of this bank is to provide financial and other required assistance to the exporter and importer of a country.
- Payment bank are newly developed form of banking in India. They are differentiated bank (niche banks) which cater to the needs of certain demographic segments of the population. These banks can carry out most of banking operations but cannot advance loans or issue credit cards. The also provide services such as Internet banking, mobile banking, ATM, debit card.
- Branch banking is a system of banking where the bank provides banking services through a wide network of branch offices. This system has made the banking more convenient by removing the geographical barriers.
- Unit banking is a system of banking where an independent isolated bank undertakes banking business/ functions in a particular area to cater the financial needs of particular region.
- Group banking is a system of banking where two or more banks come together as a group to provide banking services. These individual banks act as a subsidiary of the holding or parent company. The holding company may be a banking or non-banking institutions.
- Chain Banking is a system of banking when small group of individuals control two or more banks which are independently chartered. In this system a number of separately incorporated banks are controlled through holding majority of shares in each bank or inter-locking of directorship.
- Retail banking is a system of banking which is concerned about the current requirements of the individual customers. It provides financial services to the individual consumers rather than the corporate clients
- Universal banking is a banking system which offers a set of services under one roof. It carries on the comprehensive financial services comprising of investment banking and commercial banking.
- Wholesale banking can be described as banking system where the target customers are the large clients, such as banking institutions, non-banking institutions, Government agencies, large corporations, real estate developers.

- A scheduled bank refers to those banks which are included in the Second Schedule of the Reserve Bank of India Act 1934.
- Public sector banks are those banks in which the government holds more than 50% ownership.
- Nationalization of bank means taking over of a bank owned by the private sector into public ownership of a national government by purchasing more than 50% of stake.
- Regional Rural banks are public sector banks as 50% of their capital is provided by Central government, 15% by the State government concerned and the remaining 35% by the sponsoring public sector commercial banks.
- Foreign banks are those banks which are registered or incorporated outside India. They have an office or branches in India.
- Those banks which are not listed in the second schedule of the Reserve Bank of India are called Non-Scheduled banks.

3.7 Key Terms

- Bank - According to Sec 5 (1) (b) of the Banking Regulation Act, 1949, "Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques, draft, and order or otherwise."
- Deposits – A deposit is a financial term that means money held at a bank. A deposit is a transaction involving a transfer of money to another party for safekeeping.
- Commercial Bank – A financial institution which provides the services of accepting deposits and giving loans for investment with the aim of earning profit.
- Loans – A sum of money that is borrowed and is expected to be paid back with interest.

3.8 Model Questions

Short- Answer Questions:

1. What are Regional Rural Banks?
2. Explain in brief about Development Banks.
3. Give the features of Branch Banking System.
4. Why is Payment Bank important in the present era?
5. Write in short about the State Bank of India and its associates along with the latest mergers?

Long – Answer Questions:

1. Explain in detail the types of Banks in India.
2. Elucidate the Banking System in India.
3. Discuss the Structure of Commercial Banks in India.

3.9 References and Suggested Readings

1. Muraleedharan D. 2014, *Modern Banking Theory and Practise*. PHI Learning Private Limited, Delhi.
2. Gupta Shashi K, Sharma R.K, and Gupta Neeti, 2014, *Financial Institutions and Markets*. Kalyani Publishers, Delhi.
3. Nag Rajdeep 2014, *Modern Banking Practises*. Aditya Book Distributor, Guwahati.

******

Unit-4

Recent Developments in Banking Operations: E-banking, Core Banking Services, Electronic Fund Transfer, RTGS and NEFT

Unit Structure:

4.1 Introduction

Banking systems and financial institutions are an integral part of an economy. Seamless functioning of these sectors is important for an economy to grow. Due to the advent of digital technology, banking and financial services have undergone a massive shift in their mode of operations. New trends are gaining momentum at a fast pace as the customers find it convenient and also flexible at the same time. The emergence of financial technology has resulted in the introduction of several technological advancements in the industry. Internet banking and mobile banking are just some examples that mark this shift. This unit will introduce you to the latest trends that are revolutionising the Indian banking and financial sector.

4.2 Objectives

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

- define E-Banking,
- conceptualise the functioning of Core Banking Services,
- understand Electronic Fund Transfer,
- discuss Real Time Gross Settlement and National Electronic Funds Transfer,
- explain the difference between NEFT and RTGS.

4.3 Recent Development in Banking Operations

The face of Indian Banking system has changed over the years. The banking industry has evolved and transferred itself from a social banking to a liberalised , modernised and technology oriented industry. With the growing importance of IT new dimension such as CBS(core banking solution),ATM, net banking, plastic money , RTGS, NEFT etc has evolved over time. We shall focus our discussion on some of the latest developments such as E-banking, Core Banking Service, and Electronic Fund Transfer, RTGS and NEFT.

4.4 E-Banking and E-Banking Services:

E-banking is a blanket term used to indicate a process through which a customer is allowed to carry out, personal or commercial banking transactions using electronic and telecommunication network. It is a product offered by banks which facilitates online banking, with the help of which the customer can have access to the bank account in just one click. Through e-banking, a client can acquire his record and manage numerous exchanges utilising his cell phone or personal computer.

Electronic banking has many names like web-based banking, e-banking, virtual banking, or web banking, and online banking. It is just the utilisation of telecommunications networks and electronic networks for conveying different financial services and products. It covers facilities such as – fund transfer, checking account statements, utility bill payments, opening of bank account, locating nearest ATM, obtain information on financial products and services, applying for loans, etc. using a personal computer, smartphone, laptop or personal digital assistant.

4.4.1 E-Banking Services

E-banking refers to a banking arrangement, with which the customer can perform various transactions over the internet, which is end-to-end encrypted, i.e. it is completely safe and secure. It promotes paperless/ cashless transactions and comes with a number of rights, responsibilities and fees as well. The range of services covered under E-banking are:

Internet Banking

A banking facility provided to the customers through which the customers are able to perform a number of monetary and non-monetary transactions, using the internet, through the bank's website or application.

Here are some of the best features of internet banking:

- Provides access to financial as well as non-financial banking services
- Facility to check bank balance any time

- Make bill payments and fund transfer to other accounts
- Keep a check on mortgages, loans, savings a/c linked to the bank account
- Safe and secure mode of banking
- Protected with unique ID and password
- Customers can apply for the issuance of a chequebook
- Buy general insurance
- Set-up or cancel automatic recurring payments and standing orders
- Keep a check on investments linked to the bank account

Mobile Banking

Almost all the banks have designed their mobile applications with which one can perform transactions at their fingertips. For this, four things are required – a smartphone, internet, mobile application, and mobile banking service enabled in the bank account.

Automated Teller Machines (ATM)

Automated Teller Machine, popularly known as ATM is one of the most common and initial service, provided under e-banking. It is not just a machine with which one can withdraw cash as and when required, but it also allows a customer to check their account status, transfer fund, deposit fund, changes mobile number, change Debit Card PIN, i.e. Personal Identification Number.

Debit Card

Debit cards are used in our day to day life so as to perform end number of transactions. Debit cards are linked to the customer's bank account and so the customer only needs to swipe the card, in order to make payment at Point of Sale (POS) outlets, online shopping, ATM withdrawal. In this way, the amount is deducted from the customer's account directly.

Credit Card

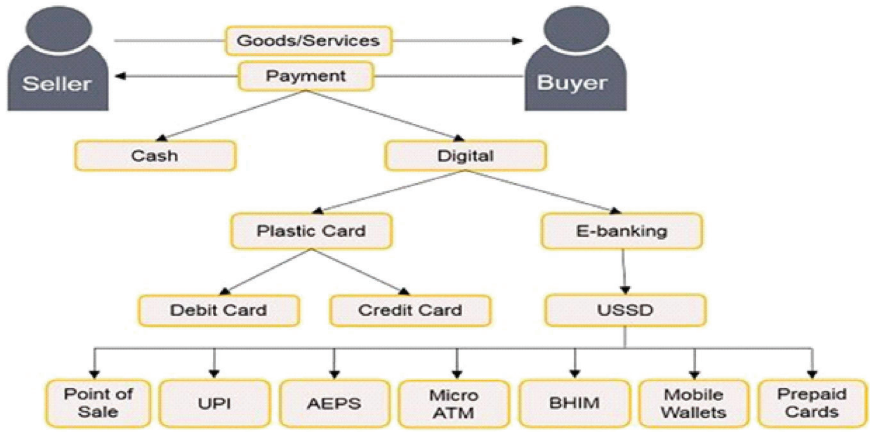
Just like a debit card, a credit card is also a payment card which the banks issue to the customers on their request, after checking their credit score and history. It enables the cardholder to borrow funds upto the pre-approved limit and make payment. The limit is granted by the banks which issue the card. The cardholder promises to repay the amount within a stipulated time, with some charges, for the use of credit card.

Point of Sale (POS)
Points of sale system refers to the point, in terms of date, time and place (retail outlet) where the customer makes a payment, using a plastic card, for the purchase made or services received.

Electronic Fund Transfer (EFT)

When money is transferred electronically from one bank to another, it is called as electronic fund transfer. It covers direct debit, direct deposits, wire transfers, NEFT, RTGS, IMPS, etc.

Let us understand E-Banking better



Stop to Consider
Are electronic banking and internet banking the same?
No, electronic banking and internet banking are often confused with each other. However, these are two different services launched by the bank. Electronic banking is a broad term or category which includes various forms of banking services and transactions performed through electronic means such as internet banking, mobile banking, telebanking, ATMs, debit cards, and credit cards. Internet banking is one of the latest additions to electronic banking. Thereby, internet banking is a part of electronic banking.

4.4.2 Significance of E-Banking

A. Importance to customers

Convenience of initiating financial transactions: E-banking is largely preferred because of the convenience that it provides while fund transfer and bill payments. Registered users can use almost all the banking services without having to visit the bank and standing in queues. Financial transactions such as paying bills and transferring funds between accounts can easily be performed anytime as per the convenience of the user.

Proper Track of Transactions: Acknowledgement slips are provided by the bank after transactions which have a high possibility of getting misplaced. However, with internet banking, it becomes very easy to track the history of all the transactions initiated by the user. Transactions and fund transfers made online are organised in the 'Transaction History' section along with other details such as payee's name, bank account number, the amount paid, the date and time of payment, and remarks.

Quick and Secure:E-banking users can transfer funds between accounts instantly, especially if the two accounts are held at the same bank. Funds can be transferred via NEFT, RTGS or IMPS as per the user's convenience. One can also make bill payments, EMI payments, loan and tax payments easily. Moreover, the transactions, as well as the account, are secured with a password and unique User-ID.

Non-financial Transactions: Besides fund transfer, internet banking allows the users to avail non-financial services such as balance check, account statement check, application for issuance of cheque book, etc.

Lower cost per exchange: Since the customer doesn't need to visit the branch for each exchange, it saves him both time and cash.

No topographical hindrances: In conventional financial frameworks, geological distances could hamper specific financial exchanges. Nonetheless, with e-banking, geological obstructions are diminished.

B. Importance to Businesses

Better efficiency: Electronic banking further develops usefulness. It permits the computerisation of ordinary, regularly scheduled payments and provides further banking activities to upgrade the efficiency of the business.

Lower costs: Usually, costs in financial relationships and connections depend on the assets used. Assuming that a specific business needs more help with deposits, wire transfers, and so on, at that point, the bank charges its higher expenses. With internet banking, these costs are limited.

Lesser errors: Electronic banking diminishes mistakes in normal financial exchanges. Awful penmanship, mixed-up data or information, and so on can cause mistakes that can be exorbitant.

Diminished misrepresentation: Electronic banking gives an advanced impression to all representatives who reserve the privilege to alter banking exercises. In this manner, the business has better perceivability into its exchanges, making it hard for any fraudsters from committing crimes.

Account reviews: Business proprietors and assigned staff individuals can get to the records rapidly utilising a web-based financial interface. This permits them to audit the record action and, furthermore, guarantee the smooth working of the account.

C. Importance to banks:

Lesser exchange costs: Electronic exchanges are the least expensive methods of exchange.

Lesser desk work: Advanced records decrease desk work, paperwork, and make the cycle simpler to deal with. Likewise, it is ecological.

Decreased fixed expenses: A lesser requirement for branches which converts into a lower fixed expense.

More steadfast clients: Since e-banking administrations or services are convenient to the clients, banks experience higher reliability from their clients.

A decreased edge for human blunder: Since the data is handed-off electronically, there is no space for human mistakes or errors.

4.4.3 Advantages of E-Banking

E-banking has changed the banking system completely developing a convenient banking system. Some of the reasons for adopting e-banking may be highlighted as under.

i. Faster Transactions

E-banking provides the facility of instant transfer of funds to its customers. It saves the time of customers as funds get transferred very fast from one account to another. People don't need to wait in queue to transfer their funds or pay off their bills; they can easily do it through their device. It saves the time of customers as they can easily access their account with the help of their device.

ii. Lowers Transaction Cost

E-Banking reduces the cost involved in doing financial transactions. Electronic transactions are termed as the cheapest medium of doing transactions. It reduces the manpower requirements as workload is reduced.It has also reduced the paperwork in organisations as all transactions are recorded digitally.

iii. Provides 24×7 Service

This is the most important feature of e-banking. E-Banking provides customers with all-time access facility to their accounts. Customers can easily access their account anytime and from anywhere with no limitations. It provides convenience to the customers as they can perform transactions as per their wish.

iv. Reduces the chances of error

E-banking has reduced the chance of human error. It has reduced the role of the human in the whole transaction process. E-banking system works fully automated over the internet. All transactions are recorded and stored digitally. So, the chances of human error are minimised.

v. Develops Loyalty in Customers

E-banking helps the banks to develop large number of loyal customers. Through E-banking service banks are able to serve their customers well. They are able to provide fast & better service to customers. Customers are able to get a user-friendly interface from the banking website. They are able to avail services any time even from their home comfort. This develops a sense of loyalty among customers when they are happy with the services of their banks.

vi. Removes geographical barriers

E-Banking has removed all distance barriers for performing transactions. It has removed all distance barriers that customers used to face in the traditional method of performing transactions. It provides the facility of instant transfer of funds both nationally and internationally. All systems are connected to each other online which facilitate easy transfer of funds.

vii. Provides better productivity

E-banking plays an efficient role in increasing the productivity of the businesses. The whole financial transaction system is supported by automated software systems. These systems are specially designed for doing transactions of funds.It thus reduces the time required for doing transactions and also reduces the workload of business organisations. It increases the overall productivity of the businesses.

viii. Reduce frauds in transactions

Another important feature of e-banking is that it helps in continuously monitoring of accounts. A customer can easily track each and every transaction of their accounts. They can easily track if any fraud is done by anyone in financial transactions.It provides a complete digital footprint of all those who can modify a customer's banking activities and commit fraud.

4.4.4 Disadvantages of E-Banking

E-banking has various advantages which improves the banking system but there are disadvantages of using it too. These are as follows:

i. Security issues

Internet banking is completely insecure as there are many problems related to the website and data can be hacked by the hackers. It can lead to financial loss to the users. The financial information can also be stolen that can also create financial loss.

ii. Lack of direct contact between customer and banking officer

E- banking requires effective customer service for handling issues faced by the user. But lack of customer support creates disappointment among the customers. There are some online payments which may not be reflected in the system due to technical issues. It also creates insecurity among the customers. Thus, the lack of support from customer service executive is a barrier in online banking.

iii.Transaction problem

During online banking there are various issues faced by the user such as transferred payment is not reflected, payment failed, and other issues due to technical support.

iv. Long procedure to access e-banking

In order to avail internet banking facilities a procedure needs to be followed which sometimes requires quite a lot of formalities as well as time. A form to avail the service needs to be filled in and sent for approval. Once approved, the customer can access security password to log in. The App then needs to be downloaded and all credentials needs to be filled for logging in successfully.

v.Training and development

The banks need to conduct training and development program for employees for providing quality online services which enhance the customer experience. It requires huge investment to train them for providing effective services.

4.5 Core Banking Services

Core Banking is an umbrella term that refers to the services rendered by a range of networked bank branches. It is a back-end system through which banking transactions related to deposit, loans, and credit can be processed daily across different bank branches, and updates are recorded and reflected immediately. Core banking is a business carried out by the bank with its retail and small business customers.

It assists customers to handle the transfer of funds in a quick turnaround time. Moreover, the updates related to the customer accounts are automatically posted. This is to empower the present and potential customers to achieve more freedom, as to their account transactions.

The word 'core' in the core banking system, expands to a Centralized Online Real-time Environment, which implies that applications are accessed by bank branches from centralized data centers. Hence, whenever a deposit is made, it is updated instantly on the bank's servers, and the customers are allowed to withdraw money from any branch or ATM throughout the world.

4.5.1 Need For Core Banking Services

Use of Information Technology is vital for the growth, and long term survival of any industry, and the same applies to the banking industry as well. Banks can benefit by using such technologies in terms of reduction in operation costs etc. The need for core banking is significant because it can satisfy the needs of the market and customers. Core banking is needed as it can improve and simplify the process of banking and provide convenience to customers and banks.The rural areas are unexposed to such technologies, and they are unable to access banking facilities due to various reasons. Core banking can help in expanding the banking facilities to the remote and rural areas of this country.

The requirement for computerized banks in India was felt in the early 1980s. Various national committees were formed by the government to modernize the banking system in India.

In the late 1980s, the then deputy governor of Reserve Bank of India (RBI) Dr C Rangrajan implemented the concept of core banking in India. It formed a platform for facilities like telebanking, off-site ATM's and customer terminal.

In the 1990s, core banking was transformed when private sector banks and foreign banks started having access to the Indian banking industry. The progress continued due to globalization, liberalization and the introduction of TRAI(Telecom Regulatory Authority of India).

Implementation of the core banking system in India was a landmark moment for the Indian banking industry. It has transformed the way business of money is handled and the functioning of banks. Core banking could be just a beginning, paperless and branchless banking system could be the future of Indian Banking industry.

4.5.2 Objectives of Core Banking Services

The key objective of adopting core banking technology is to improve the customer experience. It ensures customer convenience and allows "anytime and anywhere" banking.

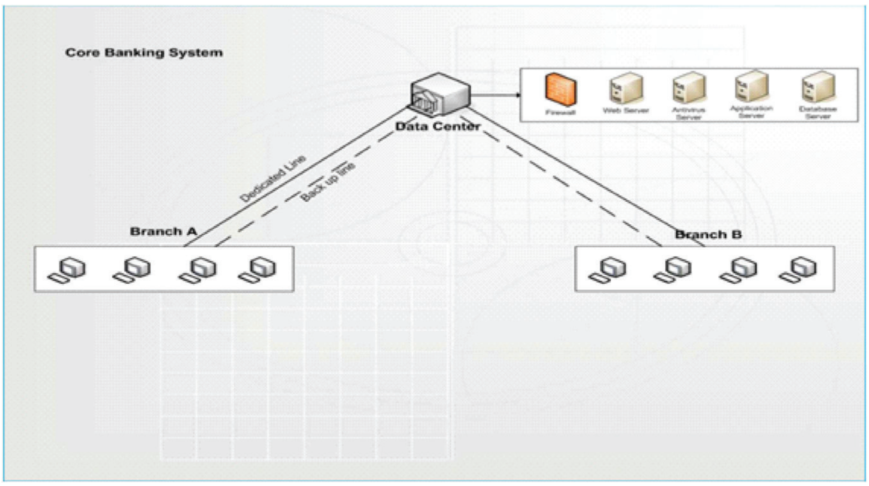
Simultaneously, it has drastically changed the way the banks function. Previously, basic bank functions like maintaining records of the account holders, deposits, transactions, maintaining ledger records, customer information, loan accounts, and others were performed manually. With the introduction of IT technology, various applications have been developed to automate these processes. Now, recording the transactions, calculation, assimilating customer information and maintaining a huge database is possible through software that enables automatic recording in the digital backend database. And the same software is installed throughout the systems of the many branches of the banks, creating a core banking network of the bank.

Another core objective of this new technology is to make informed decisions with the help of facts and figures. The various processes of the core banking system enable banks to store the data in proper format. All the data and reports can be quickly accessed through an authentication system and allow the customers and employees to make informed decisions.

Additionally, it helps in generating and providing the statutory and regulatory reports to the regulators of the government. Furthermore, core banking software provides the opportunity for customization.

In simple words, core banking is a bank automation process that aims to provide impeccable means of book-keeping, enhanced customer services and ease the decision-making process. When all of these fundamental goals are achieved, it eventually leads to increased efficiency, customer satisfaction, and profitability.

ILLUSTRATION



4.5.3 Features of the Core Banking Services.

Some of the key features of the Core Banking Services are as follows:

i. Opening new accounts in the bank

ii. Processing and recording money deposits and cash withdrawal

iii. Calculating loan interest

iv. Processing loans

v. Cheque clearance

vi. Payment clearance

vii. Managing customer information

viii. Calculating and managing interest rate

ix. Maintaining customer relationship

x. Assists in developing new banking products

xi. Banking analytics

xii. Banking products like mobile banking, internet banking, ATMs and more.

4.5.4 Advantages of Core Banking System

With a better understanding of the working principle and features of the core banking platform, the key benefits of theCore Banking System can be highlighted as under:

i. Enhanced productivity

Core banking platforms increase operational efficiency by reducing the time it takes to connect with multiple branches. As a result, banks can process transactions faster, regardless of the client's physical location.

ii. Improved security

Core banking systems use advanced encryption modules to protect the infrastructure from hackers and malware. On the client's side, bio-verification and two-factor authentication also provide additional layers of security to the platform. These features help banks maintain KYC standards and comply with other banking regulations.

iii. 24/7 access to banking services

In this era of contactless payments, access to round-the-clock bank services is vital. Users can conduct financial operations anywhere and anytime since the core banking platform never goes offline. Customers can also contact customer support for assistance at any time.

iv. Lower operational costs

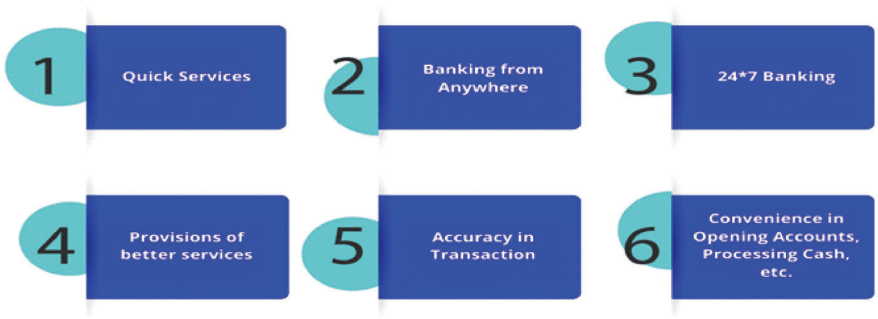
Banks can rely on their core platforms to reduce operational costs since these systems require fewer human resources to function. Besides, the powered infrastructure increases the completion rate of operations and reduces the chances of errors in documentation.

v. Multiple currencies

The customers can trade in multiple currencies instantly without needing to change large amounts at a currency exchange.

In a nut shell it can be seen that customers are benefitted in multiple ways – round-the-clock banking, quicker services anywhere, anytime, convenience of banking processes through a single datacenter, rural/remote area penetration and so on.

Banks benefit in no lesser way. Among the primary boons are process standardization, customer retention, improved documents management and considerable eradication of errors, and better safety & compliance process.



4.5.5 Limitations of Core Banking System

Despite the benefits of core banking system, it still has certain flaws like:

i. Technical downtimes can disrupt regular banking operations, thereby frustrating customers.

ii. Using a core banking system can introduce a single point of failure that affects all branches simultaneously in the case of a cyber-attack.

iii. Modern core banking systems can be expensive to buy and maintain, especially for small and medium-sized banks.

iv. Legacy core banking software can leave the entire infrastructure vulnerable to system failure. The modernization effort will also cost a lot of money.

4.4.6 How Does Core Banking Work

A core banking system comprises back-end servers that handle standard operations like interest calculation, passbook maintenance, and withdrawal.

For example, when a customer withdraws money from a branch or an ATM, the application sends a request to the centralized data centre, which then processes the request and authenticates the operation.

The data centre contains the database, an application server, a web server, and a firewall to protect the system from malware attacks. Banks can host their data centre locally or on the cloud.

To have a successful Core Banking system, the following criteria needs to be fulfilled:

i. Centralized Dashboard

Bankers need a single-view dashboard to visualize the system in real time. Also, bankers and customers should have access to the same dashboard view which will help diagnose and solve issues faster.

ii. Onboarding (with KYC features)

Before using the dashboard, the customer must sign in to their account with a unique username and password. With KYC features, banks can verify identities of prospective customers when they register. The onboarding process should also be simple enough for users to complete without stress.

iii. Two-factor authentication

The system needs to offer two-factor verification to boost security and protect customers' sensitive data.

iv. Push notifications

When building a core banking solution for mobile, push notifications should be installed to deliver timely account updates to customers.

v. Loan management

The core banking solution must allow customers to monitor their loans and schedule payments according to the specified plan.

vi. Interest calculators

For loan and mortgage payments, users need access to real-time calculators to help them make informed decisions.

vii. Live chat

A live chat feature must be on the platform to help users contact support agents when they need assistance. Automated chatbots can also provide templated answers to frequently asked questions.

viii. Transaction management

Customers can customize their popular payments and P2P transfers to ensure that their contact lists remain updated. They can also use multi-currency exchanges to trade on their preferred currencies.

Core banking in India has tremendously evolved in the past few years, and it is still evolving. Therefore, one can expect better and improved features in the future. Almost all private sector banks and public sector banks in India have adopted the core banking system. Still, some are left to adopt, but RBI is hopeful of 100% implementation of this system all over India.

Check Your Progress

1. Define E-banking. State any two features of e-banking.
2. Mention any two merits and demerits of adopting e-banking by the modern commercial banks.
3. Note down the services provided under e-banking.
4. What is a Core Banking Services?
5. How does CBS work?

4.6 Electronic Funds Transfer

An electronic funds transfer is a widely used method for moving funds from one account to another using a computer network. Electronic funds transfers replace paper-based transfers and human intermediaries, but provide the customer with the convenience of doing their own banking.

In simple words, an electronic funds transfer (EFT) is the electronic transfer of money over an online network.

Electronic funds transfers can be performed between the same bank or a different one, and can be accomplished with several different types of payment systems. An EFT can be initiated by a person or by an institution like a business and often doesn't require much more than a bank account in good standing.

Every time a banking customer uses her credit or debit card, whether at a physical point-of-sale or online, she's engaging in an electronic funds transfer. Any preauthorized charges, such as direct deposits or utility bills, also utilize an EFT.The most popular form of electronic funds transfer is a direct deposit, in which an employee of a company preauthorizes his/her employer to pay the salary directly into his/her bank account.

Numerous other electronic funds transfers exist, including the following:

- ATMs.

- Online peer-to-peer payment apps like PayPal and Venmo.
- Pay-by-phone systems.
- Wire transfers.
- Online or mobile banking.
- Electronic checks.

4.6.1 Understanding Electronic Funds Transfer (EFT)

Every transaction has a starting point. The starting point happens anytime a money transfer is initiated through an electronic system with an electronic funds transfer. These systems include ATMs, computers, telephones, remote banking programs, or magnetic tape (the black data stripe on the back of credit and debit cards).

Making an electronic funds transfer is fairly straightforward. The process allows the person sending money to initiate a transfer from an originating account.

EFTs work via electronic signals that the sender generates when initiating sending money to the receiver. Instantly the networks and the servers or payment terminals receive the signals to initiate and continue with the payment. The receiver and the sender can be many parties like employers to their employees, vendors to customers, retailers, etc.

EFT is possible by initiating a digital cheque — usually between vendors and retailers during the purchase, direct deposit and phone payments — for utility payments, ATMs and card payments or internet transactions via proper authorization.

Electronic funds transfers are secured by a personal identification number (PIN) or the login information that unlocks the customer's online banking service. ETFs are encrypted across 128-bit signals, ensuring security. As such, they are secure and swift, and cost effective for businesses.

It requires very little effort to set up, usually requiring a bank account and proper documents to allow transfers at the time of set-up only. During the transfer, there is no necessity of providing documents or physical presence to initiate the transaction.

Stop to Consider.

- *Have you availed e-banking services? If yes, which are the most frequently availed services by you. Note down.*
- *Identify the core banking service provided by your bank branch or the branch nearest (any bank) to you.*

4.6.2 Types of Electronic Funds Transfer

Electronic funds transfer can be considered a blanket term that describes all digital money transactions. To help you better understand, here are some common types of EFT services you may encounter.

1. Direct Deposit

This allows a user to authorize specific deposits into their bank account, including paychecks, social security checks, or other benefits. One can also preauthorize automatic withdrawals directly from your bank account for recurring expenses such as auto insurance, mortgage payments, and utility bills.

2. ATM

An ATM (Automated Teller Machine) is an electronic terminal that allows access to a bank almost anywhere at any time. A person can use them for withdrawing cash, making deposits, or transferring funds between accounts. The process generally involves inserting an ATM card and entering the security PIN.

3. Personal Computer Banking

Being able to handle banking tasks straight from the comfort of your home is a reality due to online banking. By using one's personal computer and a secure internet connection, a person can make transfers between accounts or even pay bills electronically. There are also apps that extend this service to smartphones.

4. Pay-by-Phone Systems

Making an electronic funds transfer by phone (telephone banking) involves calling the customer's financial institution and providing instructions to either pay specific bills or transfer money between accounts. Typically, the customer must have an agreement with their bank or credit union to make these transfers.

5.Debit or Credit Card Transactions

Whether using a debit or credit card, both works similarly by allowing a person the ability to make purchases or make payments. Card transactions can occur in person, online, or via phone. The most significant difference between the two is that debit card purchases quickly remove money from the account. Hence, it's crucial to make sure the money in the account is sufficient to cover your payment before using a debit card.

6. Electronic Cheque Conversion

This is a process that converts paper cheques into electronic payments. It works because a digital cheque gets generated after being authorized by the person making the payment or purchase. This can be done in a store or after a company receives the cheque by mail.

7. Peer-to-Peer Payment Apps

Sending money to someone you know is easier than ever since the introduction of peer-to-peer (P2P) payment apps such as PayPal, Venmo etc. These apps allow the sender to transfer money to another person by entering the recipient's email address or phone number. Most of these transactions occur in real-time. However, in most cases, P2P payments do not offer the same protections as debit and credit cards. The sender may be solely held responsible for losses if the incorrect email or number is entered and money is mistakenly sent to the wrong person.

4.6.3 Advantages and Disadvantages of Electronic Funds Tranfer (EFT)

A. ADVANTAGES

i. Cost-effective: For businesses, EFTs are a cost-effective way to save money on printing paper cheques and postage. EFTs not only eliminate the risk of human counting errors and fraudulent bills, but they also eliminate the risk of cheques being lost or intercepted in the mail.

ii. *Safe and convenient:* For consumers, no matter which method is chosen, transferring funds typically requires minimal effort. In addition, it eliminates the need for visiting bank branches in person, which increases the consumer-convenience factor.

B. DISADVANTAGES

i. *Debit cards are susceptible to fraud:* If a debit or ATM card is lost or stolen, the person could lose money if he doesn't report the loss quickly enough.

ii. *Isn't always immediate:* Depending on the business and type of recurring transaction, it could take a few days or a few weeks to cancel recurring payments or direct deposits. Plus, fees could be involved, especially if one requests for a stop payment.

iii. *Electronic Funds Transfer Fees:* When using an ATM, it's important to note that some financial institutions and ATM owners may charge fees. These fees may be more likely if a person doesn't have an account with the ATM owner or transactions occur at remote locations.

4.7 Real Time Gross Settlement (RTGS)

With the digitalisation of banking transactions, many new receiving and sending money methods have come into place. One such way of transaction in money is RTGS, which stands for Real-Time Gross Settlement. It is a system in which money can be transferred from one bank account to the other instantly.

The term real-time gross settlement (RTGS) refers to a funds transfer system that allows for the instantaneous transfer of money and/or securities.It is a process used for the transfer of funds instantly from one bank to another bank. It involves high-value transactions. It is the continuous process of settling payments on an individual order basis without netting debits with credits across the books of a central bank. Once completed, real-time gross settlement payments are final and irrevocable. In most countries, the systems are managed and run by their central banks.

To simplify it, Real-Time Gross Settlement or RTGS means transaction takes place in "real-time", that is, the transaction or settlement takes place immediately as per the requestor's instructions without any delay. And "Gross Settlement" means that the transactions are settled on a one-to-one basis and not on a deduction of one amount from another or netting-off basis.

The meaning of RTGS in banking is a real-time fund transfer system for the customers to initiate money transfers from anywhere using online banking services. The customer can also transfer funds using the offline mode where they are required to deposit the money in the bank branch that provides RTGS services and submit a form requesting fund transfer through the RTGS system.

4.7.1 Importance of Real-Time Gross Settlement (RTGS)

The Real-Time Gross Settlement system (RTGS) is an important element in today's banking system in which maximum transactions are performed online. In the fast-moving business environment where time is a major constraint and security of money or funds is a major concern, RTGS provides a fast and secure measure for high-value money transactions.

The RTGS transactions are safe and secure. The high-value transactions are settled in real-time on a one-to-one basis. Also, the RTGS system is legally backed and is controlled by the Reserve Bank of India. Thus, the risk is reduced as compared to other modes of transfer.

There are no geographical limitations in transferring funds within India. The customers can access internet banking on their mobile devices and laptops from anywhere and utilise this service to transfer money to other bank accounts in any country's location.

The service of RTGS can be availed on a 24*7 basis. Thus, the funds can be transferred through online mode using the Real Time Gross Settlement Service even on the weekends and bank holidays. Therefore, the customers can initiate transactions anytime. Moreover, There is no delay in processing RTGS requests, and the funds can be transferred speedily.

There is no upper limit for the amount that can be transferred using this system. Any amount above Rs 2,00,000 can be transferred using RTGS. However, some banks can impose restrictions on the maximum amount transferred using the RTGS service through Net Banking.

4.7.2 Modes to Use RTGS System

The customers can transfer the funds from one bank account to another via the RTGS system in the following two ways:

1. Online mode- The customers can use the RTGS service at their comfort in online mode using their mobile and Internet banking.
2. Offline mode- The customers can also transfer the funds using RTGS through offline mode. For this, they need to visit the bank branch that

provides the RTGS service and deposit the funds to be transferred in cash and fill up an RTGS request form for RTGS payment.

4.7.3 Process of Real Time Gross Settlement (RTGS)

A. Limits for transfer

The amount to be transferred using the RTGS system shall not be less than Rs 2 Lakh. An amount less than this limit cannot be transferred using the RTGS system.However, any other mode like net banking, national electronic Funds transfer or NEFT etc., can be used.

The Real-Time Gross Settlement (RTGS) system is mainly used for high-value transactions. Therefore, there is no upper or maximum limit of the amount of money transferred utilising this system.

B. Information sought in the process

To transfer money via RTGS, a user needs to mention the following information:

1. Name of the beneficiary, the person to whose account the money is to be transferred.
2. The amount needed to be transferred.
3. Name of the bank of the receiver or beneficiary of the money.
4. The IFSC code of the bank name of the receiver or beneficiary.
5. The beneficiary's account number, the person in whose account the money will be transferred.

Stop to Consider

A beneficiary is a person to whom the funds are to be transferred or, in simple terms, the receiver of the money. The fund's transfer under the RTGS system can occur only after 24 hours of adding a beneficiary. The maximum amount that can be transferred without adding a beneficiary is Rs 50,000.

With the Indian government's endeavour to enable maximum financial transactions through online mode, money transfer has become faster, safer and more accessible. It is easy to track online transactions, and therefore, it has increased the transparency in the banking system. The Real-Time Gross Settlement (RTGS) is helpful for businesses. A fast-growing economy also needs a faster money transfer system. RTGS payments can be made using net banking and mobile banking without the use of cheques or drafts. Hence, RTGS is a safe system for transferring higher amounts.

4.8 National Electronic Funds Transfer (NEFT)

NEFT stands for National Electronic Funds Transfer. Started in November 2005, NEFT is an electronic funds transfer system set up and managed by the Reserve Bank of India. NEFT allows the online transfer of funds from one NEFT-enabled bank account to another.

4.8.1 Features of NEFT

The National Electronic Funds Transfer system is one of the various methods of online money transfer. It is regulated by the RBI and hence, works as per the guidelines laid down by RBI. Some of the unique features of NEFT can be summed up as under:

i. NEFT is a one-to-one payment facility.

ii. NEFT transactions can be processed only between the banks that offer NEFT-enabled services.

iii. Transactions made through NEFT do not take place in real-time; implying that it takes a few days for NEFT transactions to complete.

iv. Earlier,any NEFT transaction could be processed only between 8:00 AM and 6:30 PM from Monday to Friday and 8:00 AM to 12:00 PM on Saturdays. However, from 2020, NEFT transactions can be performed 24*7.

v. To transfer funds through NEFT, one must add beneficiaries on the internet banking portal of the required bank.

vi. There are no limits on the amount of NEFT transactions.

vii. There is a fee applicable on all NEFT transactions; the amount varies from Rs. 2.5 to Rs. 25, depending on the amount being transferred.

viii. As per RBI guidelines, the payments made via NEFT are processed and settled in batches of half-hour

4.8.2 Operation of NEFT

Under NEFT, individuals, corporate and firms can be able to transfer funds electronically from any bank branch to any individual, corporate or firm having an account with any other branch of a bank in India participating in the Scheme. Here are the processes you should know about the NEFT system.

Step 1: First, an individual or corporate or firm who wants to originate a transfer of funds through NEFT, will have to fill an application form giving details of the beneficiary and the amount to be remitted.

For example, details like name of the beneficiary, name of the bank branch where the beneficiary has an account, IFSC of the beneficiary bank branch, account type and the account number have to be filled in. The application form will be available at NEFT enabled originating bank branch.

The remitter will have to authorise their bank branch to debit their account and remit the specified amount to the beneficiary.Customers enjoying net banking facility offered by their bankers can also initiate the fund transfer request online. Some banks offer the NEFT facility even through the ATMs.

Step 2: In the next step, the originating bank branch will prepare and send a message to its pooling centre (also known as the NEFT Service Centre).

Step 3:The pooling centre will then forward the message to the NEFT Clearing Centre (operated by National Clearing Cell of RBI in Mumbai) to be included for the next available batch.

Step 4: The Clearing Centre will sort the fund transfer transactions destination bank-wise, prepare to account entries to receive funds from the originating banks (debit) and provide the funds to the destination banks (credit).

Thereafter, bank-wise remittance messages will be forwarded to the destination banks through their pooling centre (NEFT Service Centre).

Step 5: The destination banks will receive the inward remittance messages from the Clearing Centre and pass on the credit to the beneficiary customers' accounts.

4.8.3 Advantages of NEFT

- NEFT makes the transfer of funds easy, convenient and feasible.
- All NEFT transactions take place online; hence, there is no involvement of a third party.

- Owing to the involvement of RBI, NEFT transactions are completely safe and secure.
- The receiver and sender of the funds gets notified instantly upon completion of the transaction.
- NEFT does not require cheques or demand drafts while transferring money; hence, it is economical.
- Any account holder, whether an individual, firm or corporate can carry out NEFT transactions. The only required condition is that the banks of both the parties must be NEFT-enabled.
- Apart from transferring money, a person can also use NEFT to pay one's loan installment, credit card dues, EMIs, etc.

4.8.4 Difference Between NEFT and RTGS

NEFT (NATIONAL ELECTRONIC FUNDS TRANSFER)	**RTGS (REAL-TIME GROSS SETTLEMENT)**
Through National Electronics Funds Transfer, transactions of any amount can be sent to the recipient's account without any maximum limit to the funds that can be sent in a day	Large amounts of funds can be used to transfer instantly with Real-Time Gross Settlement. The transaction speed is faster than any other form of online payment.
The National Electronic Funds Transfer method does not have a minimum transfer limit ceiling.	The minimum amount needed to be transferred has to be of Rs. 2 Lakhs and above for RTGS
Any NEFT transaction would be processed only between 8:00 AM and 6:30 PM from Monday to Friday, and 8:00 AM to 12:00 PM on Saturdays. *However, from 2020, NEFT transactions can be performed 24*7.*	The Reserve Bank of India (RBI) has allocated the following time-slots for Real-Time Gross Settlements settlements: • 9:00 AM – 4:30 PM on weekdays • 9:00 AM – 1:30 PM on Saturdays *However, RTGS is now available 24*7*
The settlement of funds happens on a half-hourly basis	The settlement of funds is instantaneous and happens in real-time
The NEFT mode is used when the transactions are of smaller values.	RTGS is used in high-value transactions.

The National Electronic Funds Transfer system was introduced in November 2005 to replace the Special Electronic Fund Transfer (SEFT) system that was in use at the time.	The Real-Time Gross Settlement system was first implemented in India in March 2004 as a major technology-based electronic funds transfer system across the country.
When NEFT transactions fail or are not processed on time, destination banks are required to return the fund to the originating branch within two hours of completion of the batch in which the transaction was processed	In an event when transactions fail, the money is credited into the sender's account once the money is received back by the remitting bank. The funds are returned to the originating bank within one hour or before the end of the RTGS business day or whichever comes first

** *https://byjus.com/free-ias-prep/difference-between-neft-and-rtgs/*

Check Your Progress

1. Identify the various means of Electronic Funds Transfer(EFT).
2. What are the advantages of EFT ?
3. Mention any two advantages of NEFT and RTGS

4.9 Summing Up

New trends are gaining momentum at a fast pace as the customers find it convenient and also flexible at the same time. The emergence of financial technology has resulted in the introduction of several technological advancements in the industry. The face of Indian Banking system has changed over the years. The banking industry has evolved and transferred itself from a social banking to a liberalised, modernised and technology oriented industry. With the growing importance of IT new dimension such as CBS (core banking solution), ATM, net banking, plastic money, RTGS, NEFT etc has evolved over time.

4.10 Model Questions

1. Discuss the role of internet in facilitating banking service.
2. Elaborate the recent development in banking operations.
3. Mention any three features of Core Banking Service
4. Differentiate between NEFT and RTGS.

4.11 References and Suggested Readings

Bhole, L.M. *Financial Institutions and Markets*, New Delhi;Tata McGraw Hills.

Srivastava, Dr. P.K. *Banking Theory and Practice,* Mumbai; Himalaya Publishing House.

Nayak, Vaman R. *Indian Financial System*, Ludhiana; Kalyani Publishers.

Paul, R.R. *Money and Financial Systems*, Ludhiana; Kalyani Publishers.

https://www.shareyouressays.com/knowledge/what-are-the-important-achievements-of-the-reserve-bank-of-india/117044

******

Unit-5
Central Bank and its Functions– Reserve Bank of India

Unit Structure:

5.1 Introduction

Central bank is the heart of the entire banking system. It is the highest monetary institution in the country. It is a financial institution given privileged control over the production and distribution of money and credit for a nation. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks.

5.2 Objectives

After going through this unit, you will be able to:

- understand the importance of Central Banks,
- differentiate between Central Bank and Commercial Banks,

- know the functions of the Reserve Bank of India,
- analyse the mechanism implemented by the Reserve Bank of India in controlling credit.

5.3 Central Bank

Central Banking is essential for the smooth and sound functioning of the economy. Just as a man cannot survive without its heart, so also it is almost impossible for a country to survive without a central bank.

A central bank is an independent authority that formulates monetary poliiesy, regulates the banks functioning within the country, provides financial services while including economic research. Its goal is to stabilize the nation's currency, keep unemployment low, and prevent inflation.

5.3.1 Evolution

The story of central banking goes back at least to the seventeenth century, to the founding of the first institution recognized as a central bank, the Swedish Riks Bank. Established in 1668 as a joint stock bank, it was chartered to lend the government funds and to act as a clearing house for commerce.

A few decades later, the most famous central bank of the era, the Bank of England, was founded also as a joint stock company to purchase government debt. Other central banks were set up later in Europe for similar purposes, though some were established to deal with monetary disarray.

Early central banks issued private notes which served as currency, and they often had a monopoly over such note issue. While these early central banks helped fund the government's debt, they were also private entities that engaged in banking activities. Because they held the deposits of other banks, they came to serve as banks for bankers, facilitating transactions between banks or providing other banking services. These factors allowed them to become the lender of last resort in the face of a financial crisis.

At the turn of the twentieth century, some banks were set up primarily to consolidate the various instruments that people were using for currency and to provide financial stability. Many also were created to manage the gold standard.Central banks of this era also learned to act as lenders of last resort in times of financial stress—when events like wars, bad harvests, defaults by rail and roads happen leading to a crisis for liquidity.

The central banks were originally started as private joint stock banks which were managed by shareholders. The idea of state ownership of central banks gathered momentum after the First World War so much so that today central banks have become na important organ to the government.

Below are the names of a few distinguished central banks of various countries along with their year of establishment.

YEAR OF ESTABLISHMENT	*NAME OF THE CENTRAL BANKS*
1668	Riks Bank of Sweden
1694	Bank of England
1914	Federal Reserve Bank (USA)
1924	National Bank of Hungary, Bank of Poland
1934	Reserve Bank of New Zealand, Central Reserve Bank of Salvador
1935	Reserve Bank of India, Central Bank of Argentina, Bank of Canada
1948	State Bank of Pakistan, Union Bank of Burma, Central Bank of Philippines, National Bank of Cuba
1954	Bank of Israel

5.3.2 Functions of Central Bank

Central bank is regarded as an apex financial institution in the banking system. It is considered as an integral part of the economic and financial system of a nation. The central bank functions as an independent authority and is responsible for controlling, regulating and stabilising the monetary and banking structure of the country.

The functions of a central bank can be highlighted as under:

1. Currency regulator

2. Banker to the government

3. Lender of last resort

4. Custodian of cash reserves

5. Custodian of International currency

6. Clearing house for settlement

7. Controller of credit

8. Protecting depositors' interests

Let us discuss them in detail.

Currency regulator: Central banks possess the monopoly right to manufacture and issue notes in a country. All the central banks across the world are involved in issuing notes.

This is one of the most important functions of the central bank and due to this the central bank is also known as the bank of issue.

The central banks being authorised to function as the issuer of currencies resulted in uniformity in circulation and balanced supply of money within the country.

Banker to the government: The central bank accepts deposits and issues funds to the government. It is also involved in making and receiving payments for and on behalf of the government. They also offer short term loans to the government in times of emergencies or crises.

In addition to being the bank to the government, it acts as an advisor and agent of the government by providing advice to the government in areas of economic policy, capital market, money market and loans from the government.

Lender of last resort: The central bank acts as a lender of last resort by providing money to its member banks in times of shortage of cash. This is regarded as one of the most crucial functions of the central bank wherein it helps the member banks from financial crunches.

Custodian of cash reserves: It is a practice of the commercial banks of a country to keep a part of their cash balances in the form of deposits with the central bank. The commercial banks can draw that balance when the requirement for cash is high and pay back the same when there is less requirement of cash.

Custodian of International currency: An important function of the central bank is to maintain a minimum balance of foreign currency. The purpose of maintaining such a balance is to manage sudden or emergency requirements of foreign reserves and also to overcome any adverse deficits of balance of payments.

Clearing house for settlement: In a clearing house, the representatives of different banks meet and settle the inter-bank payments. The Central bank acts as a clearing house of the commercial banks and helps in settling of their mutual indebtedness.

Controller of credit: The central bank controls the credit creation by commercial banks which in turn increases inflation. It is done by engaging in open market operations or bringing about a change in the CRR to control the process of credit creation by commercial banks.

Protecting depositors' interests: Central bank also needs to keep an eye on the functioning of the commercial banks in order to protect the interests of depositors.

5.4 Difference Between Central Bank and Commercial Bank

CENTRAL BANK	COMMERCIAL BANK
The central bank is the apex institution in the monetary and banking system of the country.	The commercial bank is only a constituent unit of the banking system of the counry.
The main motive of the central bank is not to make profits but to promote general economic policy of the government.	A commercial bank on the other hand is a profit-making institution.
The central bank is closely related to the government as its banker, agent and advisor. It does not engage itself in ordinary banking business.	Commercial banks on the other hand acts as banker and advisor to the general public.
The Central bank is generally given the statutory power to check on the activities of the commercial banks.	The commercial banks are however not given the right to check the workings of the central bank nor other commercial banks.
Central bank helps in establishing financial institutions to strengthen the economy of the country.	Commercial banks help in setting up industries by underwriting their shares and debentures.
Central bank possesses the monopoly of note issue.	This right is not held by he commercial banks at present.
The Central bank act as the custodian of foreign reserves while also maintaining the stability in the exchange rates.	Though the commercial banks deal with foreign currencies, they are neither the custodian nor are they required to maintain the stability.
Every country has just one Central bank .	There are many commercial banks with hundreds of branches both within and outside a country.

5.5 The Reserve Bank of India

The Reserve Bank of India is India's central bank. It is the apex monetary institution which supervises, regulates, controls and develops the monetary and financial system of the country. The Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. Initially it was constituted as a private shareholder's bank with a fully paid-up capital of Rs. 5 crores. Eventually, it was nationalised on January 1, 1949.

Stop to Consider

THE TIMELINE

Year	Event
1934	The British enacted the Reserve Bank of India Act
1935	Reserve Bank of India was established on 1st of April in Calcutta
1937	Reserve Bank of India was permanently moved to Mumbai
1949	Got nationalized after independence. The bank was held by private stakeholders before this.

In the year 2016, the original RBI Act of 1934 was amended and that provided the statutory basis for the implementation of the flexible inflation-targeting framework.

5.5.1 Organisation and Management

The Head Office of the Reserve bank of India is located in Mumbai.There are 31 Regional Offices of the Reserve Bank of India in the following places:

Srinagar. Jammu, Chandigarh, Shimla, Dehradun, New Delhi, Jaipur, Lucknow, Kanpur, Patna, Bhopal, Ahmedabad, Nagpur, Raipur, Kolkata, Belapur, Mumbai, Hyderabad, Ranchi, Bhubaneswar, Panaji, Bengaluru, Chennai, Kochi, Thiruvananthapuram, Gangtok, Guwahati, Imphal, Shillong, Aizawl and Agartala

The management of the bank is under the control of the Central Board of Directors consisting of 20 members.

i. The executive head of the bank is called the Governor who is assisted by four Deputy Governors. They are appointed by the Government of India for a period of five years.

ii. There are four local boards situated in Delhi, Kolkata, Chennai and Mumbai representing the four regional areas, namely, northern, eastern, southern and western respectively. These are basically advisory in nature and the government nominates one member from each board to the Central Board.

iii. There are ten directors from various fields nominated to the Central Board by the government along with one government official from the Ministry of Finance.

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

1.Banking Department

This department handles various bank's service for the government as well as the other banks. There are 4 sub-divisions to this department namely, a. Public Debt Department, b. Public Accounts Department, c. Securities Department and d. Deposit Accounts Departmen. The Joint or Deputy Manager heads the branches of the banking department.

2.Issue Department:

The Issue department is concerned with the proper and efficient management of the note issue.

3. Currency Management Department

This department is responsible for forecasting the long-term requirements of the currency and subsequently allocating it to the various other branches. It takes into account the storage facilities, demand pattern, etc. The Chief Officer heads this department.

4. Government and Bank Accounts Department

The main task of this department is to handle and maintain the various bank's accounts in the banking and issuing departments. It compiles weekly statements and the balance and annual profit and loss account. The Chief Accountant heads this department.

5. Budgetary Control and Expenditure Department

Under this department, the bank's budget and various expenditures are monitored for the different units. This department is headed by the Financial Controller.

6. Department of Exchange Control

This department is responsible for maintaining the exchange rate and controlling the foreign exchange. They try to stabilize the exchange rate of the country.

7. Department for Industrial Credit

This department as the name suggests is related to the credit-related activities of the industries. Their primary task is to provide various credit guarantee schemes for the small-scale industries and looking after its administration. They work in tandem with the government of India, SFCs, and the Industrial Development Bank of India (IDBI). Their task is to collect data about the finances of the small-scale businesses and other related problems.

8. Banking Operations and Development Department

This department looks after the commercial banks in India. They control, supervise and develop these banks. Earlier, this department was also involved in works related to bank credit and lead bank scheme for the priority sectors.

9. Agriculture Credit Department

This department deals with the problems of agricultural credit and provides facilities of rural credit to state governments and state cooperatives. It also provides the required financial assistance to the state governments to improve their financial structure.With the formation of NABARD, all the agriculture credit-related activities are now shifted towards the new institution.

10. Non-banking Companies Department

The primary task of this department is to regulate the deposits related to non-banking financial companies. Further, it also controls and administers companies.

11. Credit and Rural Planning Department

This is one of the oldest departments in the RBI. This department is concerned with the issues like lead bank scheme, credit plans for the district, provision for the expert assistance, processing the credit line for short-term loans of the NABARD and putting forward the policies for Reserve Bank regarding rural India.

12. Economic Policy and Analysis Department

This department handles the economic reviews and research for banking and financial conditions of the country. It comprises majorly of 5 units, a. International Financial Unit, b. Internal Finance Unit, c. General Unit, d. Analysis of National Economic Parameters Unit and e. Prices, General and Production Unit.

They are in charge of preparing the annual report and the report on progress and trend of banking in India. Besides this, the department produces a report on finance and currency and the bulletins for RBI.

13. Computer Services and Statistical Analysis Department

This department as the name suggests collects, generates, processes and compiles the statistical data related to the financial and banking sectors from the operational point of view of the RBI.

14. Legal and Inspection Department

The inspection department carries out the inspections of the various departments and offices of the RBI. For the legal advice on various issues referred by the RBI, the legal department is responsible.

15. Department of Administration and Personnel

It looks after the general administration and personnel policy, such as recruitment, training, placements, promotions, transfers, discipline, appeals, service conditions, wage structure, etc.

16. Premises Department

It is mainly concerned with the construction of buildings for the Bank's offices, training institutions and staff quarters.

17. Management Services Department

It is basically concerned with organisational analysis, systems research and development, work procedure studies and codification, manpower planning, costing studies, etc.

18. Reserve Bank of India Service Board

Its functions involve conducting of examinations/interviews for the selection and promotion of staff in the Reserve Bank.

19. Central Records and Documentation Centre

It is meant for the preservation of non-current records of the Bank. It provides arrangement for the scientific preservation of records, retrieval service to the enquirer departments, tools of reference such as catalogues, indices, etc.

20. Secretary's Department

It attends to the secretarial work connected with the meetings of the Central Board and its committee and of the Administrators of the RBI Employee's Provident Fund and RBI Employees' Co-operative Guarantee Fund.

21. Training Establishments

The Reserve Bank has set-up three prominent training institutions for imparting training in different areas of banking.These are:

(i) the Banker's Training College, Mumbai

(ii) the College of Agricultural Banking, Pune

(iii) the Reserve Bank Staff College, Chennai

There are also Zonal Training Centres situated in Mumbai, Kolkata, Chennai and New Delhi for conducting induction, functional and short-term preparatory courses for the clerical staff.

Check Your Progress

1. Which is the first Central Bank established?
2. When was the Reserve Bank of India established?
3. What is the objective behind the establishment of the Central Bank?
4. Why is the Central Bank considered the lender of last resort?
5. Mention any two differences between Central Bank and Commercial Bank.
6. Note down the various departments of the Reserve Bank of India.
7. Who is the present governor of the Reserve Bank of India?
8. Where is the head office of RBI?

5.5.2 Functions of the Reserve Bank

The functions of the Reserve Bank of India may be divided under two categories:

A. Central Banking Functions and

B. Other Functions

A. Central Banking Functions

*1. Issue of Bank Notes:*The Reserve Bank of India has the monopoly of note issuein the country. It has the sole right to issue currency notes of all denominations except one-rupeenotes, The one-rupee notes are issued by the Ministry of Finance. However, the Reserve Bank being the only source of legal tender the one-rupee notes are circulated by it.

The Reserve Bank has a separate Issue Department which is entrusted with the job of issuing currency notes. The reason for concentration of note issue with Reserve Bank may be cited as under:

- Uniformity in note circulation to attain effective state supervision.
- Control over undue credit expansion by the commercial banks.
- To give distinctive prestige to the note issue.
- Maintain stability in the internal and external value of the currency.

2. *Banker to the Government:* The Reserve Bank of India acts as a banker to the central and the state governments.

- It maintains and operates government deposits.
- It collects and makes payments on behalf of the government.
- It helps the government to manage public debts.
- It sells Treasury Bills on behalf of the government.
- It undertakes foreign exchange transactions on behalf of the government.
- It provides development finance to government to undertake five year plans
- It advises the government on matters related to investments, loan operations, planning, banking, economic development etc.

3. Banker's Bank:

As Banker to banks, the Reserve Bank provides similar banking functions to other banks just like the commercial banks provide to their customers.It provides short-term loans and advances to select banks, when necessary, to facilitate lending to specific sectors and for specific purposes.

Among other provisions, the Reserve Bank stipulates minimum balances to be maintained by banks in these accounts. It is the responsibility of each bank maintaining current account with the Reserve Bank to ensure that sufficient balance is available in the account to avoid defaults in payments and settlements.

The current accounts of individual banks are being opened by Banking Departments of the Regional Offices. These current accounts are maintained for participation in Centralised and Decentralised Payment Systems and are used for settling inter-bank obligations, such as clearing transactions or clearing money market transactions between two banks, buying and selling securities and foreign currencies.

4. Custodian of Exchange Reserve:

Exchange control was first imposed in India in September 1939 at the outbreak of World War II and has been continued since. Under it, control was imposed on both the receipts and payments of foreign exchange.

The RBI acts as the custodian of the country's foreign exchange reserves, manages exchange control and acts as the agent of the government in respect of India's membership of the International Monetary Fund.

The foreign exchange regulations requires that all foreign exchange receipts whether on account of export earnings, investment earnings, or capital receipts or private account or on government account, must be sold to the Reserve Bank of India (RBI) either directly or through authorized dealers (mostly major commercial banks). This resulted in centralisation of country's foreign exchange reserves with the RBI and facilitated planned utilization of these reserves.

The exchange control was so operated as to restrict the demand for foreign exchange within the limits of the available supplies of it. This became essential in the context of actual or potential shortage of foreign exchange, which had been an important constraint on India's efforts at planned economic development, most of the time.

5. Controller of Credit:

Reserve Bank of India formulates and implements the Monetary Policy of India to keep the economy on the growth path. Monetary Policy refers to the process employed by Reserve Bank to control availability and cost of currency, thus keeping inflationary & deflationary trends low and stable. RBI adopts various measures to regulate the flow of credit in the country. The measures adopted by RBI can broadly be categorized as Quantitative & Qualitative tools.

Quantitative measures of credit control are applicable to entire money and banking system without discrimination. They broadly refer to reserve ratios, bank rate policy etc. Reserve ratios are the share of net demand & time liabilities (NDTL) which banks have to keep aside to ensure that they have sufficient cash to cover customer withdrawals.

Qualitative measures of credit control are discriminatory in nature and are applied for specific purpose or to specific financial organization, bank or others which RBI thinks are violating the monetary policy norms.

B. OTHER FUNCTIONS

The Reserve Bank is authorised to transact the following ordinary banking business:

- Acceptance of money on deposits without interest from the Central and the State Government.
- The purchase, sale and rediscounting of bills of exchange and promissory notes arising out of bonafide transactions.
- The purchase, sale and rediscounting of bills for financing agricultural operations or marketing of crops etc.
- Making of loans and advances to states, local bodies, scheduled banks and state cooperative banks.
- Making of ways and means advances to Central and State Governments.
- The purchase and sale of securities of the Central and State Governments.
- The purchase and sale of gold bullion.
- All such functions as may be incidental or consequential upon the exercise of its powers or discharge of duties under the Reserve Bank of India Act.

Stop to Consider

Reserve Bank of India works as:

Monetary Authority:

- Implementation of monetary policies,
- Monitoring the monetary policies,

- Ensuring price stability in the country considering the economic growth of the country

Regulator and Administrator of the Financial System

It determines the comprehensive parameters of banking operations responsible for the functioning of the country's banking and financial system.

- License issuing,
- Liquidity of assets,
- Bank mergers,
- Branch expansion etc.

Managing Foreign Exchange

- RBI manages the FOREX of India.
- It is responsible for maintaining the value of the Rupee outside the country.
- It aids foreign trade payment.
- Issuer of currency

5.5.3 Reserve Bank of India as Controller of Credit

Apart from meeting developmental and expansionary requirements of the economy, the Reserve Bank has also been assigned the task of controlling the inflationary pressure on the economy. It formulates and implements the monetary policy of India to keep the economy on growth path thus keeping inflationary & deflationary trends low and stable. The Reserve Bank adopts various measures to regulate the flow of credit in the country. These can broadly be categorized as Quantitative measures and Qualitative measures.

QUANTITATIVE TOOLS

Quantitative measures of credit control are applicable to the entire money and banking system without discriminations. They broadly refer to reserve ratios, bank rate policy etc. Reserve ratios are the share of net demand & time liabilities (NDTL) which banks have to keep aside to ensure that they have sufficient cash to cover customer withdrawals.

a. *Bank Rate:*

The bank rate is the rate at which the Reserve Bank advances to the member banks against approved securities or rediscounts the eligible bills of exchange or other papers.It is the interest rate which the Reserve Bank charges from other banks when they borrow for long term requirements. Change in the Bank rate influences the entire interest rate structure including both long term and short-term interest rates.

A rise in the Bank rate leads to a rise in the other market interest rates which implies a costly monetary policy increasing the cost of borrowing, Similarly, a fall in the Bank rate results in a fall in the other market rates, which implies a cheap monetary policy with reduced cost of borrowing.

The Reserve Bank changes the Bank rate from time to time to meet the changing conditions of the economy. It now serves as a reference-rates for other rates in the financial markets. The current bank rate is 6.25%. the bank rate is not used to control money supply these days although it provides the basis of arriving at lending and deposit rates.

b. Cash Reserve Ratio (CRR):

Cash Reserve Ratio is most commonly used by Reserve Bank as a quantitative tool of credit control. The ratio specifies the minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank.

The Reserve Bank can change the cash reserve requirement of the bank in order to affect their credit creation capacity.

An increase in the cash reserve ratio reduces the excess reserve of the bank. Therefore, the banks are unable to inject more money in the market in the form of lending loans. This in turn reduces the flow of money in the market. Similarly, a decrease in the cash reserve ratioincreases the excess reserve of the banks which again enables them to provide more and more credit to the public and the market at large.

The Reserve Bank is empowered to vary the cash reserve ratio between 3 percent and 15 percent.The present cash reserve ratio prevailing in the country is 4 percent (as in 2019-20). Earlier, the cash reserve ratio in India averaged 5.67 percent from 1999 until 2016, reaching an all-time high of 10.50 percent in March of 1999 and a record low of 4 percent in February 2013.

Example:

Let us suppose, a bank has a total reserve of Rs. 100 crores. With the prevailing CRR at 10%, the bank is required to keep Rs. 10 crores as reserve and the remaining 90 crores can be lent out by the bank to earn interest from it. Now, we assume that the economy is showing inflationary trends and the Reserve Bank wants to control this situation by adjusting the CRR. If the Reserve Bank increases the CRR to 20% then bank will be left only with Rs. 80 crores for operations. Now it will be very difficult for bank to maintain profitability with such small capital. Bank will be left with no choice but to raise interest rate which will make borrowing costly. This will in turn reduce the overall demand and hence price will come down eventually.

c.*Statutory Liquidity Ratio (SLR):*

The main goal of the Reserve Bank is to make sure that prices are always stable in the nation without heavy fluctuations. Its primary responsibility is to create and operate a monetary policy which helps in administering the flow and supply of money for the purpose of attaining good growth in the economy. This is in one way done by monitoring and managing various interest rates.

Statutory Liquidity Ratio (SLR) refers to the minimum reserve requirement that needs to be maintained by commercial banks in the nation. The word 'statutory' indicates that it is mandatorily and legally required. The Reserve Bank states that every commercial bank in India has to keep a certain amount of time deposits as well as demand deposits as liquid assets in its independent and own vault.In the case of statutory liquidity ratio, these assets can be gold, cash, securities that are approved by the Indian government, etc. Apart from these assets, securities that are sanctioned under market stabilisation schemes (MSS) as well as market borrowing programmes, and treasury bills are included in the statutory liquidity ratio.

The current SLR announced by the Reserve Bank is 19% of net demand and time liabilities (NDTL) as announced in 2020.

d. Open Market Operation (OMO):

Open Market Operation is the activity of buying and selling of government securities in open market to control the supply of money in the banking system.Through this technique, the Reserve Bank seeks to influence the excess reserve position of the banks by purchasing and selling government securities and other such papers.

When the Reserve Bank purchases securities from the banks, it increases their cash reserve position, and hence their credit creation capacity. On the other hand, when the Reserve Bank sells securities to the banks, it reduces their cash reserve and hence their credit creating capacity. Thus, the Reserve Bank indirectly controls the money supply and influences short-term interest rates. This operation has also been used as a tool to assist the government in raising borrowings.

In India, after the economic reforms of 1991, the Open Market Operation has gained more importance than the Cash Reserve Ratio in adjusting liquidity.When there is excess supply of money, the Reserve Bank sells government securities thereby taking away excess liquidity. Similarly, when economy needs more liquidity, the bank buys government securities and infuses more money supply into the economy.

e. Repo Rate:

When banks need to borrow short term money from the Reserve Bank, the banks have to pledge government securities as collateral. This kind of deal happens through a repurchase agreement and at the Repo rate.

Say for example, if a bank wants to borrow Rs. 100 crores, it has to provide government securities at least worth Rs. 100 crores and agree to repurchase them at Rs. 106.50 crore at the end of borrowing period. The bank has paid Rs. 6.50 crore as interest. This is the reason it is called repo rate.

To curb inflation, the Reserve Bank increases repo rate which makes borrowing costly for banks. The banks pass this increased cost to their customers which make borrowing costly in the whole economy. Fewer people apply for loan and aggregate demand gets reduced. This results in inflation coming down. The opposite is done to fight deflation.

The present repo rate is 5.75% with effect from June 6, 2019.

f. Reverse Repo Rate:

Reverse Repo rate is just the opposite of Repo rate. If a bank has surplus money, they can park this excess liquidity with the Reserve Bank and the ReserveBank will pay interest on it. This interest rate is called Reverse Repo rate.At present, the Reverse Repo rate is 5.75% with effect from May 2019.

g. Marginal Standing Facility (MSF):

This scheme was introduced in May, 2011 and all the scheduled commercial banks can participate in this scheme. Banks can borrow up to 2.5% of their respective Net Demand and Time Liabilities. RBI receives application under this facility for a minimum amount of Rs. 1 crore and in multiples of Rs. 1 crore thereafter. The important difference with repo rate is that unlike Repo where the collateral offered as security against the loan should not be from the Stautotry Liquidity Reserve, the banks in this case can pledge government securities from SLR quota (up to 1%). The current MSF rate is 6.25%.

QUALITATIVE TOOLS

Qualitative or Selective Credit Control measures are tools undertaken bt the Reserve Bank to divert the flow of credit from speculative and unproductive activities to productive and urgent activities.

The Banking Regulation Act, 1949, empowers the Reserve Bank to issue directives to the banks regarding their advances. The following selective control measures to check inflationary pressure.

h. Margin Requirement:

While accepting the securities for the loan the banks first asses the market value of the securities and then considering the amount of loan required the bank would require the margin to be paid by the borrower which on most occasions is the difference between the market value of the securities and the amount of loan required.

The Reserve Bank can vary this percentage of margin requirement from time to time to regulate the flow of credit on certain securities.A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security. This method is effectively used to counter inflationary and deflationary conditions in an economy.

This method ensures use of available funds only for productive and useful purposes and also discourages speculative activities. It helps to control inflation by diverting the funds available to produce only goods which helps to bring down the price level.

i. Credit Rationing:

According to this method the commercial banks are instructed to encourage borrowing for certain purposes and discourage certain other types of borrowing.

The Reserve Bank may extend or curtail the consumers' loans for certain items during a particular time. For example, during inflationary period, the Reserve Bank may curtail the commercial banks from consumer durable loans.As a result, the demand for these luxury items will come down bringing down their price and indirectly helping to control general price level.

The Reserve Bank may also alter the initial money to be deposited by the borrower and through that encourage or discourage borrowing.

Changing the maturity period of the loan is one more method of consumer credit regulation. Suppose the Reserve Bank wants to encourage the consumer credit, then it may allow maximum repayment period say 60 months. On the other hand, if it wants to discourage the consumer credit, it may fix the maximum repayment period as only 36 months.

Changing the rate of interest on consumer credit is one more usual method to regulate. Increase in rate of interest will discourage borrowing while reducing the interest will encourage borrowing.

j. Control through Directives:

Under this method periodical directions, instructions, information, guidelines and warning are issued by the Reserve Bank to the commercial banks to make them follow the credit policies of the former.Every central bank is empowered to issue such directive by virtue of the statutory powers conferred on it and usually the central bank implements this policy by offering incentives like liberal refinancing facility to banks which follow the directives.The directives issued serves the following purposes:

- It controls the lending policies of the commercial banks.
- To determine the maximum amount that could be lent for certain purposes.

- It channelises the available credit to more productive and urgent uses from less urgent and less productive purposes.

k.Moral Suasion:

Moral suasion refers to the persuasive approach of the Reserve Bank towards the commercial banks in making them follow and implement their policies. The ReserveBank takes efforts to explain to the commercial banks the need for following certain policies. This is done either through periodical conferences with commercial bank or by appealing to the sentiments of the commercial banks. The Reserve Bank uses moral force instead of resorting to the legal powers. This method is applied using the conventional relationship between the commercial banks and the ReserveBank.

l. Direct Action:

Another method of selective credit control is Direct action. Under this methodthe Reserve Bank uses coercive measures against the banks violating the central bank ruling. It may vary from general instructions to the banks to special directives to the erring banks. Though this method has the legal sanction, the Reserve Bank rarely applies this method. As a matter of direction action, the Reserve Bank is vested with vast powers ranging from refusing credit and re-discounting facilities to imposing penal rate of interest on banks.

Effectiveness of Credit Control Measures:

The effectiveness of credit control measures in an economy depends upon a number of factors. First, there should exist a well-organised money market. Second, a large proportion of money in circulation should form part of the organised money market. Finally, the money and capital markets should be extensive in coverage and elastic in nature.

Extensiveness enlarges the scope of credit control measures and elasticity lends it adjustability to the changed conditions. In most of the developed economies a favourable environment in terms of the factors discussed before exists, in the developing economies, on the contrary, economic conditions are such as to limit the effectiveness of the credit control measures.

5.5.4 Achievements of the Reserve Bank

The Reserve Bank has helped in building up a well-differential structure of financial institutions to cater to the requirements of the different sectors of the economy. Some of the achievements of the Reserve Bank can be summed up as under.

i. The Reserve Bank has adopted a flexible monetary policy. It has introduced changes in monetary regulations keeping in view the seasonal character of Indian money market because of which the fluctuations in money rates have been negligible.

ii. The Bank rate has remained substantially lower than the market rate of interest. The bank rate has remained more or less stable.Thus, the interest rate policy of the Reserve Bank has resulted into a relatively stable structure of interest rates in the economy.

iii. The Reserve Bank has succeeded in building up a sound modern banking and credit structure. The Bank enjoyed vast supervisory powers which enabled it to guide the development of banking on sound lines.

iv. The Reserve Bank has successfully managed the public debt. It has floated loans for the Government at low rates of interest. It has helped in raising funds for the expansion of public sector in the economy. It has also provided short term advances to the government.

v. The Reserve Bank has succeeded in maintaining the exchange stability to a large extent. The Bank has maintained the exchange value of the rupee at a relatively higher rate than would have prevailed in the market.

vi. The Reserve Bank has introduced very cheap remittance facilities. These have been widely used by the commercial banks, the Government and cooperative banks.

vii. The Reserve Bank has taken appropriate measures to enhance public confidence in the banking systems. Bank strictly supervises the working of the Commercial banks so as to avoid their failures.

viii. The Reserve Bank has adopted measures to distribute credit to all productive sectors in accordance with social objectives and priorities. The priority sector including agriculture, small scale industries, exports, trades etc., get credit at low rate of interest.

ix. The Reserve Bank has played an active role in promoting economic development of the Indian economy. It has helped in setting up a sound structure of Development Banking. Several Industrial, Agricultural, Export and other specialised financial institutions have been established.

x. Training of bank personnel has improved their efficiency. The geographical and fundamental coverage of the banking has also increased substantially.

5.5.5 Failures of the Reserve Bank

Looking at the performance of Reserve Bank of India, it can be said with a sense of pride that Reserve Bank of India has appreciably contributed to the growth and stability of the economy. Yet there have been certain failures of the Bank too.

i. The Reserve Bank has virtually failed in regulating or controlling the activities of rural money lenders and other indigenous bankers. It has succeeded in controlling the organised sector of the Money Market, but not the unorganised one.

ii. Because of the lack of control on different sectors of the money market, different rates of interest continue to prevail. Outside the organised sector of the money market, rates of interest are extremely higher than the bank rate.

iii. Though initiatives were taken by the Reserve Bank to provide enough agricultural credit, its availability continues to be far behind its requirement. Agricultural credit it still being dominated by rural money lenders and other indigenous bankers who charge very high interest rates.

iv. Though Reserve Bank has tried to spread banking activity in all parts of the country, yet it is not sufficient in view of the large size of population. Moreover, most of the banking activities are concentrated in urban areas. People in small villages and sub-urban areas are still deprived of the banking facility.

v. The Reserve Bank has yet not succeeded in getting the Commercial Banks any notable foreign exchange business. Foreign exchange business almost continues to be a monopoly of foreign banks. Some of the Indian Banks have opened their branches abroad, but not with any notable success so far.

vi. Reserve Bank has also failed as a Bank of the Bankers. Its lack of assistance to the Commercial Banks has caused their closure. Between 1939 to 1946 nearly 444 banks failed in the country. Closure of three banks in 1985 is also a notable point. Failure of the banks erodes faith of the people in the banking system.

Check Your Progress

1. Why is RBI called the Bankers' Bank and The Lender of the Last Resort.
2. Write Notes on : open market operation, bank rate, cash reserve ratio, repo, reverse repo, margin requirement, credit rationing, moral suasion.
3. Discuss the Failure and Achievements of RBI.

5.6 Summing Up

- 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.
- Although their responsibilities range widely, depending on their country, central banks' duties and the justification for their existence usually fall into three areas.
- Central banks control and manipulate the national money supply: issuing currency and setting interest rates on loans and bonds. Typically, central banks raise interest rates to slow growth and avoid inflation; they lower them to spur growth, industrial activity, and consumer spending. In this way, they manage monetary policy to guide the country's economy and achieve economic goals

- Central Bank regulates member banks through capital requirements, reserve requirements and deposit guarantee among other tools. They also provide loans and services for a nation's banks and its government and manage foreign exchange reserves.
- Finally, a central bank also acts as an emergency lender to distressed commercial banks and other institutions, and sometimes even a government. By purchasing government debt obligations, for example, the central bank provides a politically attractive alternative to taxation when a government needs to increase revenue.
- Every country has its own Central Bank. The Reserve Bank of India (RBI) is India's Central Bank.
- As opposed to popular belief, the Reserve Bank is not controlled by the Government but instead it works as an independent institution.
- The Reserve Bank has the sole right to issue new currency notes and coins and exchange or destroy currency not fit for circulation.This gives the public adequate quantity of supplies of currency notes and coins and in good quality.
- It formulates, implements and monitors the monetary policy. It manages the interest rates offered by banks on loans and deposits and which affects the inflation and deflation in the country. In simple words, lower rates give rise to higher inflation and vice versa. This is done to maintain price stability while keeping in mind the objective of growth.
- The Reserve Bank ensures that the exchange rate value of Indian National Rupee is maintained in the international markets. This is done to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.
- It makes sure that the banks are following the issued guidelines by overlooking their financial operations and in cases of banking failures, the Reserve Bank comes ahead to safeguard the depositors' money by bailing out the distressed bank.

5.7 References and Suggested Readings

1. Bhole, L.M. *Financial Institutions and Markets*, New Delhi;Tata McGraw Hills.
2. Srivastava, Dr. P.K. *Banking Theory and Practice,* Mumbai; Himalaya Publishing House.
3. Nayak, Vaman R. *Indian Financial System*, Ludhiana; Kalyani Publishers.
4. Paul, R.R. *Money and Financial Systems*, Ludhiana; Kalyani Publishers.
5. https://www.shareyouressays.com/knowledge/what-are-the-important-achievements-of-the-reserve-bank-of-india/117044

5.8 Model Questions

1. What are the functions of the Central Bank? How do they differ from the functions of a commercial bank?
2. Explain the significance of the functions of the Central Bank as a Banker's Bank and as a Banker to the government.
3. Bring out the difference between quantitative and qualitative methods of credit control.
4. How does reserve Bank of India regulate currency and credit in India?

******