UNIT 10 : BANKS AND THEIR FUNCTIONS

UNIT STRUCTURE

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10.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define "bank" and "banking business'
- explain the importance of banking
- describe the nature and functions of commercial banks
- explain the significance of Central Bank and its functions
- discuss the nature and functions of Regional Rural Banks
- analyze the concept of private banking.

10.2 INTRODUCTION

You might have seen or visited a bank branch, where people keep their surplus money and withdraw (or take loan) money in necessity. In all over the world most common function of banks are accepting deposits from the public and deploy the funds by way of loans and advances to trade and industry to meet their financial requirements. This practice of accepting deposits and lending for short terms is known as commercial banking or deposit banking. The Indian banking system consists of scheduled banks in the public sector (27), private sector (35), foreign banks (36), co-operative banks (28) and regional rural banks (196). The banking system of India is governed by the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. In this unit we will discuss meaning and concept of banks, commercial banks and its functions, central bank activities, RRBs, the concept of private banking.

10.3 MEANING OF BANKING

In India, Banking is defined by Banking Regulation Act, 1949 under section 5(b) as the business of "acceptance of deposits of money from public for the purpose of lending or investment which may be repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise". Hence a bank must perform the following two functions to be called as a bank-

- Acceptance of deposits and
- Lending or investment of such deposits

The Banking Regulation Act, 1949, under section 49A no person other then a bank is authorized to accept deposits withdrawable by cheque. However, savings bank run by the government are exempted from this prohibition.

Under English law, **bank** is defined as a person who carries on the business of banking, which is:

- conducting current accounts for customers
- paying cheques drawn on a given person, and

- collecting cheques for their customers.

Under the English law, Bills of Exchange Act defines of the term banker as "a body of persons, whether incorporated or not, who carry on the business of banking". The business of banking is in many English common law countries not defined by statute but by common law. In English common law jurisdictions there are statutory definitions of the business of banking or banking business. "Banking business" means the business of receiving money on current or deposit account, paying and collecting cheques drawn by or paid in by customers, the making of advances to customers, and includes such other business as the Authority may prescribe for the purposes of this Act;"

Hence, "banking business" means the business of either or both of the following-

- receiving from the general public money on current, deposit, savings or other similar account repayable on demand or within less than 3 months... or with a period of call or notice of less than that period;
- paying or collecting cheques drawn by or paid in by customers;

A banker or bank is a financial institution that acts as a payment agent for customers, and borrows and lends money. In some countries such as Germany and Japan, banks are the primary owners of industrial corporations while in other countries such as the United States banks are prohibited from owning non-financial companies.

In India banking companies are defined by Banking Regulation Act, 1949.The section 5(e) of the Act defines banking company as a company which transacts the business of banking. Such company may be a company constituted under section 3 of Indian Companies Act, 1956 or a foreign company constituted under section 591 of the Act. Banks in India carry on their operation under one of the categories:

i) body corporate constituted under special statutes
ii) Company registered under the Companies Act, 1956 or foreign companies
iii) Cooperative society registered under the Cooperative Societies Act.

LET US KNOW

The name bank derives from the Italian word banco "desk/bench", used during the Renaissance by Florentines bankers, who used to make their transactions above a desk covered by a green tablecloth. However, there are traces of banking activity even in ancient times. In fact, the word traces its origins back to the Ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called macella on a long bench called a bancu, from which the words banco and bank are derived. As a moneychanger, the merchant at the bancu did not so much invest money as merely convert the foreign currency into the only legal tender in Rome- that of the Imperial Mint.

10.4 IMPORTANCE OF BANKING

Bank is an indispensable institution for an economy. It is the institution which gives the mobility to the financial resources within or outside the economy. Banks works as the mediator of the savers and lenders and work as a bridge between savings and investment. It caters to the various financial needs of individuals and body corporate and also work as an agent in many occasions. Bank also work as a catalysts of economic growth ensuring money flow to the every section and every corner as per the national priority of the government. The following points will explain the importance of the banking institutions-

- Banks act as payment agents by maintaining current accounts for customers, paying cheques drawn by customers on the bank, and collecting cheques deposited to customers' current accounts. Banks also provide for speedier customer payments via other payment methods such as telegraphic transfer, ATM etc.
- Banks, by accepting funds deposited in different accounts, accepting term deposits and by issuing debt securities such as banknotes and bonds give mobility to the surplus funds in the hands of customer and also provide return on them.

- Banks, by making advances to customers, by making installment loans, and by investing in marketable debt securities and other forms of lending contribute for expansion of economic and entrepreneurial activities.
- Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Non-banks that provide payment services such as remittance companies are not normally considered an adequate substitute for having a bank account. Hence bank works a facilitator of economic transactions and also custodian of monetary assets of customer.

CHECK YOUR PROGRESS - 1

A) State two important points regarding importance of banks

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10.5 CLASSIFICATION OF BANKS

In earlier sections we have discussed about the concept of banking and its importance. Now we will discuss the various types of banks that are in operation. In India we find banks broadly in three types by its nature of functions- Central bank, Commercial banks, Regional Rural banks and Cooperative banks. Central bank is the regulatory authority of the banking system in India. Commercial banks can be further classified as Public sector and Private sector and foreign banks on the basis of ownership. On the other hand, Cooperative Banks can be classified as State Cooperative Bank (at State level), Central/District Cooperative banks (at district level) and primary Credit Society (at village level) on the basis of its area of operation. Currently, India has 88 scheduled commercial banks (SCBs) - 28 public sector banks (that is with the Government of India holding a stake), 29 private banks (these do not have government stake; they may be publicly listed

and traded on stock exchanges) and 31 foreign banks. ANZ Grindlays Bank, Citibank, American Express Bank Ltd. etc. are some of the foreign banks operating in India. They have a wide network of branches and ATMs. The public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively.

Fig: Classification of banks

ACTIVITY 1

List down names of five banks operating in your district. You can take help from your parents /friends/ relatives.

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10.6 CENTRAL BANK

A central bank is an entity responsible for the monetary policy of its country. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates and acting as a lender of last resort to the banking sector during times of financial crisis. It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently. Central banks are normally government owned banks, often charged with quasi-regulatory responsibilities, e.g. supervising commercial banks, or controlling the cash interest rate. They generally provide liquidity to the banking system and act as Lender of last resort in event of a crisis.Hence the common basic objectives of a central bank are:

- To maintain the internal value of the nation's currency;
- To preserve the external value of the currency;
- To ensure a reasonable price stability:
- To promote economic growth with the rising levels of employment, output and real income:
- To promote banking and financial institutions

Fig: Objectives of central bank

The oldest central bank in the world is the Riksbank in Sweden, which was opened in 1668 with help from Dutch businessmen. This was followed in 1694 by the Bank of England, created by Scottish businessman William Paterson in the City of London at the request of the English government to help pay for a war. The Bulgarian National Bank was established on 25 January 1879. The US Federal Reserve was created by the U.S. Congress through the passing of the Glass-Owen Bill, signed by President Woodrow Wilson on December 23, 1913. The Reserve Bank of India (RBI) is the central bank of India, and was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. Since its inception, it has been headquartered in Mumbai. Though originally privately owned, RBI has been fully owned by the Government of India since nationalization in 1949.

There is no standard terminology for the name of a central bank, but many countries use the "Bank of Country" form (e.g., Bank of England, Bank of Canada, Bank of Russia). Some are styled national banks, such as the National Bank of Ukraine. In other cases they may incorporate the word "Central" (e.g. European Central Bank, Central Bank of Ireland). In many countries, there may be private banks that incorporate the term national. Many countries have state-owned banks or other quasi-government entities that have entirely separate functions, such as financing imports and exports. In some countries, particularly in some Communist countries, the term national bank may be used to indicate both the monetary authority and the leading banking entity, such as the USSR's Gosbank (state bank). In other countries, the term national bank may be used to indicate that the central bank's goals are broader than monetary stability, such as full employment, industrial development, or other goals.The word "Reserve" is also used, primarily in the U.S., Australia, New Zealand, South Africa and India.

10.7 FUNCTIONS OF CENTRAL BANK

In view of the above objectives, the central bank of a developing country performs various functions from time to time. These functions may be grouped as follows:

As a Monetary Authority

- Formulates implements and monitors the monetary policy.
- Maintains price stability and ensures adequate flow of credit to productive sectors.
- Maintains optimum Liquidity in the economy.

As a Regulator and supervisor of the financial system

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- Supervises the banks and financial institutions
- Maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.
- setting the official interest rate - used to manage both inflation and the country's exchange rate - and ensuring that this rate takes effect via a variety of policy mechanisms

As a Manager of Exchange Control

- Manages the Foreign Exchange reserves in the country.
- Facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

As a Issuer of currency

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Ensure adequate quantity of supplies of currency notes and coins and in good quality.

As a Banker to the Government

- Performs merchant banking function for the central and the state governments; also acts as their banker.
- Functions as owner and operator of the depository (SGL) and exchange (NDS) for government bonds.

As a Banker to banks

- Maintains banking accounts of all scheduled banks.
- Providing loan to commercial bank

CHECK YOUR PROGRESS - 2

A) Discuss the functions of central bank as regulator of the financial system.

B) Select the correct answer:

Bank rate is the rate at which-

a. Commercial bank lend to the borrowers

b. Commercial bank lend to the borrowers

c. Commercial banks accept deposit from customers

d. A bank lends to another bank

10.8 INSTRUMENTS OF CENTRAL BANK

The main monetary policy instruments available to central banks are open market operation, bank reserve requirement, interest-rate policy, re-lending and re-discount (including using the term repurchase market), and credit policy (often coordinated with trade policy). While capital adequacy is important, it is defined and regulated by the Bank for International Settlements, and central banks in practice generally do not apply stricter rules.

To enable open market operations, a central bank must hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves. It will often have some influence over any official or mandated exchange rates: Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float").

Fig: Instruments of Central bank

- **Interest rates**

By far the most visible and obvious power of many modern central banks is to influence market interest rates; contrary to popular belief, they rarely "set" rates to a fixed number. Although the mechanism differs from country to country, most use a similar mechanism based on a central bank's ability to create as much fiat money as required.The mechanism to move the market towards a 'target rate' (whichever specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities, until the targeted market rate is sufficiently close to the target. Central banks may do so by lending money to and borrowing money from (taking deposits from) a limited number of qualified banks, or by purchasing and selling bonds.

A typical central bank has several interest rates or monetary policy tools it can set to influence markets.

- Marginal Lending Rate .A fixed rate for institutions to borrow money

from the Central bank.(In the US this is called the Discount rate, in India -bank rate).

- Main Refinancing Rate. This is the publicly visible interest rate the central bank announces. It is also known as Minimum Bid Rate and serves as a bidding floor for refinancing loans. (In the US this is called the Federal funds rate).
- Deposit Rate. The rate parties receive for deposits at the Central Bank.

These rates directly affect the rates in the money market, the market for short term loans.

- **Open Market Operations**

Through open market operations, a central bank influences the money supply in an economy directly. Each time it buys securities, exchanging money for the security, it raises the money supply. Conversely, selling of securities lowers the money supply. Buying of securities thus amounts to printing new money while lowering supply of the specific security. The main open market operations are:

- Temporary lending of money for collateral securities ("Reverse Operations" or "repurchase operations", otherwise known as the "repo" market). These operations are carried out on a regular basis, where fixed maturity loans (of 1 week and 1 month for the ECB) are auctioned off.
- Buying or selling securities ("Direct Operations") on ad-hoc basis.
- Foreign exchange operations such as forex swaps.

All of these interventions can also influence the foreign exchange market and thus the exchange rate.

- **Capital requirements**

All banks are required to hold a certain percentage of their assets as capital, a rate which may be established by the central bank or the banking supervisor. For international banks, including the 55 member central banks of the Bank for International Settlements, the threshold is 8% of risk-adjusted assets, whereby certain assets (such as government bonds) are considered to have lower risk and are either partially or fully excluded from total assets for the purposes of calculating capital adequacy. Partly due to concerns

about asset inflation and term repurchase agreements, capital requirements may be considered more effective than deposit/reserve requirements in preventing indefinite lending: when at the threshold, a bank cannot extend another loan without acquiring further capital on its balance sheet.

- **Reserve requirements**

Another significant power that central banks hold is the ability to establish reserve requirements for other banks. By requiring that a percentage of liabilities be held as cash or deposited with the central bank (or other agency), limits are set on the money supply.

In practice, many banks are required to hold a percentage of their deposits as reserves. Such legal reserve requirements were introduced in the nineteenth century to reduce the risk of banks overextending themselves and suffering from bank runs, as this could lead to knock-on effects on other banks.. As the early 20th century gold standard and late 20th century dollar hegemony evolved, and as banks proliferated and engaged in more complex transactions and were able to profit from dealings globally on a moment's notice, these practices became mandatory, if only to ensure that there was some limit on the ballooning of money supply. Such limits have become harder to enforce.

- **Exchange requirements**

To influence the money supply, some central banks may require that some or all foreign exchange receipts (generally from exports) be exchanged for the local currency. The rate that is used to purchase local currency may be market-based or arbitrarily set by the bank. This tool is generally used in countries with non-convertible currencies or partially-convertible currencies. The recipient of the local currency may be allowed to freely dispose of the funds, required to hold the funds with the central bank for some period of time, or allowed to use the funds subject to certain restrictions. In other cases, the ability to hold or use the foreign exchange may be otherwise limited.

In this method, money supply is increased by the central bank when the central bank purchases the foreign currency by issuing (selling) the local currency. The central bank may subsequently reduce the money supply

by various means, including selling bonds or foreign exchange interventions.

- **Margin requirements and other tools**

In some countries, central banks may have other tools that work indirectly to limit lending practices and otherwise restrict or regulate capital markets. For example, a central bank may regulate margin lending, whereby individuals or companies may borrow against pledged securities. The margin requirement establishes a minimum ratio of the value of the securities to the amount borrowed.Central banks often have requirements for the quality of assets that may be held by financial institutions; these requirements may act as a limit on the amount of risk and leverage created by the financial system. These requirements may be direct, such as requiring certain assets to bear certain minimum credit ratings, or indirect, by the central bank lending to counterparties only when security of a certain quality is pledged as collateral more finely tuned and regionally varied.

- **Banking supervision and other activities**

In some countries a central bank through its subsidiaries controls and monitors the banking sector. In other countries banking supervision is carried out by a government department such as the UK Treasury, or an independent government agency (eg UK's Financial Services Authority). It examines the banks' balance sheets and behaviour and policies toward consumers. Apart from refinancing, it also provides banks with services such as transfer of funds, bank notes and coins or foreign currency. Thus it is often described as the "bank of banks".Many countries such as the United States will monitor and control the banking sector through different agencies and for different purposes, although there is usually significant cooperation between the agencies. For example, money center banks, deposit-taking institutions, and other types of financial institutions may be subject to different (and occasionally overlapping) regulation. Some types of banking regulation may be delegated to other levels of government, such as state or provincial governments.

ACTIVITY 2

Why do we require Banks?

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10.9 COMMERCIAL BANKS

Commercial banks are the banks that extend the short term loans to the individuals, businessmen, traders and industries apart from mobilizing savings through savings account. The commercial banks are generally organized as Joint Stock Company. As such the bank raises its capital through sale of its stocks and shares. Generally commercial banks provide short term loans to commerce and industry. However, with the harmonization of the banking system, these commercial banks have been providing long term finance also. The special feature of the commercial bank is that they can create credit. The commercial banking system consists of scheduled and non-scheduled banks.

- **Scheduled Commercial Bank**

The banks included in the second schedule of the Reserve Bank of India Act, 1934 are called Scheduled Commercial banks. The Reserve Bank of India Act, 1934 under section 42(6) includes banking institution in the schedule provided that:

- It satisfies the RBI that its affairs are not conducted in a manner detrimental to the interest of its depositors;
- Its paid up capital and reserves have an aggregate value of not less than its stipulated amount fixed from time to time;
- It can be a state cooperative bank or Indian or foreign commercial bank.

The scheduled commercial banks avail certain facilities from the RBI like coverage of Deposit Insurance Scheme and the Credit Guarantee Scheme and refinance from the development banks. They have to abide by

all the directives issued by the Reserve Bank of India from time to time.

- **Non-scheduled banks**

Banks which are not included in the scheduled of the Reserve Bank of India Act, 1934 are called non-scheduled banks. There were 474 non-scheduled banks in the year 1951 out of total 566 banks in India. Through the process of merger, acquisition and amalgamation the number of non scheduled bank is reduced to 3 in 1989.Presently, there is no non- scheduled bank in India and hence this classification has no practical existence.

The commercial banks can again be classified into two categories- public sector and private sector banks.

- **Public sector banks**

Public sector banks are those where the more then 50 percent shares are held by Government and the rest are held by private parties or individuals. The ownership of the bank remains with the Government. State bank of India, Punjab National bank, Canara Bank, Bank of Baroda etc are examples of public sector banks

- **Private sector banks**

If a bank is promoted and majority shares are held by the private parties such bank is called private bank. Ownership and management of this type of bank is vested on private parties. ICICI Bank, Axis Bank, IDBI Bank, Yes Bank, Kotak Mahindra Bank etc. are examples of private sector banks.

10.10 FUNCTIONS OF COMMERCIAL BANKS

Now, we will discuss the functions of commercial banks, which can be classified as under:

1. Acceptance of deposits and savings mobilization is the most primary function of commercial banks. Commercial banks accept three types of deposits from the customers. (i) Fixed deposit- a deposit for a fixed period which gives a higher rate of interest. The money so deposited can not be withdrawn before the expiry of the period. Hence it is also called time deposit or term deposit ;(ii) Current account deposit- it is

also known as demand deposit as because the deposit amount is returned by the bank to the customer on demand. The customer can withdraw at any time he/she wants. Generally no interest is given on these deposits by the bank ;(iii) Savings account deposit –this is also like current account but with certain restrictions like restrictions in withdrawal of maximum amount in a day, number of withdrawal per week etc. Deposits accepted under this account fetches a nominal rate of interest which is rather lower than what is offered by the fixed deposits. Through this type of account commercial banks encourage the small savings.

2. Issue of money, in the form of banknotes and current accounts subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable and/or repayable on demand, and hence valued at par and effectively transferable by mere delivery in the case of banknotes, or by drawing a cheque, delivering it to the payee to bank or cash.

3. Netting and settlement of payments — banks act both as collection agent and paying agents for customers, and participate in inter-bank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economise on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables payment flows between geographical areas to offset, reducing the cost of settling payments between geographical areas by processing of payments by way of telegraphic transfer, EFTPOS, internet banking or other means.

4. Credit intermediation –The deposits received by the banks are redirected towards the borrowers who are in need of money in the form of loans and advances. Banks borrow and lend back-to-back on their own account as middle men. Accepting money on term deposit and lending money by way of overdraft, cash credit, installment loan or otherwise banks act as intermediaries to the savings and investment process.

5. Credit quality improvement — banks lend money to ordinary

commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and the bank's own capital which provides a buffer to absorb losses without defaulting on its own obligations. However, since banknotes and deposits are generally unsecured, if the bank gets into difficulty and pledges assets as security to try to get the funding it needs to continue to operate, this puts the note holders and depositors in an economically subordinated position.

6. Maturity transformation — banks borrow more on demand debt and short term debt, but provide more long term loans. Bank can do this because they can aggregate issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemptions of banknotes), maintain reserves of cash, invest in marketable securities that can be readily converted to cash if needed, and raise replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets) because they have a high and more well known credit quality than most other borrowers.
7. Credit creation-As pointed out above, granting of loans and advances is an important function of commercial bank. But the process by which they grant loans and advances is significant for the economy. Whenever the bank lends money, it creates a deposit or a liability against itself. Since the deposit of bank circulate as money, the creation of such deposit leads to an increase in money stock in the economy. This is known as creation of money or credit.
8. Act as promoter to the economic activities providing documentary and standby letters of credit, guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures
9. Provide custodian and safekeeping services of money and other valuables of customers like documents and other items in safe deposit boxes
10. Commercial banks in recent times deals in many other financial innovation like currency exchange sale, distribution or brokerage, with

or without advice, of insurance, mutual fund unit, share broking and similar financial products as a 'financial supermarket'

CHECK YOUR PROGRESS - 3

A) State three functions of commercial banks.

B) State whether following statements are true or false

a. The commercial banks performs custodian function for the central and the state governments and also acts as their banker.

b. Scheduled banks are not included in the second Schedule of the RBI Act, 1934

10.11 COOPERATIVE BANKS

The Co-operative banks are institutions established with principles of co-operation. The objective of such organization is to facilitate rural credit and to promote thrift and self-help among the farmers and economically weaker sections of the society who are in the economic evils and moral degeneration .Like commercial banks the co-operative banks also receive deposits and lend money. But they lend money to their members and make incidental profits, although their sole objective is not profit making. The co-operative credit movement in India began with the passing of the Cooperative Credit Societies Act of 1904. The Act provided for the formation of credit societies, emphasizing on rural credit. Unlimited liability was the rule in rural societies. These credit societies slowly paved the way in the formation of co-operative banks.

The co-operative banking in India has grown in size and volume. A special feature of co-operative banks in India is its federal structure, the units ranging from primary level to national level. Co-operative Banking in India can be divided into two important areas, namely,

a) **Agricultural Co-operative Bank** - they are primarily operative at the village level, Central Co-operative bank at the district level and the State co-operative bank at the state level.

b) **Non-Agricultural Co-operative Bank** - they mainly include Urban

Co-operative bank, Employee Credit co-operative banks and Housing Co-operative bank.

Some important features of Co-operative Banks in India

- Cooperative banks are governed by the Cooperative Societies Act 1912, the Reserve Bank Act 1934 as well as the Banking Regulation Act 1949.
- The cooperative banking system comprises of State Cooperative Banks (SCBs) at the state level, Central Cooperative Banks (CCBs) at the district level, Primary Agricultural Credit Societies (PACSs) at the village level, Land Development Banks (LDBs) and Urban Cooperative Banks (UCBs).
- They generally cater to the credit needs of the farmers and rural population. However, these days cooperative banks especially the SCBs are doing commercial banking too.
- They perform all the main banking function but work on a "no profit, no loss basis.
- They are only partially financial intermediaries because a significant part of their resources i.e. in the form of borrowings from the RBI, NABARD, Central and State Governments and Cooperative Apex Institutions. Certain Cooperative Banks (e.g.; LDBs) raise resources by issuing debentures of different types.
- Cooperative banks account for 42 percent of institutional lending to the rural sector and it covers about 65 percent of the rural population.
- They comprise of scheduled and non-scheduled cooperative banks.
- Earlier their interest rotes were regulated by the RBI, but they have been mostly deregulated now. (They are also generally subject to monetary controls).
- The apex body for regulating and promoting the cooperative banks/ credit is the National Bank for Agriculture and Rural Development(NABARD)

The cooperative credit system in the country is into arms for short-term credit (production credit) structure and long term credit (Investment credit) structure. The short term cooperative credit structure has at its base

the Primary Credit Societies (PACS) dealing mainly in credit, the Farmers Service Societies (FSS) which are multipurpose primary societies with a large area of operation and membership. These societies are affiliated to the District Central Cooperative Banks at district level which in turn affiliated to State Co- operative Banks at the state level. At present, there are more than a lakh PACS about 500 DCCBs and 28 SCBs are supplying short term and medium term agricultural credit to the rural areas.

Fig: Cooperative Credit System

The long term credit structure consists of 19 State Co- operative Agricultural and Rural Development Banks (SCARDBs) with about 800 Primary Cooperative Agricultural and Rural Development Banks (PCARDBs) in respect of federal structure and around 1500 branches in the unitary structure. Cooperative banking has been quite successful .There has been an impressive growth in deposits, credit and working capital of these banks.

ACTIVITY 3

Distinguish between a commercial bank and cooperative bank

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10.12 REGIONAL RURAL BANKS

Regional Rural Banks have been in existence for around three decades in the Indian financial scene. Inception of regional rural banks (RRBs) can be seen as a unique experiment as well as experience in improving the efficacy of rural credit delivery mechanism in India. With joint share holding by Central Government, the concerned State Government and the sponsoring bank, an effort was made to integrate commercial banking within the broad policy thrust towards social banking keeping in view the local peculiarities. The genesis of the RRBs can be traced to the need for a stronger institutional arrangement for providing rural credit. Since the early 1970's there was a growing realization that the workings of the banking were not up to the level of satisfaction of the credit needs of the rural population ,especially those of the weaker section. Subsequently, the Government of India appointed a Working Group in 1975 to study the problem and to evolve an alternative channel of credit to those sections of society. According to the recommendation of the committee, the Government promulgated the Regional Rural Banks ordinance on September26, 1975 which was later replaced by the regional Rural Banks Act, 1976. The creation of RRBs as a new set of regionally oriented rural banks, have combined the local feel and familiarity of rural problems characteristic of cooperatives with the professionalism and large resource base of commercial banks. The preamble to the Regional Rural banks Act states that the object of setting up the RRBs is to develop the rural economy by providing, for the purpose for the development of agriculture, trade, commerce, industry and other productive activities in rural areas, credit and other facilities particularly to

small and marginal farmers, agricultural labourers, artisans and small entrepreneurs.

The basic features of the RRBs are

- **State Sponsored**- RRBs are jointly sponsored by the Central Government, State government and a scheduled commercial bank ,generally a public sector bank. The equity of a RRB is held by the Central Government, concerned State Government and the Sponsor Bank in the proportion of 50:15:35.
- **Regionally Based**- The operations of the RRB s are spread over a region. Generally, a RRB is allotted a compact area of one to five districts within the state with homogeneity in agro-climatic and socio-economic characteristics.
- **Commercial Banking Function** –These banks may accept all types of deposits from customers and grant loans and advances and carry on the business of banking covered under the Banking regulation Act, 1949.
- **Rural Oriented**- These banks emphasis and concentrate on the weaker sections and the rural activities while granting loans and advances. Most of the branches of RRBs are generally situated in the rural areas .These play an effective role in mobilization of savings in the rural areas.
- **Consortium Character in Management** – The management of the Regional Rural Banks is vested in a nine- members board of Directors, headed by a Chairmen who is an officer deputed by the sponsor bank but appointed by the Government of India. Six members in the board of directors have to be appointed by the central Government, two by the sponsored bank and one by the State Government.
- **Financial Resources**-The financial resources of RRBs come from the deposits mobilized by them, refinance from RBI and advances from the sponsoring bank on liberal terms. They also get refinance from the RBI in the same terms on which refinance are given to cooperative banks.

Growth of RRB

Over the years, the RRBs, which are often viewed as the small man's bank, have taken deep roots and have become a sort of inseparable part of the rural credit structure. They have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach and business volume as also contribution to development of the rural economy. A remarkable feature of their performance over the past three decades has been the massive expansion of their retail network in rural areas. From a modest beginning of 6 RRBs with 17 branches covering 12 districts in December 1975, the numbers have grown into 196 RRBs with 14,446 branches working in 518 districts across the country in March 2004. RRBs have a large branch network in the rural area forming around 43 per cent of the total rural branches of commercial banks.

The rural orientation of RRBs is formidable with rural and semi-urban branches constituting over 97 per cent of their branch network. The growth in the branch network has enabled the RRBs to expand banking activities in the unbanked areas and mobilise rural savings. RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto"(RRBs Act, 1976).

The presence of RRBs shows wide variation both across States and sponsor banks. Although RRBs are spread over twenty-six States, they have most of their presence in seven States, i.e., Andhra Pradesh, Bihar, Karnataka, Madhya Pradesh, Maharastra, Rajasthan and Uttar Pradesh. Uttar Pradesh has the highest number of RRBs, i.e., thirty-six and Kerala has got only two amongst the major States of the country. The north-eastern States like Manipur, Meghalaya, Mizoram and Nagaland have got only one RRB. Like-wise, seven sponsor banks amongst twenty-eight, viz., Bank of Baroda, Bank of India, Central Bank of India, Punjab National Bank, State Bank of India, United Bank of India and UCO bank account for more than three fifths of the RRBs.

CHECK YOUR PROGRESS - 4

A) State whether following statements are true or false-

a. The structure of the cooperative credit structure is three tier.

b. Cooperative banks can not perform commercial banking functions

c. The RRBs can not expand its branches at national level

10.13 PRIVATE BANKING

After discussing central bank, commercial banks, co- operative banks and regional rural banks, now we are going to discuss the private banking. These are practices expanded recently by the banks to tap wider market. In fact Banks' activities can be divided into Retail Banking, Business Banking, Corporate Banking, Private Banking and investment banking.

(i) Retail banking means dealing directly with individuals and small businesses;

(ii) Business banking means providing services to mid-market business;

(iii) Corporate banking means dealing with large business entities directly;

(iv) Private banking means providing wealth management services to High Net Worth Individuals and families;

(v) Investment banking means activities relating to the financial markets.

Private banking is a term for banking, investment and other financial services provided by banks to private individuals having a sizable assets.The term "private" refers to the customer service being rendered on a more personal basis than in mass-market retail banking, usually via dedicated bank advisers. It should not be confused with a private bank, which is simply a non-incorporated banking institution.

Historically private banking has been viewed as very exclusive, only catering for high net worth individuals with liquid assets over $ 1 million, although it is now possible to open some private bank accounts with as little as $ 50,000 for private investors. An institution's private banking division will provide various services such as wealth management, savings, inheritance and tax planning for their clients. A high-level form of private banking (for the

especially affluent) is often referred to as wealth management. The word "private" also alludes to bank secrecy and minimizing taxes via careful allocation of assets. An offshore bank account may be used for this purpose. Private Banking consists of a whole gambit of services required to free the client of operational hassles. As a one-stop shop for your financial needs Private Banking Term works closely tighter to ensure smooth functioning for customers at every step.

10.14 SERVICES OFFERED UNDER PRIVATE BANKING

Portfolio Advisory Services

Advisory Desk consists of an experienced research team headed by Head Advisory Desk. Detailed Research combined with in-depth technical analysis is used for deciding the investment universe, which comprises of Commodities, Derivatives, Direct Equity, Mutual Funds, Bonds, IPO\NFOs, etc. The process of putting together a portfolio recommendation for the client goes through a 4-stage process of Screening, Fundamental Research, Model Portfolio Construction and Implementation. Private Banking ensures that a diversified portfolio of securities is developed in consultation with customers. These securities are carefully selected to integrate into customer overall financial plan and reflect the risk with which they are comfortable. The securities could be from an array of asset classes –equities, debt, mutual funds, insurance and property

Non-Discretionary Portfolio Management

Here, investment research team constructs clients portfolio after doing a through risk-reward analysis of the financial products in the market. This is finally brought to them to their very own 'private banker' who is their one-point contact with the bank for all their financial requirements. The most important aspect of this process is the optimal allocation of clients' assets. It is the critical factor affecting the potential return on clients' investments. Private Banking helps identify own investment profile, which fully reflects his specific needs, expectations and your attitude towards risk and expected return. While designing customer's financial plan, Banks understand they

tax implications and advise them to structure the ownership of their assets using appropriate vehicles, so as to optimize the returns on their assets.

Operational and Regulator Service

Right from ensuring PAN availability, procuring legal permissions to enable clients to trade in the market to payment bills, Private Banking takes care financial and regulatory requirements.

Transactions service

Private Banking ensures smooth process flow all investments and banking transactions. Private Banker will continuously monitor clients' investments on an ongoing basis and keep in touch regularly with them about their performance, which allows for fine-tuning of clients financial strategy to their changing requirements. In-house investment advisory and research capabilities complemented by outside specialists ensure that customers are kept fully informed about emerging trends, providing investment advice that is always objective and thoroughly researched. They bring portfolio data regularly on a monthly basis or at the frequency desired by the clients.

Trust & Estate Planning

This offering is in line with the philosophy of Wealth Generation, Wealth Preservation and Wealth Transmission.

Private Investment Banking

Private banking offers business families, in the SME and mid-corporate segment, advice on their business and solutions to their fund raising and business restructuring requirements.

Value Added Services

As a one stop financial solution provider, private banking bring to customer a wide spectrum of value-added services. Apart from Investment Advisory Service private banking also provide: Transaction Execution platform, Custodial Services, Banking Services.

- **Transaction Execution platform**: Private banking provide internal & external platform to execute equity, debt, mutual funds, insurance, property and foreign exchange transactions. They facilitate to execute transactions through Mutual Funds houses, property, insurance, tax

and legal consultants to provide customers convince of execution across asset classes.

- **Custodial Service**: Private banking offers comprehensive share custody system handles all aspects of processing – portfolio updating, scrip handling and registration, settlement, dividend, bonus/rights handling and client reporting, debt securities services (debt market) and depository services.
- **Banking Services**: Along with the more sophisticated financial instruments at customers disposal, they also offer a full range of banking services, backed by the convenience of facilities such as netbanking, remittances, deposit and loan products.

Services to NRIs

Private banking takes care of investment needs and NRIs residential status and provide them array of services and products designed to keep them in control of their funds. Private banking plans investment in financial markets taking care of their clients' regulatory requirements, through powerful Net banking. Moreover, private banking manages NRIs operational needs through in house custodial services offerings.

Benefits of Private Banking

In today's dynamic and increasingly complex investment environment, private banking helps customers in making key decisions relating to finance and wealth. The following benefits are generally available under private banking services.

i) Many facilities under single window

- Saving Account, Fixed Deposits, Recurring Deposits, Current Accounts
- Resident Foreign Currency (Domestic) Accounts etc.
- Asset Products- Home loans, Car & Personal loans, Loan against securities etc.
- Investment-Government of India Bonds, Mutual Funds, Capital Gain Bond etc.
- Insurance
- Web Trade and Demat Accounts

- Gold Bars & Coins
- Foreign Exchange Services
- International Debit and Credit cards
- And many more.....

ii) Exclusivity and Convenience

- Relationship Manager
- Separate interaction area in the branch
- Anywhere Banking facility
- Exclusive Phone Banking service

iii) Competitive Pricing

- Reduced rates for products and services
- Several Complimentary Offers
- Value-linked benefits

iv) Value Added Facilities

Debit Card

Private Banking customers are provided with a personalized Private Banking Debit Card. Exclusively features of this card are:

- High Purchase Limits
- Fuel Surcharge Waiver
- International Acceptance
- Free SMS and Email Alerts on purchase-
- ATM Interchange Waiver-
- Zero Liability Protection

Credit Card

Private Banking Credit Card member deserves nothing but the best.

Exclusive features

- Low Interest Rate- Introductory 6-month offer of only 1.49% per month of both Cash and Retail transactions. After 6 months the interest rate will change to 2.49%. Low balance Transfer rates of only 0.49% per month for 6 months only for ICICI Bank Private Banking Credit Card holders!
- Wavier of fuel surcharge at HPCL Petrol Pumps
- Concierge service which include:

A) Travel Services

B) Car Rental and Limousine Service

C) Business Services

D) Hotel & Dining offers

E) Express Rewards

F) Internet banking

G) Value benefits and much more

Private Banking is a one-step financial solution provider, offering a board spectrum of value-added services to clients. The major international groups offering private banking services are UBS, Citigroup, HSBC, Credit Suisse, Merrill Lynch, Deutsche Bank, ABN-AMRO while ICICI Bank, HDFC Bank, ING-Vysya Bank are among the top ranking Indian banks offering private banking in India.

CHECK YOUR PROGRESS - 5

A) State two features of Debit card.

B) Select the correct answer-

Private Banking services are provided to-

a. Small investors b. High net worth individuals

c. Private companies d. all of the above

ACTIVITY 4

Collect a few names of banks who offer private banking and list down the services they offer under private banking.

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10.15 LET US SUM UP

We have discuss the following points in this unit-

- Now you are aware that banking means acceptance of deposits of money from the customers for lending or investment. Such deposits are accepted under different account having different features. Deposits may be payable on demand or may be for a certain period of time as per the norms of the account under which the deposits are accepted. Customers are allowed to withdraw their deposits by cheque.
- Banking in India mainly governed by the Banking Regulation Act 1949 and Reserve Bank Act 1934. Section 6 of Banking Regulation Act identifies the permissible and prohibited business of a bank.
- Banks are classified as the commercial banks, cooperative banks and regional rural banks. However, all of the three can offer the commercial banking functions as per the law. Cooperative banks and Regional Rural Banks cater to the credit needs of agriculture and rural areas while commercial banks cater to the credit needs across the sectors and areas. Cooperative Banks are established under the cooperation principles and registered under the Societies Registration Act, 1912.They are structured in three tiers. RRBs operate in a specified allotted area of a few districts .RRBs are promoted by the central government, state government and a sponsored scheduled bank.
- The central bank is the apex body of the banking and monetary system of a country. Different countries have different names for central bank. In India the name of the central bank is the Reserve Bank of India. It is the body which regulates the entire banking and financial system. It also issues notes, work as a Government's bank and Bankers' Bank. As a head of the monetary system the central bank issues monetary and credit policy to control the money supply and stabilize price level.
- Among various innovative services of banks, private banking has become a very important one. Private banking means providing banking, investment, asset and wealth management and other financial services to a private individual by a bank giving personal attention. This service is offered to the high net worth individuals (rich customers).

10.16 FURTHER READINGS

1) Indian Banking

2) Reserve Bank of India Bulletins.

10.17ANSWERS TO CHECK YOUR PROGRESS

ANSWER TO CHECK YOUR PROGRESS 1

A) a. banks provide financial assistance to the customers

b. banks acts as the payment agents of the customers

ANSWER TO CHECK YOUR PROGRESS 2

A) a. supervises the banks and financial institutions

b. sets the interest rates.

B) a.

ANSWER TO CHECK YOUR PROGRESS 3

A) a. Commercial banks accepts deposits from the public

b. Commercial banks create credit.

c. Commercial banks promote economic development of the country

B) a. False b. False

ANSWER TO CHECK YOUR PROGRESS 4

A) (a) True

(b) False

(c) True

ANSWER TO CHECK YOUR PROGRESS 5

A) a. High Purchase Limits

b. International acceptance

B) b.

10.18 MODEL QUESTIONS

Q 1: Define 'bank'. Discuss the functions of commercial banks.

Q 2 Why a central bank is required? Explain the basic functions of a central bank.

Q 3 Discuss the importance of cooperative banks. How are they different from the RRBs?

Q 4 Write the advantages of private banking.

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UNIT 11 : DEVELOPMENT BANKS AND NON-BANKING FINANCIAL INSTITUTIONS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Development Banks- Meaning and Features

11.4 Functions of Development Banks

11.5 Non- Banking Financial Companies- Meaning and Importance

11.6 Categories and Features of Non- Banking Financial institutions

11.7 Investment Banking- Meaning and Features

11.8 Services provided by Investment Banking

11.9 Unregulated Credit Markets in India

11.10 Let Us Sum Up

11.11 Further Reading

11.12 Answers To Check Your Progress

11.13 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- explain meaning and features of the Development Banks
- describe the functions of Development Banks
- discuss the concept and importance of Non-banking financial companies
- identify the different types of non-banking financial companies
- explain the concept and services of investment banking.

11.2 INTRODUCTION

In the unit 1, we have discussed about financial institutions- as a component of Indian financial system. Apart from commercial banks, Indian financial system consists of various institutions of varied nature and functions. There are development banks, specialized financial institutions

and other non-banking institutions operating in the financial system. These institutions play a very important role in meeting the credit gap as well as in the capital formation through mobilization of savings. They also contribute to the growth process of an economy by involving in implementation of the national agenda. In this unit we will discuss the concept and the basic features of the non bank financial institutions operating in Indian financial system.

11.3 DEVELOPMENT BANKS- MEANING AND FEATURES

Development Banks are special industrial financial institutions. These banks are mostly set up after World War II in both developed and under developed countries. Every country felt the need to accelerate the rate of development in post world war era. There was a need for reconstruction of economics at a faster speed. A need to set up such institutions which could take up promotional activities besides financing was felt necessary to achieve the twine goals of nation- growth and social welfare.

The following points were considered to be the reasons for the establishment of development banks:

- Lay foundation for industrialization
- Meet capital needs
- Need for promotional activities
- Help small and medium sector

At the same time, there was also a great need for the modernization and replacement of obsolete machinery in already established industries.

Developments banks are the institutions engaged in the promotion and development of industry, agriculture and other key sectors. D.M. Mithani states that "A development bank may be defined as a financial institution concerned with providing all types of financial assistance medium as well as long term to business units, in the form of loans, underwriting, investment and guarantee operations and promotional activities- economic development in general and industrial development in particular."

Development Banks do not mobilize savings like other banks but

invest the resources in a productive manner. These banks make significant contribution to the industrial development while conventional institutions serve mainly to provide liquidity to the investments made earlier. The development banks are mainly meant to further the cause of development.

A development bank has the following features or characteristics:-

(a) A development bank does not accept deposits from the public like commercial banks and other financial institutions who entirely depended upon saving mobilization.

(b) It is a specialized financial institution which provides medium and long term lending facilities.

(c) It is a multipurpose financial institution. Besides providing financial help it undertakes promotional activities also. It helps an enterprise from planning to operational level.

(d) It provides financial assistance to both the private as well as public institutions.

(e) The role of development bank is gap filler.

(f) Development banks primarily aim to accelerate the rate of economic growth.

(g) The objective of these banks is to serve public interest rather than earning profits

(h) Development banks react to the socio-economic needs of development.

LET US KNOW

In India the need for such special institutions was felt long ago, but they have been established only after 1948. Except the Industrial Financial Corporation of India which was set up in 1948, all the other financial institutions were established in the third quarter of the twentieth century (1950-1975). Some of these Development banks are: State Financial Corporations (1951), The Industrial Credit and Investment Corporation of India (1955), National Industrial Development

Corporation (1954), The Industrial Development Bank of India (1964), National Agricultural Development Bank of India (1982) etc. India is witnessing a harmonization of development banks and Commercial Banks during last couple of decades. For example ICICI and IDBI, the most important specialized development banks were merged with their commercial banking arms. This is in fact a tendency towards universal banking which is a concept of providing all financial services in single institution.

11.4 FUNCTIONS OF DEVELOPMENT BANKS

Following are the main functions of a development bank:

- **Financing-** Development banks basic function is to finance development projects and enterprises. They provide long term and medium loans to the existing as well as new industrial undertaking for expansion of business and /or setting up of new business. Usually commercial banks do not provide long term credit. Hence development banks play a very important role in industrial development.
- **Arranging finance-** Development bankers not only provide medium term and long terms long but also help the industrial enterprises in raising their funds subscribing to the bonds and debentures of the company and underwriting to the shares and debentures and giving guarantee to the loans raised from foreign and domestic sources.
- **Refinancing-** Development banks also extend refinance facilities to the lending institution and banks. In these schemes, there is no direct lending to the enterprise. The lending institutions are provided funds by development banks. For example National Bank for Agricultural and Rural development Bank (NABARD) provide refinance to the commercial and cooperative banks for their agricultural loans. Similarly, Small industries Development bank of India (SIDBI) provide refinance to the banks for their loan given to the small industries. Other development financial institutions which provide refinance are State Financial Corporations, State Industrial Development Corporations and special development banks like North Eastern Development Financial Corporation Ltd etc.

- **Promotion of entrepreneurship-** Development banks promote entrepreneurship by providing seed capital/venture capital to the new generation /budding entrepreneurs and thereby help them to become successful entrepreneurs. They offer other promotional facilities in terms of low rate of interest, subsidy on the loan amount, flexible repayment terms etc.
- **Development of specified sector-** Another function of development is to develop or promote certain prioritized sectors of the economy as per national agenda. Export- Import Bank, for example, functions for the promotion of the export sector by providing credit and other facilities to the export oriented units. Similarly, Power Finance Corporation takes care of the financial needs of the power sector. NABARD, SIDBI, IL & FS are some development finance institutions which work for development finance.

CHECK YOUR PROGRESS 1

A) Select the correct answer

Which of the following activity can not be performed by a development bank?

a. Providing long- term credit b. Refinance

c. Promotional Activities d. Accepting deposits from the public

B) State two features of development bank

i) .....

ii) .....

ACTIVITY 1

Write the names of major development banks of India and list down their main functions

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11.5 NON- BANKING FINANCIAL COMPANIES-MEANING AND IMPORTANCE

Over the years the Non-Banking Financial Companies (NBFCs) have become an integral part of the Indian financial system. They are financial intermediaries offering various financial services which cater to the needs of individuals and corporate. While their functions and the services are different, the common feature are- acceptance of deposits from the public, borrowing from banks and participating in the capital market. NBFCs mobilize savings from public through various schemes and lend to needy customers in different forms. However, they are not permitted to accept deposits through savings bank A/c and current A/c like commercial banks. In India, NBFCs refer to the institutions in the range of development banks, insurance companies, UTI, hire-purchase financial institutions, chit funds etc.

NBFCs are defined by the RBI (Amendment) Act, 1997 as an institution or company whose principal business is to accept deposits under any scheme or arrangement or in any other manner, and to lend in any manner. To be called a NBFC, a financial institution must fulfill the following-

- A company
- Principal business is the receiving of deposits under any scheme/ arrangement/ in any other manner or lending in any manner.
- Have obtained certificate and permission to start the functioning as NBFC from the RBI.

Definition of NBFC include only Non-banking institution, that is any hire-purchase finance, investment, loan or mutual benefit financial company and an equipment leasing company, insurance companies, stock exchange, stock broking company and merchant banks are also recognized as non banking financial company.

Hence NBFCs perform a diversified range of functions and offer various financial services to individuals, corporate and institutional clients. They cover a wide range of institutions from highly specified institutions such as development banks or insurance companies to simple institutions like mutual savings society.

Importance of NBFCs-

Non-Banking Finance Companies play an expanded role the pace of growth of the financial market. They also help to bridge the credit gap in several sectors. They play an important role in economic development. They play important role in the following ways:

- **Intermediary:** They collect the savings of the people and lent to various parties like household, firm, small enterprises on sustained basis. In this ways they bring the savers and lenders together and this help in mobilizing resources through the economy.
- **Promotion of Business sector:** It helps the business sector by financing it through loans, mortgages, purchase of bonds, shares etc. in flexible terms and procedures.
- **Help the Central, state and local government:** NBFCs helps the local bodies by purchasing their bonds and by selling and purchasing the securities of the government.
- **Provide liquidity:** NBFCs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money.
- **Employment generation:** NBFCs help both direct and indirect employment generation. They have employed many persons to man their offices. Besides office staff, institutions need the services of experts which help them in finalizing lending proposals.
- **Specialized Credit Requirements:** NBFCs provide various types of loans and financial services which are of special nature and different firm customer to customer. Banks can not meet there requirement on they are having lending policies confirming to the banking legislation.
- **Efficient and competitive sector:** Advent of NBFCs has ensured a healthy, efficient and competitive financial sector which reinsured the quality financial services to the customers.
- **Capital formation:** NBFCs help in mobilizing savings in very remote and unbanked areas and there by contribute to the capital formation of the economy.

CHECK YOUR PROGRESS 2

A) What are the conditions to be fulfilled by a financial institution to recognized itself as NBFC?

B) Select bthe correct answer

NBFCs are required to register with

a. SEBI b. RBI

c. IRDA d. NABARD

11.6 CATEGORIES AND FEATURES OF NON- BANK FINANCIAL COMPANIES

The Reserve Bank of India, categorizes the NBFCs into various categories on the basis of their nature and activities:-

1. Equipment leasing Company

Equipment leasing company means any company, principal business of which is leasing of equipment or the financing of such activity.

2. Hire Purchase Company

Hire Purchase Company means any company which principal business is hire-purchase or financing such transactions. Hire-purchase Company finances the price of the goods to be sold on a future date. The goods are in fact let on hire by the hire purchase company with a condition to pay the installment by the hirer and other all the installments are paid the hirer will have an option to purchase it.

3. Housing Finance company

Housing Finance company is a company which provides finance for acquisition and or construction of houses, acquisition of land and development of plot/land.

4. Investment Company

The main business of an Investment Company is to acquire securities and resale it later. They buy new issues from security issuers and make the arrangement of resale to the investing public.

5. Loan Company

Loan company is a company which carry an as its principal business

the providing of finance whether by making loans or advances or otherwise for any activity other than its own. These activities exclude leasing and hire purchase.

6. Mutual Benefit Financial Companies

Mutual Benefit Financial companies are the companies usually the 'nidhi' which are notified by the Central Government under section 620A of the Companies Act 1956 (1 of 1956). These companies provide finance to the members of the companies and accept deposits form them.

The important features of these companies are:

- They mobilize deposits from their members and public with an assurance to provide credit when required by deposits.
- They provide credit to those who are usually not financed by banks or out the reach of commercial banking.
- MBFCs are easily accessible local in character and follow easy and simple procedures.
- They work on sound principles of banking. Their operations are governed by the directives of the RBI.

MBFCs are very old financial institutions existing over 100 years operating mainly in South India.

7. Miscellaneous Non-Banking Company (MNBC)

MNBC is a company or a financial institution performing all or any of the following activities:

- Collection of money in one lump sum/installments by way of contributions/subscriptions, sale of units and other instruments, granting membership admission fee or in any manner.
- Manage/conduct/supervise transaction/arrangement relating to an agreement with the subscribers, each one of whom subscribes a certain sum in installments over a definite period, and is entitled to a prize amount on the basis of draw of lots or by auction/tender.
- Carry on the activity of any other form of chit or kuri.
- Undertake/carry on/ engage in any other business similar to the above.

8. Residuary Non-Banking Company (RNBC)

RNBC is defined as a company that receives deposits under any

Underwriter: An investment bank, who undertakes the responsibility to sell the shares to the investors on behalf of the issuing company against underwriting commission.

Divestiture: The sale of an asset or a subsidiary by the company

scheme/arrangement in one lump sum / installments by way of contributions/ subscriptions or by sale of units/certificate/other instruments or in any other manner. Usually RNBCs mobilize deposits from a large number of small and uniformed deposits through field staff promising that their money would be invested in banks and government securities. They are in general small in size and all non banking companies other than NBFCs and MNBCs fall into the category of RNBCs.

11.7 INVESTMENT BANKING- MEANING AND FEATURES

Investment banking business is dedicated for providing corporations and entrepreneurs the highest quality independent financial advice and transaction execution. Range of services and transaction expertise, including private placement of equity service in public markets, mezzanine and convertible debt, mergers and acquisitions advisory services are offered by investment bankers. **Investment banking is one of the most global industries** and hence continuously challenged to respond to new developments and innovation in the global financial markets.

Investment Banking is defined as the division of banking encompassing business entities dealing with capital for other companies. In addition to acting as agents or underwriters for companies in the process of issuing securities, investment banks also advise companies on matters related to the issue and placement of stock.

Mezzanine Financing: It is used to finance an existing company.

Investment bank is an individual or institution which acts as an underwriter or agent for corporations and municipalities in issuing securities. Most of them also perform broker/dealer operations, maintain markets for previously issued securities, and offer advisory services to investors. Investment banks also have a large role in facilitating mergers and acquisitions, private equity placements and corporate restructuring. Unlike traditional banks, investment banks do not accept deposits from the public and provide loans to individuals.

Investment banks help companies and government to raise money by issuing and selling securities in the capital markets (both equity and debt),

as well as providing advice on transactions such as mergers and acquisitions. Until the late 1980's, the United States and Canada maintained a separation between investment banking and commercial banks.

A majority of investment banks also offer strategic advisory services for mergers, acquisitions, divestiture or other financial services for clients, such as the trading of derivatives, fixed income, foreign exchange, commodity, and equity securities.

Hence the main features of investment banks are -

- An individual or an institution or a division of banking
- Acts as agents or underwriters or advisor for raising capital, buyback and divestitures
- Facilitates mergers and acquisitions, takeover and corporate restructuring.
- Does not accepted deposit and provide loans to individuals
- Offers risk management, project valuation, and investment structuring services

11.8 SERVICES PROVIDED BY INVESTMENT BANKING

i) Equity Capital Markets

Investment banks are in the vanguard of equity capital markets having brought to the market a large number of successful and path breaking transactions. They advise leading Indian companies, banks, institutions and other businesses in matters of mobilising capital from investors in domestic and overseas markets. Investment banks provide opportunities for clients to raise funds through the following-

- Initial Public Offering (IPOs)
- Follow-on Public Offering (FPOs)
- Qualified Institutional placements (QIP)
- Rights Issues
- Preferential Allotments
- Foreign Currency Convertible Bonds (FCCBs)

ii) Global Depository Receipts (GDRs)

Investment banks also cater to the entire spectrum of capital market means through other services such as managing takeovers, delisting and buyback. They assist innovative and exciting companies in the equity capital market. Investment banks manage transactions for clients across numerous industry sectors including:

- Aviation
- Chemicals
- FMCG (Fast Moving Consumer Goods)
- Hospitality
- Infrastructure
- Media and entertainment
- Metals
- Real estate
- Technology
- Telecom
- Textiles

Investment banks offers clients a bouquet of products encompassing primary offerings, secondary equity offerings, buybacks, open offers and delisting, with the objective of continuously creating and maximizing value for all stakeholders including companies and investors.

iii) Real Estate Advisory

Ever since the easing up of FDI (Foreign Direct Investment) into real estate development in India, investment banks have dedicated in offering Real Estate Advisory Solutions to property developers and investors seeking to invest into the Indian real estate markets. Their advisory solutions are primarily focused on capital raising and cover the optimal financing mix, project valuation, investment structuring and accomplishing capital raising at either the enterprise level or the asset level.

Investment banks manage real estate, IPOs (Initial Public Offering) and advise enterprise level private equity financing, and enterprise level mezzanine financing and structured debt. For Example, Edelweiss, a large investment bank has completed ever $ 700 million in capital raising in the

last 18 months across multiple formats. Edelweiss' key value proposition to clients include an excellent understanding an access to both public and private capital markets combined with structuring capabilities and a strong knowledge of underline real estate markets in India through our in house research.

iv) Infrastructure Advisory

A critical ingredient for sustainable development in India is the pressing need for infrastructure creation on a commercially viable basis. This signifies immense opportunities and challenges for the sector. Recognizing this, Investment banks has formed innovative solutions tailored to the unique financing and advisory requirements of Indian infrastructure projects and developers. They provide infrastructure project companies and developers the full range of capital and advisory services. These services include:-

- Capital Rising
- Private equity
- Project equity
- Structured finance
- Project and ECB Debt
- Advisory Services
- Mergers & Acquisitions – both sell side and buy side
- Divestitures, corporate Restructuring and Spin offs

v) Structured finance Advisory

Over the years, investment banks have built up significant expertise in structuring appropriate finance client specific situations and identifying and placing the transaction with institution portfolio of solutions comprise the following-

- Promotion Funding
- Acquisition Financing

vi) Promotion Funding

Promoter financing is mostly done to enable promoters to raise their stake in financing is usually against collateral of shares or other securities held by the promoter group company. The transaction helps in unlocking

the value of promoter shared additional funds. It can be structured to refinance a loan raised against the client earlier.

vii) Acquisition Financing

There has been a significant increase in the number of acquisitions by Indian compared as well as overseas. Acquisition financing plays a critical role in the success of planned by the acquirer. Based on each client's unique requirements, we have advise financing through appropriate stacked financing structures which comprise foreign secured debt with recourse to parent companies, rupee senior secured debt with companies, equity investment by the promoters, non-recourse debt, guaranteed equity upside.

vii) Mergers and Acquisitions Advisory

Investment banking provides insights into how companies can grow and enhance M&A team is engaged in turnkey transaction management and advises a diverse medium to large transactions. Investment banks advise companies in the entire transaction process – this range from starting to deal closure. They provides both buy-side and sell-side advisory services as part of offering. Services include identification and short listing of target universe, strategic acquisition and arranging finance for the transaction, if required.

Hundies: Financial instruments used in trade and credit transactions in India.

CHECK YOUR PROGRESS 3

A) State two features of Investment banking

i) .....

ii) .....

ACTIVITY 2

Write five reasons why investment banks are required in an economy.

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11.9 UNREGULATED CREDIT MARKETS IN INDIA

The Unregulated credit markets in India are also continuous of the financial market. The most important constituent of the unregulated credit markets are indigenous bankers, money lenders, nidhis, chit funds and loan offices. These unregulated credit markets in India are not under the guidelines and regulatory framework issued by the RBI. They are also known as unorganized sector of the financial market.

Indigenous Bankers: The Indian Central Banking Enquiry Committee defines an indigenous bankers or bank as an individual or private firm receiving deposits and dealings in hundies or money lending. According to the committee, those who do not accept deposits were to be treated as money lenders. But as pointed out by the Madras Provincial Banking Enquiry Committee Receiving deposits could not be treated as the soul distinguishing features of indigenous banker's scale of operation is generally larger, their resources are bigger, and deposits from the public constitute a sizeable portion of their funds. They provide finance to traders and industrialist.

Indigenous Banking is the monopoly of certain castes. It is mostly family business carried on in a heredity way. The principal castes carrying out Indigenous Banking are Jains, Chettis, Bengalis, Multanis and Marwaris.

The Indigenous bankers may be divided into those principal business is trade. Usually indigenous bankers lend money on a written promissory note or receipt singed by the borrowers acknowledging the loans and stating the agreed rate of interest. The rate of interest is usually dependent on the security offered. They also lend money against bonds written out on stamped legal forms, which state all the conditions of the loans in details, including higher rate of interest if the loans are not repaid on due dates.

Nidhis, Chit funds and Loans offices: Nidhis and semi banking institutions registered under the Indian Companies Act, receiving deposits in monthly installments either in the usual form or in the form of withdrawal share capital. Nidhis perform several functions. They promote savings among members and mobilise them for being used for loaning purposes. The funds of these Nidhis are obtained not so much by acceptance of regular

deposits as by subscription to members for all purposes on good security.

Chit funds or Kuris: They are loose organization of a small number of persons to promote savings and to lend to members. They are priced chits and auction chits. In the former case a fixed price is drawn by a lot and in the latter case the person who offers to pay the highest amount in advance as interest gets the loans.

The loans offices are mostly found in Bengal depend entirely on deposits for their working funds. They lend money to zamindars and their tenant cultivators. They do not finance to trade or industry generally.

11.10 LET US SUM UP

In this unit we have discuss the following points :

- From one point of view financial institutions are divided into the banking and non-banking ones. Non-banking financial institutions consist of development banks and other non-banking financial companies. The main difference between banks and non-banking financial institutions is that bank are "creators" of credit and the latter are mere 'purveyors' of credit.
- Development banks are established two direct the credit to the selected sector for development of their sectors like industries, small entrepreneurs etc. Most of the development banks came into existence because of government efforts to provide assistance for specific purposes. Their creation has been motivated by the philosophy that the credit needs of certain borrowers might not be otherwise adequately met by the usual sources. IDBI, ICICI, LIC, SIDBI, SIDCs, SFCs, NABARD are example of development banks. The role of development banks has lost its ground during recent time because of the harmonization of financial institutions with commercial banks.
- Many other non-banking financial institutions perform their functions as intermediary between savers and investors. They mobilize savings as well as lend money. Leasing, hire purchase, loan companies and other non-banking financial companies and small businessmen with

varied financial services that can not be offered by commercial banks. They also play a very important role in inculcating the financial habit to the people of unbanked or non-bankable areas.

- Investment Banking is the traditional aspect of investment banks which involves helping customers raise funds in the Capital Markets and advising on mergers and acquisitions. Investment bank may involve subscribing investors to a security issuance, coordinating with bidders, or negotiating with a merger target. Other terms for the Investment Banking Division include Mergers & Acquisitions (M&A) and Corporate Finance. The Investment Banking Division (commonly referred to as IBD) is generally divided into industry coverage and product coverage groups. Industry coverage groups focus on a specific industry such as Healthcare of Technology, and maintain relationships with corporations within the industry to bring in business for the bank. Product coverage groups focus on financial products, such as Mergers & Acquisitions, Financial Sponsors, and Leveraged Finance.

11.11 FURTHER READING

1) Financial institutions and markets by LM Bhole, Tata McGraw Hill.

11.12 ANSWERS TO CHECK YOUR PROGRESS

ANSWER TO CHECK YOUR PROGRESS 1

A) d.

B) a. It is a multi- purpose financial institution

b. It aims at accelerating the economic growth rate

ANSWER TO CHECK YOUR PROGRESS 2

A) a. It must be a company

b. The principal business of the company must be receiving of deposits

c. It must obtain a certificate from the RBI to act as NBFC

B) (b)

ANSWER TO CHECK YOUR PROGRESS 3

A) a. Acts as underwriter

b. Does not accept deposits

11.13 MODEL QUESTIONS

Q 1: Distinguish between a Commercial bank and a Development bank.

Q 2: What is Investment banking? Explain the services provided by Investment banks.

Q 3: Define Non-banking financial company. Discuss their features and activities.

Q 4: Discuss the role of (a) Development banks and (b) Non-banking financial companies in the process of economic growth.

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UNIT 12: CENTRAL BANK

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning of Central Bank

12.4 Functions of a Central Bank

12.5 Credit Control

12.5.1 Quantitative or General Methods of Credit Control

12.5.2 Qualitative or Selective Methods of Credit Control

12.6 Central Banks of Different Countries

12.7 Let Us Sum Up

12.8 Answers To Check Your Progress

12.9 Model Questions

12.1 LEARNING OBJECTIVES

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

- explain the meaning of central bank
- describe the functions of a central bank
- explain the meaning and methods of credit control
- know about central banks of some countries.

12.2 INTRODUCTION

In the previous unit we have discussed about commercial banks which deal with public and various other institutions. Since commercial banks and other financial institutions deals with public money there is a great need for monitoring and regulating such institutions. In present day situation almost every country in the world have such institutions which regulate and control the financial institutions and the monetary system as a whole. Such institutions are known as central bank. Presence of such institutions ensures safety of financial resources and brings confidence among the public and business houses.

In this unit we will discuss about various functions of central bank and also discuss about some of the central banks of different countries.

12.3 MEANING OF CENTRAL BANK

In every economy there is a need for one apex institution to regulate, control and monitor the monetary system. A central bank is the apex institution of the monetary and banking system of a country. It controls and supervise the functioning of commercial banks operating in the country. It acts as the sole authority of issuing and regulating currency and credit in the economy.

Setting up of a central bank by every country is a 20th century phenomenon. Sveriges Riksbank, which is the central bank of Sweden, is the oldest central bank in the world established in the year 1668. The Bank of England, though established in the year 1694, started functioning as central bank only after passing The Bank of Charter Act in the year 1882. Other major countries of the world which established central bank in the 19th century are France in the year 1800, Netherlands in the year 1814, Russia in the year 1860, Germany in the year 1875 etc. The Federal Reserve System, which is the central bank of USA, was established in the year 1912 and the Reserve Bank of India which is central bank of India, was established in the year 1925. Thus, almost every nation of the world has got a central bank.

12.4 FUNCTIONS OF A CENTRAL BANK

We know that different countries have their own central bank. Though functions of central banks vary from country to country, it generally performs the following common functions:

- **Monopoly of note issue:** The central bank of every country has the absolute monopoly of issuing currency notes. The currency notes issued and circulated by the central bank are accepted as legal tender throughout the country. But, in some countries the monopoly of central bank to issue currency note is partial. For example, in India, one rupee notes are issued by the Ministry of Finance, Government of India and

all other notes are issued by the Reserve Bank of India. The main advantages of giving monopoly power of note issue to the central banks are, a) it brings uniformity in the monetary system and, b) the central bank can exercise better control over the monetary system.

For printing currency notes central banks of different countries follow different systems, such as partial fiduciary system, maximum fiduciary system, proportionate reserve system, minimum reserve system and foreign exchange system. In India, the RBI follows the minimum reserve system for issuing currency notes.

- **Banker, agent and advisor to the government:** The central bank acts as banker, agent and advisor to the government. As a banker to the government, central bank maintains accounts of the government; receive deposit from the government and makes short term advances to the government.

  As an agent to the government, central bank collect tax and other payments on behalf of the government. As a financial advisor to the government, the central bank gives advice to the government on financial, economic and monetary matters.

- **Bankers' bank:** The central bank acts as bankers of all the commercial banks of the country. Central bank acts as bankers' bank in three capacities, viz: (a) custodian of the cash reserve; (b) as the lender of the last resort; and (c) clearing agent. Mandatorily, all commercial banks need to keep a certain percentage of its cash balance as deposit with the central bank of the country. This deposit is called cash reserve.

- **Lender of the last resort:** As the bankers' bank the central bank acts as the lender of the last resort to the commercial banks. In case a commercial bank fails to meet their financial requirements from other sources, the bank, as a last resort approach the central bank for financial accommodation. The central bank gives financial assistance to the commercial banks by rediscounting their eligible securities.

- **Clearing agent:** Since the Reserve Bank act as the custodian of cash reserve of commercial banks and all commercial banks maintain their accounts with the central bank, it becomes very easy for the central

bank to settle the claims of various banks against each other with least use of cash.

- **Custodian of foreign exchange reserve:** The central bank act as custodian of foreign exchange reserve of a country. The central bank also manages exchange control and act as an agent of the government in international forums.
- **Controller of credit:** This is one of the most important function performed by a central bank. Credit control function of the central bank has direct influence on the economy of the country. Through this function the central bank control the volume of money in the economy. Efficient credit control establishes stability in the price level and exchange rate. Uncontrolled credit results in to fluctuation in the economy.
- **Other functions:** Besides performing above functions a central bank also perform some other functions such as conducting survey and seminars, formulation of monetary policy, development of banking system etc.

CHECK YOUR PROGRESS

Q 1: Mention three functions of a central bank

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.....

Q 2: Name the oldest central bank of the world

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12.5 CREDIT CONTROL

Credit control is concerned with the regulation of the availability, the cost and the directions of credit. This is one of the most important functions performed by a central bank. The main objective of this function is to save the economy from inflation and deflation.

Methods of Credit Control

For controlling credit Central bank uses various methods, which can broadly be classified into following two categories: (1) Quantitative or General Methods, and (2) Qualitative or Selective Methods

12.5.1 Quantitative or General Methods of Credit Control

These are the traditional methods of credit control used by central bank. By using these methods central bank aims at regulating the volume of credit. Following are the various quantitative methods of credit control:

(a) **Bank Rate Policy:** The bank rate or discount rate is the rate at which a central bank is ready to rediscount the first class bill of exchange. In other words, the rate of interest which the central bank charge from commercial banks for rediscounting the bill is called bank rate. By changing bank rate central bank control the volume of credit. There is a direct link between bank rate and market interest rate. A change in the bank rate leads to change in the other interest rates prevailing in the market. An increase in the bank rate usually leads to the following events:

i) credit become more costly
ii) less supply of money
iii) discourage economic activity
iv) fall in price level.

Similarly, a fall in the bank rate leads to the following events:

i) cheap credit
ii) increase in the volume of money supply
iii) encourage borrowings
iv) increase in the economic activities and price level

(b) **Open market operation:** It refers to buying and selling of government securities by the central bank from money market. In countries where market for government securities is limited, open market operation may include government guaranteed

securities and municipal or other securities. In most of the countries, these operations are confined to the sales and purchases of government securities.

When the central bank wants to reduce the volume of credit, it sells eligible securities in the market. When commercial banks purchase these securities, they have to make payments to the central bank. This results in flow of cash from commercial banks to central bank. This lead to fall in the primary reserve of the commercial banks. Hence, the capacity of the banks to expand credit will be reduced. This is followed during inflationary situation.

On the other hand, when the central bank wants to increase the volume of credit, it buys the approved securities from the open market. When central bank purchases securities, it needs to make payment to the commercial banks which result in flow of cash from central bank to the commercial banks. This lead to increase in the volume of cash reserve in the hands of commercial banks. In such a situation, commercial banks find themselves in a position to expand credit. This is followed during deflationary situation.

(c) **Variation in the Cash Reserve Ratio (CRR):** We have already discussed in the beginning of this unit that all commercial banks need to keep a certain percentage of its cash balance as deposit with the central banks. This deposit is known as cash reserve. This percentage of cash reserve is used by the central bank to regulate the volume of credit in the economy.

When the central bank wants to reduce volume of credit, it increases the rate of CRR to be kept by the commercial banks. This leads to reduce in the lending ability of commercial banks. On the other hand, when the central bank want to increase the volume of credit, it resorts to reduction in the rate of CRR. This leads to increase in the lending ability of commercial banks. In this way central bank use CRR as a weapon of credit control.

(d) **Repo' agreement:** Repo means repurchase. Under Repo' agreements one party lends money to another for a fixed period

against collateral securities. At the end of the fixed period, the borrower will repurchase the securities at the predetermined price. The difference between repurchase price and original sale price will be the cost of borrowings. This is used as a tool for manipulate short-term interest rate and supply of liquidity. Repos' are used by central banks to absorb or pump liquidity in the system. In other words, in a repo transaction, central bank repurchases government securities from banks, depending on the level of money supply it decides to maintain in the country's monetary system. In India, 'Repos' are normally conducted for a period of 3 days.

Reduction in repo rate help banks to get money at a cheaper rate, while increase in repo rate make bank borrowings from central bank more expensive. If the central bank wants to make borrowings more expensive for the banks, it increases the repo rate. Similarly, if it wants to make borrowings cheaper for banks, it reduces the repo rate. So, an increase in the repo rate will reduce the supply of money and a decrease in the repo rate will increase the supply of money in the economy.

Reverse repo is the exact opposite of repo. In a reverse repo transaction, banks purchase government securities form central bank and lend money to the banking regulator, thus earning interest. Reverse repo rate is the rate at which central bank borrows money from banks. Banks are always happy to lend money to central bank since their money is in safe hands with a good interest.

Thus, repo rate is always higher than the reverse repo rate.

12.5.2 Qualitative or Selective Methods of Credit Control

The qualitative credit control methods are used as an addition to general credit control. In certain situations quantitative credit control may not be helpful.

The selective credit control methods control certain types of credit and not all credit. They directly affect the demand for bank

credit as also the capacity of the banks to lend. They can be used more effectively without any changes in the prevailing rates of interest. Under these methods the credit is made available for the productive and priority sectors and restricted to others. This is very much helpful to the developing and underdeveloped economies. In the following paragraphs we will discuss about various instrument of qualitative credit control:

(a) Rationing of credit: Through this method the central bank controls the credit created by the banks. Under this method, the central bank fixes the limit for loans that a bank can extend to a particular sector for all purposes. However, credit rationing is not used as an instrument of credit control under normal circumstances. It is used only under exceptional circumstances.

(b) Fixation of margin requirements: Margin requirement is the difference between the market value of the security and its maximum loan value against the security. If a security has a market value of Rs 1000 and the central bank prescribe a margin of 60% the bank can advance only Rs 400 against that security. The central bank prescribes the margin limit which banks and other lenders must maintain while granting loan against security.

An increase in the margin requirement by the central bank leads to decrease in the amount of credit to the borrowers and a decrease in the margin requirement by the central bank leads to increase in the amount of credit to the borrowers.

(c) Regulation of consumer credit: In consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash and the balance is financed through bank credit which is repayable by the consumer to the bank in installments. Central bank regulate consumer credit by:

(i) changing the amount that can be borrowed for purchase of consumer durable,

(ii) fixing the amount of down payment and,

(iii) changing the length of the period over which instalment may be spared.

(d) Issue of Directive: Central bank may issue directive from time to time to control the volume of credit created by banks. This directive may be in the form of written orders, warnings and appeals. Central bank issue directive to the commercial banks for the following purpose:

(i) to divert the flow of credit for productive purposes

(ii) to fix the maximum credit limit for certain purposes

(iii) to control the lending policies of commercial banks

(e) Moral Suasion: Moral suasion means advice, suggestions and persuasions to the commercial banks to cooperate the central bank in implementing general monetary policy. For example, the central bank may request the commercial banks not to grant loan for illegal or speculative purpose. If commercial banks donot follow such advice no panel action is taken against them.

(f) Direct Action: This is one of the most effective weapons of controlling credit creation. This refers to the directions issued by the central bank to the commercial banks regarding their lending and investment policies. The central bank uses this method to supplement both quantitative and qualitative methods of credit control.

CHECK YOUR PROGRESS

Q 3: Mention three quantitative methods of credit control.

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Q 4: Mention three Qualitative methods of credit control.

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12.6 CENTRAL BANKS OF DIFFERENT COUNTRIES

In the beginning of the unit we have discussed that almost all countries of the world has their own central bank. In this part of the unit we will discuss about a few central banks of different countries specially our neighboring countries.

- **Reserve Bank of India:** The Reserve Bank of India (RBI) 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 (RBI) Act, 1934 (II of 1934) provides the statutory basis of the functioning of the bank. The preamble to the Reserve Bank of India Act, 1934, states that the main function of the bank as the central bank of the country is "to regulate the issue of bank notes and the 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". Keeping in view this, the Reserve Bank of India was established as a "pure" Central bank which do not undertakes commercial banking function except in an emergency. The Act gives the monopoly of note issue, government's financial transactions, and credit control and also gives the power to control the foreign exchange reserve of the country.
- **Bangladesh Bank:** Bangladesh Bank is the central bank of Bangladesh. It is the apex regulatory body for the Bangladesh monetary and financial system. Bangladesh Bank was established as a body under Bangladesh Bank Order, 1972. The head office of Bangladesh Bank is located in Dhaka. Currently it has ten offices located in different parts of Bangladesh.
- **Royal Monetary Authority:** Royal Monetary Authority (RMA) is the central bank of Bhutan. Prior to the establishment of the RMA in 1982, central banking functions in Bhutan were conducted by three agencies viz., the Ministry of Finance, State Trading Corporation of Bhutan and Bank of Bhutan. The RMA started its functioning from 1st November,

1983 by taking over the liability of notes and coins previously issued by the Ministry of Finance. In 1988, the Authority assumed the role of government banker, holding bulk of government deposits and providing finance through ways and means advance to the Government. In the year 1992, The Royal Monetary Authority Act 1982 was amended to include licensing, regulation and supervision of financial institutions of Bhutan.

After Bhutan made the momentous transition to a Democratic Constitutional Monarchy in 2008, the Royal Monetary Authority of Bhutan, Act, 1982 was amended and accordingly the Royal Monetary Authority Act of Bhutan 2010 was enacted by the Parliament of the Kingdom of Bhutan on June, 2010. With the historic enactment of the Royal Monetary Authority Act of Bhutan 2010, and the appointment of Bhutan's first Central Bank Governor on August 18,2010, the status of the RMA has been elevated to that of an autonomous Central Bank with greater powers in terms of its mode of functioning and decision making process. It now performs all central banking functions that are generally performed by the central banks in other countries.

- **Nepal Rastra Bank (NRB):** Nepal Rastra Bank is the central bank of Nepal which was established in 1956 under Nepal Rastra Bank Act, 1955. Nepal Rastra Bank Act was amended by the Nepal Rastra Bank Act of 2002, and the functions and objective of NRB is recast.
- **The People's Bank of China (PBC):** The People's Bank of China is the central bank of China established in the year 1948. Between 1950 and 1978 the PBC was the only bank in the People's Republic of China and was responsible for both central banking and commercial banking operations. In September 1983, the State Council decided to have the PBC function as a central bank. The Law of the People's Republic of China on the People's Bank of China adopted on March 18, 1995 and central bank status was legally confirmed to the PBC's.
- **The State Bank of Pakistan:** The State Bank of Pakistan is the central bank of Pakistan. During the British Colonial period the Reserve Bank of India was the central bank for both India and Pakistan. On 30th December 1948 the British Government's commission distributed

RBI's reserves between India and Pakistan in the ratio of 30:70. In May, 1948 Muhammad Ali Jinnah took steps to establish the State Bank of Pakistan immediately. These were implemented in June 1948, and the State Bank of Pakistan commenced operation on July 1, 1948. The headquarters are located in the financial capital of Pakistan, Karachi with its second headquarters in the capital, Islamabad.

- **Bank of Japan:** Bank of Japan is the central bank of Japan. The bank was established under The Bank of Japan Act, 1882 and started functioning as central bank from October, 1882. The bank was reorganized in the year 1942. The Act of 1942 was amended several times after World War II. Such amendments included the establishment of the Policy Board as the Bank's highest decision-making body in June 1949.The Act of 1942 was revised completely in June 1997 under the two principles of "independence" and "transparency." The revised Act came into effect on April 1, 1998. The head office of the bank is located in Tokyo.
- **Bank of England:** Bank of England is the central bank of United Kingdom. Established in the year 1694, it happens to be the world's second oldest central bank. It was established to act as a banker to the British Government and still it continues to be the banker for the U.K. Government. Originally the bank was privately owned by stockholders until nationalized in the year 1946. It became an independent public organization in the year 1998, wholly owned by Treasury Solicitor on behalf of the government.
- **Federal Reserve System:** The Federal Reserve System or Federal Reserve is the central banking system of United States of America. It was created to provide the USA with a safer, more flexible, and more stable monetary and financial system. The Federal Reserve was created on December 23, 1913, when President Woodrow Wilson signed the Federal Reserve Act.

12.7 LET US SUM UP

In this unit we have discuss the following:

- Central bank is the apex institution in the monetary and banking structure of a country.
- Major functions performed by a central banks are issuing currency notes, banker to the government, bankers' bank, lender of the last resort, clearing agents etc.
- Through the function of credit control the central bank regulate the volume of money in the economy.
- Various credit control measures adopted by central bank are bank rate policy, open market operation, moral suasion, rationing of credit, issue of directive etc.

12.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Three functions performed by central banks are Banker, agent and advisor to the government, Monopoly of note issue and Bankers' bank.

Ans to Q No 2: Sveriges Riksbank is the oldest central bank in the world It is the central bank of Sweden.

Ans to Q No 3: Open market operation, Bank Rate Policy, Variation in the cash reserve ratio are the three quantitative methods of credit control.

Ans to Q No 4: Fixation of margin requirements, Rationing of credit, Regulation of consumer credit are the three qualitative methods of credit control.

12.9 MODEL QUESTIONS

Q 1: What are the functions of a central bank? Discuss

Q 2: What are the methods adopted by a central bank for controlling credit?

Q 3: Write a note on the central bank of Bhutan and Nepal.

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UNIT 13: REGULATION OF FINANCIAL MARKETS IN INDIA

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Concept of Regulation of Financial Market

13.4 Objective of financial market regulation

13.5 Regulators of Indian Financial Market

13.6 Reserve Bank Of India

10.6.1 Regulatory Functions of RBI

13.7 Securities and Exchange Board of India

13.7.1 Objectives of SEBI

13.7.2 Functions of SEBI

13.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act, 1956

13.7.4 SEBI and Regulation of Securities Market

13.8 Insurance Regulatory and Development Authority

10.8.1 Powers\Functions of IRDA

13.9 Pension Fund Regulatory and Development Authority

13.9.1 Functions and Powers of PFRDA

13.10 Let Us Sum Up

13.11 Further Readings

13.12 Answer to Check Your Progress

13.13 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define the concept of regulation of financial markets
- know the objectives of financial regulation
- identify the importance of Indian financial markets
- describe the various regulators of financial system

- outline the regulatory role of various regulatory bodies in the financial System
- describe the various initiatives for Regulation of financial market.

13.2 INTRODUCTION

A significant development of the 20th century, particularly in its later part, is expansion of financial market world over which mostly was driven by globalization, technology, innovations and increasing trade volume. India has not been an exception with probably largest number of listed companies with a very large investor population and ever increasing volumes of trades. Since the economic development of an economy is directly linked with the development of financial market, the effectiveness of monetary policies largely depend on the performance of financial market. A well-regulated financial market increases the level of confidence among the investors and insures them against the potential risk.

The regulation and supervision of the financial markets in India is carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises the major part of the financial system. The supervisory role of the RBI covers commercial banks, urban cooperative banks (UCBs), and nonbanking finance companies (NBFCs). Some of the financial institutions, in turn, regulate or supervise other institutions in the financial sector, for instance, Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank (NHB). Department of Company Affairs (DCA), Government of India regulates deposit taking activities of corporate, other than NBFCS registered under companies Act, but not those which are under separate statutes. The Registrar of Cooperatives of different states in the case of single state cooperatives and the Central Government in the case of multi-state cooperatives are joint regulators, the RBI for UCBs, and NABARD for rural cooperatives. Whereas RBI and NABARD are concerned with the banking functions of the cooperatives, management control rests with the State/

Central Government. This "dual control" impacts the supervision and regulation of the cooperative banks. The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA and PFRDA – was not designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time. Each regulator has their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services. The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act, 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc; as well as prohibiting unfair trade practices in the securities market.

13.3 CONCEPT OF REGULATION OF FINANCIAL MARKET

The functioning of financial markets is regulated by several legislations that include Acts, Rules, Regulations, Guidelines, Circulars, etc. Understanding the legislations governing the financial markets in India will give the reader a fair idea of how the financial markets in India are regulated. The regulators of the financial market lay down specific rules of behaviour for participants in the financial system and provide for the monitoring of the observance of the rules and regulation. Such regulations became more important in the situations of far reaching technological progress, liberalization and greater integration in the financial system.

13.4 OBJECTIVES OF FINANCIAL MARKET REGULATION

Following are the objectives of financial market regulation :-

(A) To protect the interest of the investor and consumer of the financial services.

(B) To maintain stability in the financial system.

(C) To reduce the fraudulent activities in the financial system.

(D) To provide confidence to the small investors to invest in the financial market

(E) To provide easy and flexible financial transaction.

13.5 REGULATORS OF INDIAN FINANCIAL MARKET

In Indian financial system each financial services is regulated by the individual regulators.The following table will give us an idia about who regulate what.

Regulator	Financial Services and Schemes
RBI (Reserve Bank of India)	Fixed deposits and other banking products and services
SEBI (Securities and Exchange Board of India)	Services in the capital market and capital market intermediaries
Insurance Regulatory and Development Authority (IRDA)	Insurance Sector
Pension Fund Regulatory and Development Authority	New Pension Scheme

13.6 RESERVE BANK OF INDIA (RBI)

The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system. In exercise of the powers under these Acts, the RBI regulates the entry into banking business by licensing, exercise controls over shareholding and voting powers

of shareholders, exercises control over managerial persons, and regulates the business of the bank by permitting and prohibiting certain business. RBI also supervises the functioning of the banks operating in the country by inspecting and issuing directions from time to time in public interest and in the interest of the banking system as a whole. It also gives directions to the bank to adhere the norms laid down by it or by the Bank for International Settlement for maintaining an international standard in the operations of banks relating to capital adequacy, asset classification, income recognition, management quality, efficiency, liquidity and surveillance. The bank also regulates the functions of other banks by giving directions in respect of interest rates, lending limits, investment limit and other matter. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. Under the Reserve Bank of India (Board of Financial Supervision) Regulations 1994, a separate Board for Financial Supervision (BFS) was set up within the Bank. The objective of this Board is to strengthen supervision and surveillance over the financial system and to provide a sharper focus to supervisory policy and skills. This Board covers banks, non-banking financial institutions and other para-banking institutions.

13.6.1 Regulatory functions of RBI

The regulatory and supervisory functions of the RBI may be summed up as follows:

1. **Power to issue license:** The RBI grants license to banks for carrying out banking business. License is given to the new banks as well as to the existing banks for branch expansion and for opening extension counters, new branches, even to close down existing branches.
2. **Power of appointment and removal of banking board/ personnel:** An amendment Act passed in 1963, which became effective February 1, 1964, gave further powers to the Reserve Bank, particularly to restrain the control exercised by particular groups of persons over the affairs of banks and to restrict loans and advances as well as guarantees given by banks. It also

enlarged the Reserve Bank's powers of control in the appointment and removal of banks' executive personnel. Further, The RBI is empowered to supersede, after consultation with the central government, the Board of Directors of banking companies and to appoint an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks, SBI and subsidiary banks of SBI under certain circumstances and appoint Administrator.

3. **Powers to regulate the business of banking:** The Reserve Bank of India Act, 1934 (RBI Act) empowers the Reserve Bank of India (RBI) to issue rules, regulations, directions and guidelines on a wide range of issues relating to banking and the financial sector.

4. **Power to give directions to banks:** The RBI is empowered to give directions from time to time to other banks operating in India regarding various banking and other activities. Section 21 (3) of RBI act further lays down that every bank shall be "bound to comply with any direction given by Reserve Bank".

5. **Power to inspect and supervise banks:** The Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.

6. **Power to conduct audit of the banks:** Where the Reserve Bank is of opinion that it is necessary in the public interest or in the interest of the banking company or its depositors to do so, may at any time by order direct that a special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a

different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company.

7. **Powers relating to moratorium, amalgamation and winding up:** The RBI can make an application to the High Court for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.

8. **Power to impose norms of practice and maintenance of accounts:** The RBI can impose norms of practice and maintenance of accounts to other banks operating in India from time to time in accordance to the changing scenario of accounting practices prevailing in India.

9. **Power to collect and furnish credit information:** The RBI may at any time direct any banking company to submit to it such statements relating to such credit information and in such form and within such time as may be specified by the Bank from time to time

10. **Power to impose penalty:** The RBI can impose penalty on any banking company if it violates norms and practices as defined under banking law prevailing in India.

Recently a provision was incorporated by the Information Technology Act, 2000 which enabled the RBI to make regulations for regulating payment systems of banks and financial institutions.

CHECK YOUR PROGRESS

Q 1: Mention two objectives of financial regulation.

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Q 2: Mention two regulatory functions of RBI.

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13.7 SECURITIES AND EXCHANGE BOARD OF INDIA

The Securities and Exchange Board of India was established on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.

The reason the SEBI was constituted was because before the SEBI law relating to the securities market in India was contained in different enactments like Companies Act, 1956, Securities Contract (Regulation) Act, 1956, and the Capital Issues (Control) Act, 1947. The capital market witnessed a tremendous growth during 1980's, characterised particularly by the increasing participation of the public. This ever expanding investor's population and market capitalisation led to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants and others involved in the securities market. The glaring examples of these malpractices include existence of self –styled merchant bankers, unofficial private placements, rigging of prices, unofficial premium on new issues, non adherence of provisions of the Companies Act, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. These malpractices and unfair trading practices have eroded investor confidence and multiplied investor grievances. The Government and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation. In view of the above, the Government of India decided to set-up a separate regulatory body known as Securities and Exchange Board of India.

13.7.1 Objectives of SEBI

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the

securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.
3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

13.7.2 Functions of SEBI

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market. It also has certain protective functions, Which are mention bellow :-

Regulatory Functions

1. Registration of brokers and sub brokers and other players in the market.
2. Registration of collective investment schemes and Mutual Funds.
3. Regulation of stock brokers, portfolio managers, underwriters and merchant bankers and the business in stock exchanges and any other securities market.
4. Regulation of takeover bids by compannies.
5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.
6. Levying fee or other charges for carrying out the purposes of the Act.
7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

Development Functions

1. Training of intermediaries of the securities market.
2. Conducting research and publishing information useful to all market participants.
3. Undertaking measures to develop the capital markets by adapting a flexible approach.

Protective Functions

1. Prohibition of fraudulent and unfair trade practices like making misleading statements, manipulations, price rigging etc.
2. Controlling insider trading and imposing penalties for such practices.
3. Undertaking steps for investor protection.
4. Promotion of fair practices and code of conduct in securities market.

13.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act, 1956

The Securities Contracts (Regulation) Act, 1956 (SCRA) which was enacted to prevent undesirable transactions in securities and to regulate the business of securities had given certain powers to the Central Government, under the provisions of that Act. The functions of the Central Government under that Act have been granted to SEBI. These Functions are:

(a) Power to call for periodical returns or direct enquiries to be made (Section 6): SEBI will receive from every recognized Stock Exchange such periodical returns relating to its affairs as may be prescribed by SCRA rules.

(b) Power to approve the bye-laws of stock exchanges: Section 9 of SCRA provides that any stock exchange may make bye-laws for the regulation ad control of contracts with the previous approval of SEBI.

(c) Power of SEBI to make or amend bye-laws of recognized stock exchanges (Section 10, SCRA): SEBI may either on a request in writing received by it in this behalf from the governing

body of a recognized stock exchange or in its own motion make bye-laws on matters specified in Section 9 of SCRA or amend any bye laws made by stock exchange.

(d) **Licensing of dealers in securities in certain areas (Section 17 SCRA):** SEBI has been empowered to grant a license to any person for the business of dealing in securities in any State or area to which Section 13 of SCRA has not been declared to apply.

(e) **Power to delegate:** Section 29A of SCRA provides that the Central Government may, by order published in the Official Gazette, direct that the powers exercisable by it under any provision of the SCRA shall, in relation to such matters and subject to such conditions, if any as may be specified in the order, be exercisable also by SEBI or the Reserve Bank of India.

More Powers for SEBI: Certain additional powers with regard to certain provisions under the Companies Act, 2013, related to issue and transfer of securities and non-payment of dividend, in the case of listed public companies intending to get their securities listed on any recognized stock exchange, shall be administered by SEBI.

CHECK YOUR PROGRESS

Q 3: Mention two powers of SEBI.

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13.7.4 SEBI and Regulation of Securities Market

SEBI prescribes the conditions for issuer companies to raise capital from the public so as to protect the interest of the suppliers of capital (investors). The extensive disclosures prescribed for issuers facilitate informed investment decision making by investors while simultaneously ensuring quality of the issuer. Further, it has prescribed norms for such corporates on 'on

going' basis and also during their restructuring (like substantial acquisition, buy back and delisting of shares) to safeguard the interest of investors. To ensure fair and high standards of service to investors, SEBI allows only fit and proper entities to operate in the capital markets as intermediaries. In this regard, it has prescribed detailed and uniform norms of their registration. Further, to ensure market integrity, it has prescribed norms for fair market practices including prohibiting fraudulent and unfair trade practices and insider trading. Detailed norms for safeguarding the interest of investors in secondary markets have also been prescribed. SEBI also prescribes conditions for operation of collective investor schemes, including Mutual Funds. SEBI tries to create favourable situation for the entry of investors with confidence in the market with a purpose to expand capital market particularly security market. SEBI's intervention has resulted into improvements in proper methods of transaction and to minimize defects and manipulations in them. But infrequently large improper transactions are taking place. For example, in 1992 Harshad Mehta used money from banks to make personal gains via investment in shares; in 1998 C R Bhansali raised public money through FDs, MFs and debentures via nonexistent firms and invested them in stocks for personal gains; in 2001 Ketan Parekh made Circular trading in selected stocks via borrowed money from banks to manipulate share prices; and in 2010 Sahara Chief Subrata Roy issued Sahara Housing Bonds to 29.6 million investors without following Sebi regulations and investor protection measures mentioned therein.

Activities of SEBI

The focus area of SEBI's activities are as follows:

- Increasing market transparency through further improvement of disclosure standards
- Improving the standards of corporate governance
- Improving market efficiency by speeding up the process of dematerialization and introducing rolling settlement in a phased manner.

- Reducing transaction costs by refining the margin system
- Enhancing the market safety through an efficient margin system and stepping up surveillance.

SEBI has identified the following areas for focusing its attention for the overall growth and the development of the stock market in India:

- Registration of the stock brokers
- Authorization of Merchant Banker
- Monitoring and controlling of the mutual funds business.
- Issue of portfolio managers regulations.
- Issue of guidelines for disclosure and investor protection.

13.8 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY(IRDA)

The government in order to provide better insurance cover to citizens and also to augment the flow of long term sources of financing infrastructure, initiated reforms in the insurance sector by setting up of committee under chairmanship of R. N. Malhotra, former Governor of RBI. The Committee on reforms of the insurance sector recommended for the creation of a more efficient and competitive financial system in tune with global trends. It recommended amendments to regulate the insurance sector to adjust with the economic policies of privatization. The government in pursuance of the recommendation of the committee, decided to establish a Provisional Insurance Regulatory and Development Authority in 1999, to replace the erstwhile authority called the Controller of Insurance constituted under the Insurance Act, 1938, which initially worked under the Ministry of Commerce and later transferred to the Ministry of Finance. Finally, the decision to establish the Insurance Regulatory and Development Authority was implemented by the passing of the Insurance Regulatory and Development Authority Act, 1999. In India, presently after the opening up of the insurance sector, the regulator for the monitoring of the operations of the insurance companies is the IRDA, having its head office in Hyderabad. The regulatory framework mainly aims to focus on three areas, viz.,

- The protection of the interest of the consumers
- To ensure the financial soundness of the insurance industry
- To pave the way to help a healthy growth of the insurance market

where both the government and the private players play simultaneously.

Need of IRDA in Regulation of Insurance Businesses

Any industry wherein the stakes of the public are high would come within the purview of a Regulation – reason being that failure of such companies could result in serious implications on the economy of the country at large. Insurance business involves collection of money from various Policyholders, investing them properly, honouring the obligations of the Policyholders and providing an efficient service. It is important to ensure that the entities providing these services stick to their commitments. Failure to honour commitments by such entities could have major repercussions on the financial services industry. After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.

13.8.1 Powers/Functions of IRDA

Under Section 14 of the IRDA Act, IRDA has the following powers:

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

(c) Specification of requisite qualifications, practical training and code of conduct for insurance agents and intermediaries.

(d) Specification of code of conduct for surveyors and loss assessors.

(e) Promoting efficiency in the conduct of insurance business.

(f) Promoting and regulating professional organizations connected with insurance and reinsurance business.

(g) Levying fees and other charges for carrying out the purposes of the Act.

(h) Calling for information from or undertaking inspection of insurance companies, intermediaries and other organisations connected with insurance business.

(i) Control and regulation of rates, terms and conditions that may be offered by general insurance companies.

(j) Specifying the form and manner in which books of account shall be maintained by insurance companies and intermediaries.

(k) Regulation of investments of funds by insurance companies.

(l) Regulation of maintenance of margin of solvency.

(m) Adjudication of disputes between insurers and insurance intermediaries.

(n) Supervising the functioning of Tariff Advisory Committee.

(o) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations.

(p) Specifying the percentage of insurance business to be undertaken by insurers in rural or social sectors.

(q) Such other powers as may be prescribed.

13.9 Pension Fund Regulatory Development Authority (PFRDA)

Pension Fund Regulatory and Development Authority (PFRDA) was established by the Government of India on 10th October 2003 to promote old age income security and to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental there to. The Central Government has introduced the National Pension System (NPS) with effect from 1st January 2004. The NPS covers, at present, new entrants to Central Government services (excluding Armed Forces), some State Government services and autonomous bodies at their discretion and all citizens of India on a voluntary basis with effect from 1st May 2009. PFRDA has since been constituted under the provisions of the

PFRDA Act 2013 w.e.f. 1st February 2014. PFRDA is responsible for appointment of various intermediate agencies such as Central Record Keeping Agency (CRA), Pension Fund Managers, Custodian, NPS Trustee Bank, etc. Currently, PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

13.9.1 Functions and Powers of PFRDA

- Regulate and ensure orderly growth of NPS and other pension schemes.
- Registering and regulating intermediaries.
- Protecting interest of subscribers by ensuring safety of contribution and by ensuring that intermediation and operational costs under NPS are economical and reasonable.
- Promoting professional organisations connected with pension system, research and projects.
- Adjudicating of disputes between intermediaries and between intermediaries and subscribers.
- Residuary powers like inspection, conducting inquiries, investigation, audit.
- Powers of Civil Court for the purpose of examining persons, inspection of books, register etc.
- Powers of restrain, impounding and retaining proceeds etc.

CHECK YOUR PROGRESS

Q 4: Mention two powers of IRDA.

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Q 5: Mention two powers of PFRDA.

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13.10 LET US SUM UP

In this unit we have discuss the following points :

- The major aim of financial regulation is to maintain integrity of the financial market.
- The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system.
- The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.
- After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.
- PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

13.11 FURTHER READINGS

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13.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two Objectives of financial market regulation are:

(a) To protect the interest of the investor and consumer of the financial services.

(b) To maintain stability in the financial system.

Ans to Q No 2: Two powers of RBI are-Power to issue licenses and Powers to regulate the business of banking.

Ans to Q No 3: Following are the two powers of SEBI:

(a) To regulate stock exchanges and the securities industry to promote their orderly functioning.

(b) To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

Ans to Q No 4: Following are the two powers of IRDA

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

Ans to Q No 5: Following are the two powers of PFRDA

(a) Regulate and ensure orderly growth of NPS and other pension schemes.

(b) Registering and regulating intermediaries.

13.13 MODEL QUESTIONS

Q 1: Discuss the functions of SEBI.

Q 2: Discuss the regulatory powers of RBI.

Q 3: Discuss the powers and functions of IRDA and PFRDA.

Q 4: Explain the regulatory environment of financial markets in India.

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