BANKING AND INSURANCE

UNIT I

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Structure of Banking Sector in India

Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 under the RBI Act of 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions. As of now 26 public sector banks in India out of which 21 are Nationalised banks and 5 are State Bank of India and its associate banks. There are total 92 commercial banks in India. Public sector banks hold near about 75% of the total bank deposits in India.

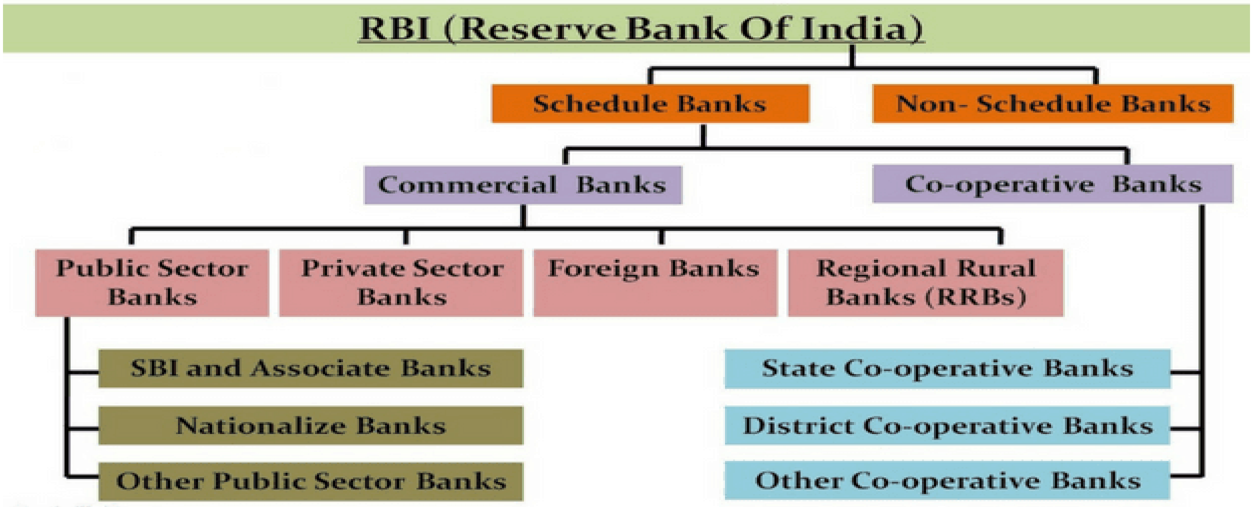
Indian Banks are classified into commercial banks and Co-operative banks. Commercial banks comprise: (1) Schedule Commercial Banks (SCBs) and non-scheduled commercial banks. SCBs are further classified into private, public, foreign banks and Regional Rural Banks (RRBs); and (2) Co-operative banks which include urban and rural Co-operative banks.

The Indian banking industry has its foundations in the 18th century, and has had a varied evolutionary experience since then. The initial banks in India were primarily traders' banks engaged only in financing activities. Banking industry in the pre-independence era developed with the Presidency Banks, which were transformed into the Imperial Bank of India and subsequently into the State Bank of India.

The initial days of the industry saw a majority private ownership and a highly volatile work environment. Major strides towards public ownership and accountability were made with Nationalisation in 1969 and 1980 which transformed the face of banking in India**.** The industry in recent times has recognised the importance of private and foreign players in a competitive scenario and has moved towards greater liberalisation.

Modern banking in India originated in the last decade of the 18th century. Among the first banks were the Bank of Hindustan, which was established in 1770 and liquidated in 1829–32; and the General Bank of India, established in 1786 but failed in 1791. In 1809, it was renamed as the Bank of Bengal.

Structure of Indian Banking System is as Follows:



Commercial Banks

The institutions that accept deposits from the general public and advance loans with the purpose of earning profits are known as **Commercial Banks**. Commercial banks can be broadly divided into public sector, private sector, foreign banks and RRBs.

- In **Public Sector Banks** the majority stake is held by the government. After the recent amalgamation of smaller banks with larger banks, there are 12 public sector banks in India as of now. An example of Public Sector Bank is State Bank of India.
- **Private Sector Banks** are banks where the major stakes in the equity are owned by private stakeholders or business houses. A few major private sector banks in India are HDFC Bank, Kotak Mahindra Bank, ICICI Bank etc.
- A **Foreign Bank** is a bank that has its headquarters outside the country but runs its offices as a private entity at any other location outside the country. Such banks are under an obligation to operate under the regulations provided by the central bank of the country as well as the rule prescribed by the parent organization located outside India. An example of Foreign Bank in India is Citi Bank.
- **Regional Rural Banks** were established under the Regional Rural Banks Ordinance, 1975 with the aim of ensuring sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area notified by the Government. RRBs are owned jointly by the Government of India, the State Government and Sponsor Banks. An example of RRB in India is Arunachal Pradesh Rural Bank.

Cooperative Banks

A **Cooperative Bank** is a financial entity that belongs to its members, who are also the owners as well as the customers of their bank. They provide their members with numerous banking and financial services. Cooperative banks are the primary supporters of agricultural activities, some small-scale industries and self-employed workers. An example of a Cooperative Bank in India is Saraswat Cooperative Bank. At the ground level, individuals come together to form a Credit Co-operative Society. All the societies in an area come together to form a Central Co-operative Banks.
Cooperative banks are further divided into two categories - urban and rural.

- Rural cooperative Banks are either short-term or long-term.
    - Short-term cooperative banks can be subdivided into State Co-operative Banks, District Central Co-operative Banks, and Primary Agricultural Credit Societies.
    - Long-term banks are either State Cooperative Agriculture or Rural Development Banks (SCARDBs) or Primary Cooperative Agriculture and Rural Development Banks (PCARDBs).
- Urban Co-operative Banks (UCBs) refer to primary cooperative banks located in urban and semi-urban areas.

Development Banks

Financial institutions that provide long-term credit in order to support capital-intensive investments spread over a long period and yielding low rates of return with considerable social benefits are known as Development Banks. The major development banks in India are; Industrial Finance Corporation of India (IFCI Ltd), 1948, Industrial Development Bank of India' (IDBI) 1964, Export-Import Banks of India (EXIM) 1982, Small Industries Development Bank Of India (SIDBI) 1989, National Bank for Agriculture and Rural Development (NABARD) 1982. The banking system of a country has the capability to heavily influence the development of a country's economy. It is also instrumental in the development of rural and suburban regions of a country as it provides capital for small businesses and helps them to grow their business.

TYPES OF BANKING SYSTEM

Universal Banking: Universal Banking, means the commercial banks, Financial Institutions, NBFCs, which undertake multiple financial activities under one roof, thereby creating a financial supermarket. The entities focus on leveraging their large branch network and offer wide range of services under single brand name.

Branch Banking: Branch banking involves business of banking via branches. The branches are set up under Section 23 of Banking Regulations Act, 1949. A branch should cater to all banking services and include a specialized branch a satellite office, an extension counter, an ATM, administrative office, service branch and a credit card centre for the purpose of branch authorization policy.

Unit Banking: Unit banking is a system of banking which originated in US. It is a limited way of banking where banks operate only from a single branch (or a few branches in the same area) taking care of local community. In comparison to branch banking, the size of unit banks is very small. Due to small size and due to unit structure; the decision making in unit banks is very fast. The management in unit banks enjoy more autonomy and more discretionary powers.

Mixed Banking: Mixed Banking is the system in which banks undertake activities of commercial and investment banking together. These banks give short-term and long-term loans to industrial concerns. The banks appoint experts which give valuable advice on various financial issues and also help gauge the financial health of companies. Industries don't have to run to different places for differential financial needs.

Chain Banking: Chain banking system refers to the type of banking when a group of persons come together to own and control three or more independently chartered banks. Each of these banks could maintain their independent existence despite common control and ownership. The banks in the chains were assigned specific functions so there was no loss of profits and overlapping of interests.

Retail Banking: Retail banking means banking where transactions are held directly with customers and there are no transactions with other banks or corporations. The banks provide all kinds of personal banking services to customers like saving accounts, transactional accounts, mortgages, personal loans, debit and credit cards etc.

Wholesale Banking: Wholesale banking involves banking services for high net-worth clients like corporate, commercial banks, mid-size companies etc. India has a suitable investment climate and is seen as a favoured investment destination so it has a huge potential for the growth of this vertical of banking. It provides an ease of access to the complete financial portfolio of a client who can easily browse through the same and make suitable allocations, transfers etc.

Relationship Banking: Relationship banking is a banking system in which banks make deliberate efforts to understand customer needs and offer him products accordingly. It helps banks to gather critical soft information about the borrowers, which helps them to determine creditworthiness of such clients. Clients too often become responsible and avoid moral hazard behaviour.

Correspondent Banking: Correspondent banking prevalent in over 200 countries is a profitable way of doing business by banks in foreign countries in which they don't have physical presence or limited operational permissions. Correspondent banks thus act as banking agent for a home bank and provides various banking services to customers.

Universal Banking: Universal banking is a system of banking under which big banks undertake a variety of banking services like commercial banking, investment banking, mutual funds, merchant banking, insurance etc. It involves providing all these services under one roof by financial experts who can handle multiple financial products easily.

Social Banking: Social banking is a concept where banking services are oriented towards mass welfare and financial inclusion of the poor and vulnerable segments of society. RBI has taken some commendable initiatives to make financial inclusion a reality for the remotest segments of Indian population.

Virtual Banking: Virtual banking is performing all banking operations online. This has served as a great revolution in banking market as banks have to continuously struggle for perfection to live up to competition and stay ahead of it. As banks don't have physical offices, they find the options very cost-effective.

Narrow Banking: The Narrow Banking is very much an antonym to the Universal Banking. Narrow Banking means Narrow in the sense of engagement of funds and not in activity. So, simply, Narrow Banking involves mobilizing the large part of the deposits in Risk Free assets such as Government Securities.

Islamic Banking: Islamic banking is banking or banking activity that is consistent with the principles of sharia and its practical application through the development of Islamic economics.

Shadow Banking: Shadow banking refers to all the non-bank financial intermediaries that provide services similar to those of traditional commercial banks. They generally carry out traditional banking functions, but do so outside the traditional system of regulated depository institutions.

ORIGIN AND DEVELOPMENT OF BANKING IN INDIA

Globally, the story of banking has much in common, as it evolved with the moneylenders accepting deposits and issuing receipts in their place. Banking was fairly varied and catered to the credit needs of the trade, commerce, agriculture as well as individuals in the economy. The pre- independence period was largely characterised by the existence of private bank organised as joint stock companies. Most banks were small and had private shareholding. They were largely localised and many of them failed. The period beginning from 1967 to 1991 was characterised major development, viz.., social control on banks in 1967 and nationalisation of 14 banks in 1969 and 6 more in 1980. The period beginning from the early 1990s witnessed the transformation of the banking sector as a result of financial sector reforms that were introduced as a part of structural reforms initiated in 1991.

Early phase of Indian Banks, from 1786 to 1969

- The first bank in India, the General Bank of India, was set-up in 1786. Bank of Hindustan and Bengal Bank followed.
- The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called them Presidency banks. These three banks were amalgamated in 1920 and the Imperial Bank of India, a bank of private shareholders, mostly Europeans, was established.
- Allahabad Banks was established, exclusively by Indians, in 1865.
- Punjab National Bank was set-up in 1894 with headquarters in Lahore.
- Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were set-up.
- The Reserve Bank of India came in 1935.
- To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949, which was later changed to the Banking Regulation Act, 1949.
- In 1955, government nationalised the Imperial Bank of India and started offering extensive banking facilities, especially in rural and semi-urban areas.
- The government constituted the State Bank of India to act the principal agent of the RBI and to handle banking transaction of the Union Government and State Government all over the country.

- 7 banks owned by the Princely state were nationalised in 1959 and they become subsidiaries of the 1959 and they became subsidiaries of the State Bank of India. In 1969, 14 commercial bank in the country were nationalised.
- In the phase of banking sector reforms, 7 more banks were nationalised in 1980. With this, 80% of the banking sector in India came under the government ownership.

COMMERCIAL BANKS

A commercial banks is defined as bank whose main business is deposit, taking and making loans. This contrasts with an investment bank whose main business is securities underwriting, mergers and acquisitions advisory, asset management and securities trading. This is a financial institution providing services for businesses, organisations and individuals. Services include offering current, deposit and saving accounts as well as giving out loans to businesses. Commercial bank may be Scheduled Commercial Bank and Non-Scheduled Commercial Banks.

TYPES OF COMMERCIAL BANKS:

There are three different types of commercial banks.

- **Private Bank –** It is one type of commercial banks where private individuals and businesses own a majority of the share capital. All private banks are recorded as companies with limited liability such as Housing Development Finance Corporation (HDFC), Industrial Credit and Investment Corporation of India (ICICI) and Yes Bank, etc.
- **Public Bank –** It is that type of bank that is nationalised, and the government holds a significant stake. For example, Bank of Baroda, State Bank of India (SBI), Dena Bank, Corporation Bank and Punjab National Bank.
- **Foreign Bank –** These banks are established in foreign countries and have branches in other countries. For instance, American Express Bank, Hong Kong and Shanghai Banking Corporation (HSBC), Standard & Chartered Bank and Citibank, etc.

FUNCTIONS OF COMMERCIAL BANKS

1. Accepting Deposits

The most important activity of a Commercial Banks is to mobilise deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts which banks. Depending upon the nature of deposits, funds deposited with bank also earn interest.

Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the banks. Some important account under received deposits.

- **Current Account:** It is a calculation of a Country's foreign transactions and along with the capital account is a component of a Country's balance of payment. The current account also includes net income, such as interest and dividends, as well as transfers, such as foreign aid, though these components tend to make up a smaller percentage of the current account than exports and imports.
- **Saving Account:** It is generally opened in bank by salaried persons or by the person who have a fixed regular income. This facility is also given to student, senior citizens, and pensioners and so on. Saving account are opened to encourage the people to save money and collect their savings.
- **Fixed Deposit Account:** A deposit of money that pays higher interest than a savings account, but imposes condition on the amount, frequency, and / or period of withdrawals. Also called time deposit. All these accounts are secure and carry a government guarantee.
- **Cash Credit Account:** It will be opened as per term and conditions of sanction of such credit limits. The rules prescribe for the current accounts, will also apply to Cash Credit account in addition to the sanctioned terms and conditions.
- **Recurring Deposit Account:** In banking terminology, the term recurring deposit refers to the periodic placement of a fixed sum of funds with a bank or financial institution into a special term account, with a specified tenure, generally between 1 and 5 years. At the end of the tenure, the funds are typically withdrawn by the depositor with accrued interest.

2. Grant loans and advances

The second important function of a Commercial Bank is to grant loans and advances and to lend money. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of Interest changed on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate changed on the loans is the main source of a bank's income.

Type of loan of commercial bank are given below

- Overdraft

- Debt and loan
- Retrenchment of exchange bills
- Cash credit

3. Agency Functions

- Collection of cheques, dividends and interests
- Payment of rent, insurance premiums
- Dealing in foreign exchange
- Purchase and sale of securities
- Act as trustee, executor, attorney etc
- Act as correspondent
- Preparation of Income-Tax returns

4. Value Added Services

- Safe deposit locker facility
- Traveller cheques
- Premium of insurances
- E-banking facilities
- Anywhere banking
- ATM facilities
- Credit card facilities
- ATM debit card facilities

5. Miscellaneous Functions

- Issuing letter of credit, travellers cheques circular note etc.
- Undertaking safe Custody of valuables, important documents and securities by providing safe deposit vaults or lockers.
- Providing Customers with facilities of foreign exchange.
- Transferring money from one place to another; and from one branch to another branch of the bank.
- Standing guarantee on behalf of its Customers, for making payments for purchase of goods, machinery, vehicles etc.
- Collecting and Supplying business information;
- Issuing demand draft and pay orders;
- Providing reports on the Credit worthiness of customers.

LENDING MONEY BY COMMERCIAL BANKS

Commercial banks are financial intermediaries. They accept deposits from the public and lend them in the form of short-term loan to traders and manufacturers. They provide working capital to the business in the form of overdraft and cash credit. Money mobilized by bankers through accepting deposits is disbursed to the needy persons for productive purposes. This function is very important because the economic development of the country mainly depends on the credit schemes of banks. Banks lend money in different forms.

1. Overdraft: An overdraft is an arrangement by which the customer is permitted to draw money over and above the credit balance in his account. This facility is provided only to holders of current accounts. It is granted against some collateral security. However the customers have to pay interest for the overdrawn amount.

2. Cash Credit: Cash credit is a short-term credit given to the businessmen for meeting their working capital requirements. It is normally made against certain security. Entire amount of loan will not be given at one particular time. The banker opens the cash credit account in the name of the borrower and permits him to withdraw money from time to time up to a certain limit fixed by the value of stocks kept in the go-down of the borrower.

3. Loans and Advances: These are direct loans given to all type of customers. These loans are given against the security of the movable and immovable properties. The amount of loan is paid as cash, or customer's account is credited with it so that he can withdraw the amount from his account at any time. The interest is charged on the full amount of the loan irrespective of the amount of cash withdrawn by him. The loan is repayable in a lump sum on the expiry of the term for which loan was given. The loans can be short term, medium term, or long term loans.

4. Discounting of Bills of Exchange: Discounting of bills of exchange is another type of lending by the modern banks. If the holder of bill of exchange needs money immediately, he can get it discounted by the bank. The bank pays the value of the bill to the holder after deducting its commission. When the bill matures, the bank gets payment from the party, which had accepted the bill.

ROLE OF COMMERCIAL BANK IN THE INDIAN ECONOMY

Growth of entrepreneurship

All types of organisations and industry sectors depend heavily on capital. It is a requirement for maintaining a business. Commercial banks step in to save enterprises by providing loans in this situation. Among them are business owners, farmers, and small and medium-sized organisations. Banks support self-sufficiency, combat unemployment, and advance the proper industries by lending money to business owners and making investments for constructive objectives.

Wealth creation

Bank professionals can guide customers to mutual funds or direct investments by offering consultation and advising services. The bank can serve as custodian for all investment securities, as well as a trustee for wills and investment funds, and it can also offer safety deposit boxes and letters of credit for potential investments.

Implementation and execution of monetary policies

A number of laws and regulations established by the Reserve Bank of India's monetary policy promote fair and open financial transactions throughout the nation. However, this is only feasible if commercial banks consent to follow these policies and assist in their implementation. The future of an economy and its development is built on a strong and solid monetary policy.

Trading functions

Market makers for corporate, government and municipal bonds may be commercial banks. Through their market-making operations, banks can offer technical guidance, counselling, and advice to issuers.

Credit creation

Creating credit or liquidity in the system is simply the process of leveraging national operations and developments. A nation's banks act as its financial engine, injecting capital into the system to support economic growth on many levels. Greater economic development is attributed to a more flexible credit influx that results in higher productivity, more jobs, sales, and services.

Inculcation Savings Habits

The predictable returns that banks provide as interest income are one of the main draws for people who have bank accounts. People deposit their money in banks through a variety of deposit plans that are tied to prices and interest. This promotes the development of saving habits, which is good for the economy.

NATIONALISATION OF BANKS

The nationalisation of commercial banks took place with an aim to achieve

- Social Welfare,

- Controlling Private Monopolies,
- Expansion of Banking,
- Reducing Regional Imbalance,
- Priority Sector Lending and
- Developing Banking Habits.

In order to have more control over banks, in 19th July, 1969 Mrs Indira Gandhi the then Prime Minister nationalised 14 large commercial banks whose reserves were more than Rs 50 crore. The main aim of nationalising was to reach client in rural area and provide them which more quality services.

Following is the list of banks, which got nationalised at this time

1. Allahabad Bank
2. Bank of Baroda
3. Bank of India
4. Bank of Maharashtra
5. Central Bank of India
6. Canara Bank
7. Dena Bank
8. Indian Bank
9. Indian Overseas Bank
10. Punjab National Bank
11. Syndicate Bank
12. UCO Bank
13. Union Bank
14. United Bank of India

In 15 April, 1980 the banks with more than Rs 200 crore of reserves got nationalised. Those six banks, which got nationalised are the following

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Commerce
5. Punjab and Sindh Bank
6. Vijaya Bank

Later on, in year 1993, the government merged New Bank of India with Punjab National Banks. It was the only merge between nationalised banks.

RBI'S CONSTITUTION

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

The overall economic efficiency and the stability of a nation are dependent on the payment and settlement system prevailing in that country. As a result, the various regulators in India, including the central bank, have been regularly and consistently revising their operating models and policies to ensure and carry on the development of payment systems at the national level. These regulators are required to carefully safeguard the sanctity of payment systems, generally from systematic risks, the risk of fraud, etc. The responsibility of a central bank of any given country is to ensure and carry on the development of payment systems at the national level. In India, this responsibility is vested with the Reserve Bank of India (RBI).

HISTORY OF RBI

Strategic efforts were made to establish a central bank in India. **Warren Hastings** made the earliest attempt, when he was acting as the Governor of Bengal in 1773. He recommended for the formation of "**General Bank in Bengal and Bihar**". The Chamberlin Commission report in 1913 also raised the issue of the founding of a central bank for the country. Based on this report, **Professor J.M. Keynes** formulated the first comprehensive plan for an Indian central bank. However, Keynes' plan did not come into effect, on account of the outbreak of the First World War. The Imperial Bank of India was set up in 1921 by amalgamating three Presidency Banks, which performed a few central banking functions. However, primarily it remained as a commercial bank. The Imperial Bank served as a banker to the Government and in some capacity as the bankers' bank till the establishment of the Reserve Bank of India.

The Royal Commission on Indian Currency and Finance, which was also known as the Hilton -Young Commission, recommended the creation of a Central Bank. The recommendation was based on the principle of separation of control of currency and credit from the other functions of the Government and to facilitate the growth of the banking sector. The Reserve Bank of India Act, 1934 paved way for the creation of the Reserve Bank and operations started from the year 1935. Since, then the Reserve Bank of India has undergone numerous transformations, reflecting the growing aspirations of the country.

ESTABLISHMENT OF RESERVE BANK OF INDIA

The Reserve Bank is fully owned and operated by the Government of India. The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

- Regulating the issue of Banknotes
- Securing monetary stability in India
- Modernising the monetary policy framework to meet economic challenges

The Reserve Bank's operations are governed by a central board of directors, RBI is on the whole operated with a 21-member central board of directors appointed by the Government of India in accordance with the Reserve Bank of India Act.

The Central board of directors comprise of:

- Official Directors – The governor who is appointed/nominated for a period of four years along with four Deputy Governors
- Non-Official Directors – Ten Directors from various fields and two government Official

OBJECTIVES OF RBI

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

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

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

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

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

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

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

RBI'S MAIN FUNCTIONS

1. Notes Issuance

RBI has the sole authority for the issuance of currency notes and putting them into circulation, withdrawing them or exchanging them. RBI has issued and put in circulation notes in the denomination of Rs. 2, 5, 10, 20, 50, 100, 500, 1000 and 2000. Except Re. 1 notes and all coins, which are issued by the Government of India, but put into circulation by RBI. The RBI has about seventeen Issue Offices and above 4, 000 currency chests where new and re-issuable notes are stored. The currency chests are kept by various banking groups as agents of RBI. As a cover for the notes issue, RBI keeps a minimum value of gold coin, bullion and foreign securities as a part of the total approved assets.

2. Government's Banker

RBI acts as the banker to the Central and State Governments. It provides them banking services of deposits, withdrawal of funds, making payments and receipts, collection and transfer of funds and management of public debt. Government deposits are received free of interest and RBI does not receive any remuneration for the routine banking business of the government. RBI also makes 'ways and means advance' to central and state governments.

3. Banker's Bank

Every central bank acts as a banker's bank and so does RBI. The commercial banks and state cooperative banks which are scheduled banks (appearing in the second schedule of the RBI Act) have to keep stipulated reserves in cash and in approved securities as a percentage of their Demand and Time Liabilities (DTL). These reserves, as discussed in a later section of this Unit, regulate the banks' ability to create credit and affect money supply in the economy. RBI also changes its Bank Rate to regulate the cost of bank credit and thereby its volume indirectly. RBI also acts as a 'lender of the last resort, for banks.

4. Bank's Supervision

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

RBI's supervisory powers over commercial banks are quite wide as mentioned below and their objective is to develop a sound banking system in the country:

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

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

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

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

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

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

5. Development of the Financial System

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

(i) Industrial finance: Industrial Development Bank of India (IDBI) in 1964, small Industries Development Bank of India (SIDBI) in 1989.

(ii) Agricultural credit: National Bank for Agriculture and Rural Development (NABARD) in 1981.

(iii) Export-import finance: Export-Import Bank of India (EXIM Bank) in 1981.

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

6. Exchange Control

RBI is entrusted with duty of maintaining the stability of the external value of the national currency Indian Rupee. It used to regulate the foreign exchange market in the country in terms of the Foreign Exchange Regulation Act (FERA) 1947, (amended and enlarged in 1973). The FERA, 1973 has been replaced by the Foreign Exchange Management Act, 1999 (FEMA) and RBI is now guided by the provisions of the new Act.

7. Monetary Control

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

I. QUALITATIVE CREDIT CONTROL METHODS OF RBI

In India, the legal framework of RBI's control over the credit structure has been provided Under Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949.

1. Bank Rate Policy

Bank rate is the rate at which the Central bank lends money to the commercial banks for their liquidity requirements. Bank rate is also called discount rate. In other words bank rate is the rate at which the central bank rediscounts eligible papers (like approved securities, bills of exchange, commercial papers etc) held by commercial banks.

2. Open market operations

It refers to buying and selling of government securities in open market in order to expand or contract the amount of money in the banking system. This technique is superior to bank rate policy. Purchases inject money into the banking system while sale of securities do the opposite. During last two decades the RBI has been undertaking switch operations. These involve the purchase of one loan against the sale of another or, vice-versa. This policy aims at preventing unrestricted increase in liquidity.

3. Cash Reserve Ratio (CRR)

The Cash Reserve Ratio (CRR) is an effective instrument of credit control. Under the RBl Act of, l934 every commercial bank has to keep certain minimum cash reserves with RBI. The RBI is empowered to vary the CRR between 3% and 15%. A high CRR reduces the cash for lending and a low CRR increases the cash for lending. The CRR has been brought down from 15% in 1991 to 7.5% in May 2001. It further reduced to 5.5% in December 2001. It stood at 5% on January 2009. In January 2010, RBI increased the CRR from 5% to 5.75%. It further increased in April 2010 to 6% as inflationary pressures had started building up in the economy. As of March 2011, CRR is 6% and now it is 4% w.e.f.09/02/2013.

4. Statutory Liquidity Ratio (SLR)

Under SLR, the government has imposed an obligation on the banks to; maintain a certain ratio to its total deposits with RBI in the form of liquid assets like cash, gold and other securities. The RBI has power to fix SLR in the range of 25% and 40% between 1990 and 1992 SLR was as high as 38.5%. Narasimham Committee did not favour maintenance of high SLR. The SLR was lowered down to 25% from 10th October 1997. It was further reduced to 24% on November 2008. At present it is 23% w.e.f.11/08/2012.

5. Credit Control Function

Commercial bank in the country creates credit according to the demand in the economy. But if this credit creation is unchecked or unregulated then it leads the economy into inflationary cycles. On the other credit creation is below the required limit then it harms the growth of the economy. As a central bank of the nation the RBI has to look for growth with price stability. Thus it regulates the credit creation capacity of commercial banks by using various credit control tools.

6. Repo and Reverse Repo Rates

Reverse repo rate is the rate that banks get from RBI for parking their short term excess funds with RBI. Repo and reverse repo operations are used by RBI in its Liquidity Adjustment Facility. RBI contracts credit by increasing the repo and reverse repo rates and by decreasing them it expands credit. Repo rate was 6.75% in March 2011 and Reverse repo rate was 5.75% for the same period. On May 2011 RBI announced Monetary Policy for 2011-12. To reduce inflation it hiked repo rate to 7.25% and Reverse repo to 6.25% w.e.f 03/05/2013

II. UNDER SELECTIVE CREDIT CONTROL, credit is provided to selected borrowers for selected purpose, depending upon the use to which the control tries to regulate the quality of credit - the direction towards the credit flows. The Selective Controls are

1. Ceiling on Credit

The Ceiling on level of credit restricts the lending capacity of a bank to grant advances against certain controlled securities.

2. Margin Requirements

A loan is sanctioned against Collateral Security. Margin means that proportion of the value of security against which loan is not given. Margin against a particular security is reduced or increased in order to encourage or to discourage the flow of credit to a particular sector. It varies from 20% to 80%. For agricultural commodities it is as high as 75%. Higher the margin lesser will be the loan sanctioned.

3. Discriminatory Interest Rate (DIR)

Through DIR, RBI makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. RBI issues supplementary instructions regarding granting of additional credit against sensitive commodities, issue of guarantees, making advances etc.

4. Directives

The RBI issues directives to banks regarding advances. Directives are regarding the purpose for which loans may or may not be given.

5. Direct Action

It is too severe and is therefore rarely followed. It may involve refusal by RBI to rediscount bills or cancellation of license, if the bank has failed to comply with the directives of RBI.

6. Moral Suasion

Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with authorities of commercial banks in this respect.

SOURCES OF RISK IN BANKS

- **Credit Risk:** Credit risk is the biggest risk for banks. It occurs when borrowers or counterparties fail to meet contractual obligations. An example is when borrowers default on a principal or interest payment of a loan. Defaults can occur on mortgages, credit cards, and fixed income securities. Failure to meet obligational contracts can also occur in areas such as derivatives and guarantees provided.

- **Operational Risk:** Operational risk is the risk of loss due to errors, interruptions, or damages caused by people, systems, or processes. The operational type of risk is low for simple business operations such as retail banking and asset management, and higher for operations such as sales and trading. Losses that occur due to human error include internal fraud or mistakes made during transactions.
- **Market Risk:** Market risk mostly occurs from a bank's activities in capital markets. It is due to the unpredictability of equity markets, commodity prices, interest rates, and credit spreads. Banks are more exposed if they are heavily involved in investing in capital markets or sales and trading.
- **Liquidity Risk:** Liquidity risk refers to the ability of a bank to access cash to meet funding obligations. Obligations include allowing customers to take out their deposits. The inability to provide cash in a timely manner to customers can result in a snowball effect. If a bank delays providing cash for a few of their customer for a day, other depositors may rush to take out their deposits as they lose confidence in the bank. This further lowers the bank's ability to provide funds and leads to a bank run.

ANALYZING BANKS FINANCIAL STATEMENTS

In India banks occupy a substantial portion of the overall stock market and hence, they probably form at least some part of the investment portfolios of equity investors. No matter whether an investor invests through mutual funds or directly in stocks, it is difficult for him/her to escape banks or financial firms. With credit penetration in India still remaining low, financial firms have a long runway for growth in the coming years. It translates into the growing popularity of banking and financial stocks.

Capital adequacy ratio (CAR)

It is the measure of a bank's available capital divided by the loans (assessed in terms of their risk) given by the bank. CAR is used to protect depositors and promote the stability and efficiency of financial systems. It helps measure the financial strength or ability of the financial institution to meet its obligations by using its assets and capital. The higher the CAR, the better capitalised the bank is. In India, as per the RBI norms, Indian-scheduled commercial banks are required to maintain a CAR of 9 per cent, while Indian public-sector banks are emphasised to maintain a CAR of 12 per cent.

Gross and net non-performing assets

Non-performing assets (NPAs) indicate how much of a bank's loan book is in danger of not being repaid. A loan turns non-performing if the interest or instalment of the principal amount is not received for a period of 90 days. NPAs are further categorised as gross and net NPAs. Gross NPA includes both the principal and interest aspects of the loan, whereas net NPA is calculated mainly by subtracting the provisions made by the bank from the gross NPA.

Provision coverage ratio

In banking, it is a fact that some portions of loans will always turn bad. Banks, therefore, make provisioning for such bad loans by setting aside funds to a prescribed percentage of their bad assets. For example, if the PCR is 70 per cent for a particular category of bad loans, banks have set aside funds equivalent to 70 per cent of those bad assets out of their profits. A high PCR means that most asset-quality issues have been taken care of.

Return on assets

In the balance of banks, loans given out to borrowers are assets whereas depositors' money is a liability. Return on assets depicts how profitable the bank is relative to its total assets. It is calculated by dividing net profit by total assets. A high ROA relative to other banks can be on account of various factors, including substantial other income, aggressive lending practices, operational efficiency and other factors.

CASA ratio

It stands for current account saving account. CASA is the per cent of deposits held by banks in current and savings accounts. Banks pay low interests on such accounts. A high CASA ratio is positive for the bank, as it is able to reduce the total borrowing rate.

Net interest margin

As the name suggests, it is the difference between the interest income generated from borrowers and the amount of interest paid to depositors, relative to total deposits. It is a profitability ratio and similar to the gross margin of a normal company.

Cost to income

It is an important ratio to determine how efficiently a bank is being run. Cost to income is calculated by dividing operating expenses by the bank's operating income (interest income plus other income). There is an inverse relation between cost to income and the bank's profitability. The lower the cost-to-income ratio, the better the profitability is.