EduTap

SUMMARY SHEET

Monetary Policy Since Reforms of 1991

EduTap

EduTap Hall of Fame

NABARD Grade A 2021

62 Selections Out of 74

RBI Grade B 2020 - 21

198 Selections Out of 257

SEBI Grade A 2022

58 Selections Out of 80

Contents

1 Part I: Basics of Monetary Policy 3
  1.1 Meaning of Monetary Policy 3
2 Part II: Monetary Policy in India 5
  2.1 Reserve Bank of India – Establishment 5
  2.2 Role of Reserve Bank of India 5
  2.3 Inflation Targeting Framework in India 6
  2.4 Monetary Policy Committee – Key Facts 7
3 Part III: Instruments of Monetary Policy 8
  3.1 Quantitative Tools of Monetary Policy 8
    3.1.1 Cash Reserve Ratio 8
    3.1.2 Statutory Liquidity Ratio 10
    3.1.3 Key differences between CRR & SLR 11
    3.1.4 Repo Rate 11
    3.1.5 Long Term Repo 12
    3.1.6 Reverse Repo Rate 13
    3.1.7 Liquidity Adjustment Facility 13
    3.1.8 Marginal Standing Facility 14
    3.1.9 Liquidity Management Framework 14
    3.1.10 Bank Rate 15
    3.1.11 Open Market Operation 15
    3.1.12 Market Stabilization Scheme 16
    3.1.13 Standing Deposit Facility Scheme 16
    3.1.14 Summary of Quantitative Tools 16
  3.2 Qualitative Tools of Monetary Policy 17
    3.2.1 Credit Rationing 17
    3.2.2 Loan to Value Ratio 17
    3.2.3 Moral Suasion 17
    3.2.4 Direct Action 17
  3.3 Priority Sector Lending 17
    3.3.1 Categories under Priority Sector Lending 18
    3.3.2 Priority Sector Lending Certificates (PSLCs) 19
4 Part IV: Types of Monetary Policy 19
  4.1 Expansionary Monetary Policy 19
  4.2 Contractionary Monetary Policy 19

5 Part V: Financial Institutions in India 20
5.1 Non-Banking Financial Companies 20
5.2 Regional Rural Banks 21
5.3 Cooperative Banks 21
5.4 Small and Payment Banks 22
5.4.1 Small Finance Bank 22
5.4.2 Payments Bank 23
5.5 MUDRA Bank 23

1 Part I: Basics of Monetary Policy

1.1 Meaning of Monetary Policy

- Monetary policy is the process by which the **monetary authority of a country**, like the central bank or currency board, **controls the supply of money**, often **targeting an inflation rate or interest rate to ensure price stability** and general **trust in the currency.**
- The **Reserve Bank of India** is **India's monetary authority** responsible for monetary policy. This responsibility is explicitly mandated under the **Reserve Bank of India Act, 1934**.

What is Money?

Money is anything which performs the following four functions:

1. ***Medium of Exchange:*** Individual goods and services, and other physical assets, are 'priced' in terms of money and are exchanged using money.
2. ***A Measure of Value:*** Money is used to measure and record the value of goods or services.
3. ***A Store of Value over Time:*** Money can be held over a period of time and used to finance future payments.
4. ***Standard for Deferred Payments:*** Money is used as an agreed measure of future receipts and payments in contracts.

Money Supply

Money supply refers to the **stock of money** available in the economy at a given point of time. Money supply data are recorded and published by the **Reserve Bank of India** on a **fortnightly basis**. Money supply affects the **price level, exchange rates and business cycle** in the economy. It may also affect the **growth of GDP**. The **ratio** between **nominal GDP and money supply** is called **'Velocity of Money'**.

Measures of Money Supply

The **four most common measures of money supply**, which are used in India, are as follows:

(a) **Narrow Money (M1)** = Currency with the public + Demand deposits with the banking system + 'Other' deposits with the RBI.
(b) **M2** = M1 + Saving deposits of post office savings banks.
(c) **M3** = M1 + Time deposits with the banking system
(d) **M4** = M3 + All deposits with post office savings bank (excluding National Savings Certificates).

'Currency with the public' is currency in circulation less cash held by banks.

'Demand deposits' include all liabilities which are payable on demand and they include current deposits, demand liabilities portion of saving bank deposits, margins held against letters of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, etc.

'Time deposits' are those which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, etc.

M1 and M2 are known as *narrow money* (Currency notes, coins and demand deposits held by the public in commercial banks.). **M3 and M4 are known as *broad money*** (Narrow money + time deposits held by commercial banks and post office savings organization). These measures are in decreasing order of liquidity.

M1 is **most liquid** and easiest for transactions whereas **M4 is least liquid** of all. **M3** is the most **commonly used measure of money supply**. It is also known as **aggregate monetary resources.**

How does Monetary Policy help in controlling Inflation?

- **What is inflation?** Inflation refers to a general increase in price level.
- **Why do we have inflation in an economy or, in other words, why do prices in an economy increase?** The answer is simple. Why does price of tomato increase in a vegetable market? There can be two reasons. Either there is a short supply of tomato in the market (i.e., supply has fallen below demand) or the buyers are demanding greater than usual quantities of tomato (i.e., demand has shot above supply). In either of the above scenarios, price of tomato will increase. What is true for tomato is also true for all other goods and services. At the macroeconomic level, there will be inflation when there is a demand supply mismatch as discussed above.
- **How can RBI ensure price stability? How can RBI keep inflation under control?** Let us go back to our tomato example. For the sake of simplicity, let us assume that ours is a single-product-economy, with tomato being the sole product grown, sold, purchased and consumed. Inflation then is nothing but an increase in price of tomato. As we discussed above, if demand exceeds supply, prices of tomato will increase. In such a scenario, how can RBI help in controlling the inflation or, in other words, how can RBI help in keeping the price of tomato under control? To answer this question, let us take a step back.
- **How is it that people purchase tomato?** Answer is ridiculously simple! By paying the vegetable vendor money in exchange for tomato.
- **What if people did not have money in their pocket? Will they be able to create demand for tomato?** Obviously not.
- **In a scenario of demand exceeding supply, what will happen if suddenly all the money in people's pocket vanishes? Will they be able to demand tomato?** No. People will not be able to demand tomato. Demand for tomato will crash. **What will happen to prices when demand crashes?** Obviously, since there is no one to purchase tomato, vegetable vendor will reduce the prices in an effort to attract buyers back into the market. Decrease in price of tomato would imply that inflation is back in control! Who controls the money supply? The central bank (RBI is India's central bank) in a country controls the money supply. Central bank can create conditions such that people have easier access to money (liquidity) and have greater liquidity to spend. Conversely, central bank can create conditions such that people will find it difficult to access and liquidity and thus have lower power to purchase goods and services.
- **How can RBI keep inflation under control?** In a scenario where demand in the economy is exceeding supply, RBI will adjust the financial knobs of the macroeconomy such that money supply (liquidity) reduces. Reduced money supply → Lower money in people's pocket → Lower ability to demand goods and services → Demand may reduce → Prices may come down → Inflation under control.
- **Rules: In the scenario of price rise (or high inflation), central bank of a country needs to take steps such that money supply in the economy is reduced.**

2 Part II: Monetary Policy in India

Note:
The main objectives of monetary policy in India are:
- Maintaining price stability
- Ensuring adequate flow of credit to the productive sectors of the economy to support economic growth but at the same time protecting the credit quality.
- Financial stability
- Monitor the global and domestic economic conditions and respond swiftly as required.
- Give thrust on interest rate management, inflation management and liquidity management.

2.1 Reserve Bank of India – Establishment

In this section, we will discuss the historical background behind the establishment of Reserve Bank of India (RBI).

- RBI is India's Central Bank.
- RBI was **established on April 1, 1935** in accordance with the provisions of the **Reserve Bank of India Act, 1934**.
- The Central Office of RBI was initially established in **Calcutta** but was **permanently moved to Mumbai in 1937**. The Central Office is where the Governor sits and where policies are formulated.
- Though **originally privately owned**, since nationalization in **1949**, the RBI is **fully owned by the Government of India**.
- The RBI operates today with its **31 regional offices**, most of them situated in state capitals and its affairs are **governed by a central board of directors**.
- **Government of India** constitutes the central board of directors by appointing or **nominating the directors for a period of four years** in the following way –
  - **Official Directors: Governor** and not more than **four Deputy Governors.**
  - **Non-Official Directors: 10 nominated** from various fields and **2 government officials**. It also includes **4 Directors coming 1 each from the four local boards of RBI** (also known as **sub-offices**, they are situated at **Chennai, Kolkata, Mumbai and New Delhi**).
- **Local Boards**
  - One each for the four regions of the country in Mumbai, Kolkata, Chennai and New Delhi
  - Membership: It consist of five members each appointed by the Central Government for a term of four years
- There are **5 fully-owned subsidiaries** of the RBI, namely —
  1. **Deposit Insurance and Credit Guarantee Corporation of India (DICGC)**
  2. **Bhartiya Reserve Bank Note Mudran Private Limited (BRBNMPL)**
  3. **Reserve Bank Information Technology Private Limited (ReBIT)**
  4. **Indian Financial Technology and Allied Services (IFTAS)**
  5. **Reserve Bank Innovation Hub (RBIH)**

2.2 Role of Reserve Bank of India

Monetary Authority
- Formulates, implements and monitors the monetary policy.
- Objective: maintaining **price stability** while keeping in mind the **objective of growth**.

Regulator and supervisor of the financial system
- Prescribes broad **parameters of banking operations** within which the country's banking and financial system functions.
- Objective: maintain **public confidence** in the system, **protect depositors' interest** and provide **cost-effective banking services** to the public.

Manager of Foreign Exchange
- Manages the **Foreign Exchange Management Act, 1999.**

- Objective: to facilitate **external trade and payment** and promote orderly development and maintenance of **foreign exchange market** in India.

Issuer of currency

- **Issues and exchanges or destroys currency and coins** not fit for circulation.
- Objective: to give the public **adequate quantity** of supplies of currency notes and coins and in **good quality**.
- RBI is the only institution which can issue currency except the currency and coins of rupee one or its denominations, which are issued by Ministry of Finance itself
- This function includes the distribution responsibility of the currencies and coins also (of those ones also which are issued by the Ministry of Finance).

Developmental role

- Performs a wide range of promotional functions to **support national objectives such as financial literacy and inclusion**.
- Playing this role, it did set up developmental banks like—IDBI, SIDBI, NABARD, NEDB (North Eastern Development Bank), Exim Bank, NHB. Gradually, the ownership of these banks is being transferred from the RBI to the Government of India (aimed at enhancing regulatory freedom and professionalism of the central bank and enabling the Government to take care of the dynamic requirements of development in a better way).

Regulator and Supervisor of Payment and Settlement Systems

- Introduces and upgrades **safe and efficient modes of payment systems** in the country to meet the requirements of the public at large.
- Objective: maintain **public confidence** in payment and settlement system.

Related Functions

- Banker to the Government: performs **merchant banking function** for the central and the state governments; also acts as their banker.
- Banker to banks: maintains **banking accounts of all scheduled banks**.
- When **commercial banks need more funds** in order to be able **to create more credit**, they may **go to market for such funds or go to the Central Bank**. Central bank provides them funds through various instruments. This **role of RBI**, that of being ready to **lend to banks at all times** is another important function of the central bank, and due to this central bank is said to be the **lender of last resort**.

2.3 Inflation Targeting Framework in India

In the preceding section, we got an overview of all the roles RBI plays in the Indian economy. In the present section, we will focus the discussion on price stability. We will be deep diving into the principle of 'inflation targeting' and explore how this has become the mainstay of India's monetary policy.

- Inflation targeting is a **monetary policy strategy** used by Central Banks for **maintaining price level** at a certain level or **within a range**. It indicates the primacy of **price stability as the key objective of monetary policy**.
- The argument for price stability stems from the fact that **rising prices create uncertainties in decision making**, adversely affecting savings and encouraging speculative investments. **Inflation targeting** brings in **more predictability and transparency** in deciding monetary policy. If the central banks could ensure price stability, **households and companies can plan ahead**, negotiating wages on the basis of expecting low and stable inflation.
- Various **advanced economies** including **United States, Canada and Australia** have been using **inflation targeting** as a strategy in their monetary policy framework. The case for inflation targeting has been made in **India** as the country has been experiencing a **high level of inflation** till recently.

- The **primary objective** of RBI's monetary policy is to **maintain price stability** while keeping in mind the **objective of growth**. **Price stability** is a necessary precondition to **sustainable growth**.
- In May 2016, the **Reserve Bank of India Act, 1934** was **amended** to provide a **statutory basis** for the implementation of the **flexible inflation targeting** framework.
- The **amended RBI Act** also provides for the **inflation target** to be set by the **Government of India**, in consultation with the Reserve Bank, **once in every five years.** Accordingly, the Central Government has notified in the Official Gazette **4 per cent Consumer Price Index (CPI) inflation as the target** for the period from **August 5, 2016 to March 31, 2021** with the **upper tolerance limit of 6 per cent** and the **lower tolerance limit of 2 per cent. Further, the Central Government, in consultation with the RBI, retained the same inflation target for the 5-year period April 1, 2021 to March 31, 2026.**
- The Central Government notified the **following as factors that constitute failure to achieve the inflation target**:
    1. the **average inflation is more than the upper tolerance level** of the inflation target for any **three consecutive quarters**; or
    2. the **average inflation** is **less than the lower tolerance level** for any **three consecutive quarters**.
- **Management of monetary policy** and the **express objective of inflation targeting** has been enshrined as the **responsibility of RBI** by amending the **preamble of the RBI Act, 1934** through the Finance Act 2016 (Chapter XII). Thus, **ensuring price stability** through **inflation targeting** is a **legal responsibility of RBI since 2016.** A new Chapter (Chapter IIIF, Section 45Z) was introduced in the RBI Act, through this Finance Bill, 2016, for detailing the operation of a **Monetary Policy Committee** (MPC), which would be the **institutional arrangement at the disposal of RBI for targeting inflation.**
- Under Section 45ZA (1) of the **RBI Act, 1934**, the **Central Government determines the inflation target** in terms of the **Consumer Price Index**, once in **every five years** in consultation with the RBI. This target would be notified in the Official Gazette. Amongst other measures, **RBI targets inflation primarily by changing the "Policy Rate"** which means the **rate for repo-transactions** as defined under sub-section (12AB) of section 17 of the **RBI Act**.

2.4 Monetary Policy Committee – Key Facts

We have learnt how monetary policy can be used to tackle inflation. We have also read about the inflation targeting framework of the RBI. Now it is time to learn some key facts about the Monetary Policy Committee – the top decision-making body for monetary policy in India.

- The **Central Government constitutes the Monetary Policy Committee (MPC)** through a notification in the Official Gazette. Altogether, the MPC will have **six members**, - the **RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board** and the remaining **three members would represent the Government of India.**
- These **Government of India nominees** are appointed by the Central Government based on the **recommendations of a search cum selection committee** consisting of the **cabinet secretary (Chairperson)**, the **RBI Governor**, the **secretary of the Department of Economic Affairs**, Ministry of Finance, and **three experts in the field of economics or banking** as nominated by the central government.
- The **three central government nominees** of the MPC appointed by the search cum selection committee will **hold office for a period of four years** and will **not be eligible for re-appointment**.
- **RBI Act prohibits appointing any Member of Parliament or Legislature or public servant**, or any **employee / Board / committee member of RBI** or anyone with a conflict of interest with RBI or **anybody above the age of 70 to the MPC.**
- The **MPC** is required to **meet at least four times in a year.** From being announced twice a year (before slack and busy seasons) today the policy is a bi-monthly affair announced 6 times in a financial year after the monetary policy committee (MPC) came into being in 2016.
- The **quorum** for the meeting of the MPC is **four members.**
- **Each member** of the MPC has **one vote**, and in the event of an equality of votes, the **Governor has a second or casting vote.**

- The **resolution** adopted by the MPC is **published** after **conclusion of every meeting** of the MPC in accordance with the provisions of the Reserve Bank of India Act, 1934.
- On the 14th day, the minutes of the proceedings of the MPC are published which include:
  - the resolution adopted by the MPC;
  - the vote of each member on the resolution, ascribed to such member; and
  - the statement of each member on the resolution adopted.
- **Once in every six months**, the Reserve Bank is required to publish a **document** called the **Monetary Policy Report** to explain:
  - the **sources of inflation**; and
  - the **forecast of inflation for 6-18 months ahead**.

3 Part III: Instruments of Monetary Policy

As discussed earlier, to control inflation, RBI needs to take steps that will help reduce the money supply in the economy. And to boost growth, RBI needs to take steps that will help increase the money supply in the economy. Now we will look at the tools that actually help in controlling the money supply.

The instruments of monetary policy are of two types: first, quantitative, general or indirect; and second, qualitative, selective or direct. They affect the level of aggregate demand through the supply of money, cost of money and availability of credit.

3.1 Quantitative Tools of Monetary Policy

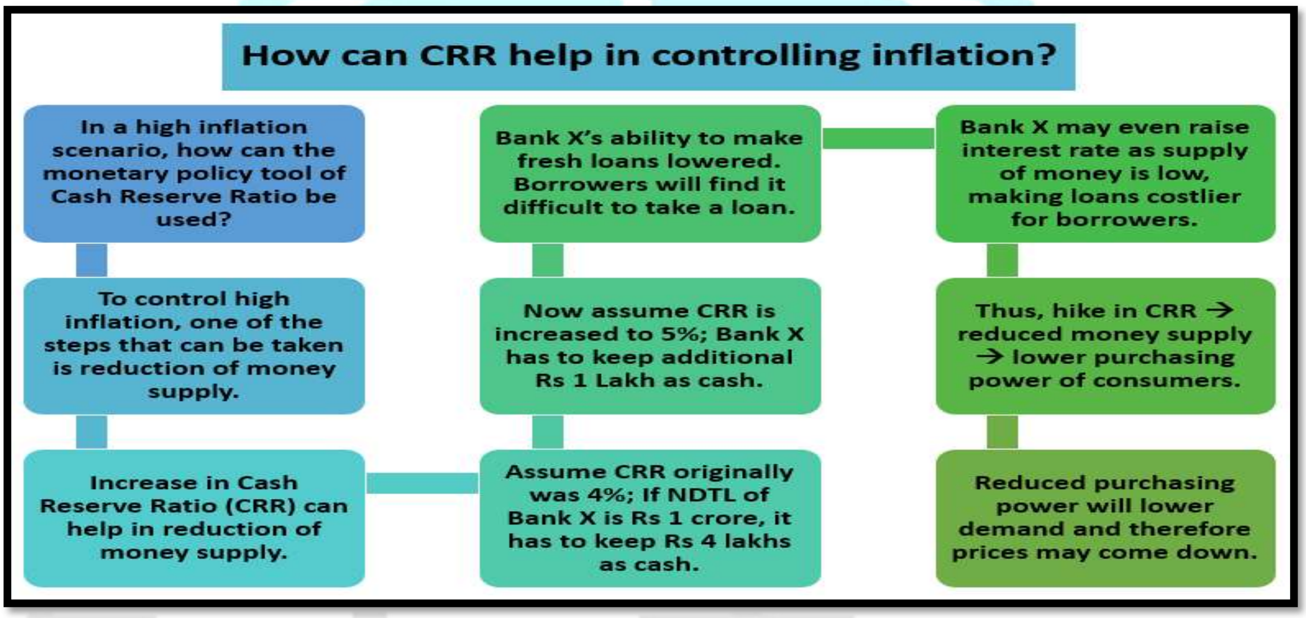
- **Quantitative instruments** influence the **money volume and credit supply** in the system. These include **variations in reserve ratio requirements, bank rate and Open Market Operations.**
- Quantitative tools are **indirect** and **general** in nature.
- Examples of quantitative tools are: **Cash Reserve Ratio, Statutory Liquidity Ratio, Repo Rate, Reverse Repo Rate, Marginal Standing Facility, Bank Rate and Open Market Operations**. Let us discuss each of these in detail.

3.1.1 Cash Reserve Ratio

Cash Reserve Ratio is an important quantitative tool of monetary policy. It is important not just from the perspective of controlling inflation, but also from the perspective of smooth daily functioning of the banking system. Let us read more about it.

- Cash Reserve Ratio (CRR) is the amount of money that the banks have to **keep with RBI in cash form**. The cash reserve is either stored in the bank's vault or is sent to the RBI.
- CRR was **introduced in 1950** primarily as a measure to ensure **safety and liquidity of bank deposits**, however over the years it has become an important and **effective tool for directly regulating the lending capacity** of banks and **controlling the money supply** in the economy.
- The **cash balance** that is to be maintained by **scheduled banks with the RBI** should **not be less than such per cent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.**
- In terms of **Section 42 (1) of the Reserve Bank of India Act, 1934**, the Reserve bank, having regard to the needs of **securing the monetary stability** in the country, **prescribes the CRR for SCBs without any floor or ceiling rate.**
- The CRR is to be **calculated on the basis of DTL**, with a **lag of one fortnight**, i.e., on the reporting Friday, the DTL as at the end of the previous fortnight will form the basis for CRR calculation.
- NDTL refers to the **total demand and time liabilities (deposits)** that is **held by the banks of public and with other banks.**
- Banks have to **maintain cash balances with RBI** to meet the prescribed CRR on average during the fortnight, subject to **daily cash balances not falling below 90% of the amount required for CRR.**

- There are **two primary purposes of the CRR:** Since a part of the bank's deposits is with the Reserve Bank of India, it **ensures the security of the amount**. It makes it **readily available when customers want their deposits back.** Also, CRR helps in **keeping inflation under control**. At the time of high inflation in the economy, RBI increases the CRR, so that banks need to keep more money in reserves so that they have less money to lend further.
- **How CRR helps in controlling inflation?** At the time of high inflation, the government needs to ensure that excess money is not available in the economy. To that extent, RBI increases the Cash Reserve Ratio, and the amount of money that is available with the banks reduces. This curb excess flow of money in the economy.
- **How CRR can help in boosting growth?** When the government needs to pump funds into the system, it lowers the CRR rate, which in turn, helps the banks provide loans to a large number of businesses and industries for investment purposes. Lower CRR also boosts the growth rate of the economy.
- Note: **RBI does not pay interest on deposits held by banks to meet the CRR, even if the deposits are in excess of minimum required by RBI. CRR, therefore, effectively increase cost of deposits to the banking sector.**
- **Penalty for non-maintenance of CRR**
    - In case of **default in maintenance of CRR requirement on a daily basis, penal interest** will be levied for that day at the rate of **three per cent per annum above the Bank Rate** on the amount by which the amount actually maintained falls short of the prescribed minimum on that day and if the shortfall continues on the next succeeding day/s, penal interest will be recovered at the rate **five per cent per annum above the Bank Rate**.
    - In cases of default in maintenance of CRR on average basis during a fortnight, penal interest will be levied as envisaged in sub-section (3) of Section 42 of Reserve Bank of India Act, 1934



Liabilities of Bank:

- Deposits of banks are its liability and consist of demand and time deposits of public and other banks.
- Demand deposits include all liabilities which are payables on demand and includes current deposits, demand liabilities portion of savings bank deposits, demand drafts, balances in overdue fixed deposits etc.
- Time deposits are those which are payable otherwise on demand and includes fixed deposits, staff security deposits, time liabilities portion of savings bank deposits etc.
- NDTL is calculated and reported every fortnight Friday by banks.

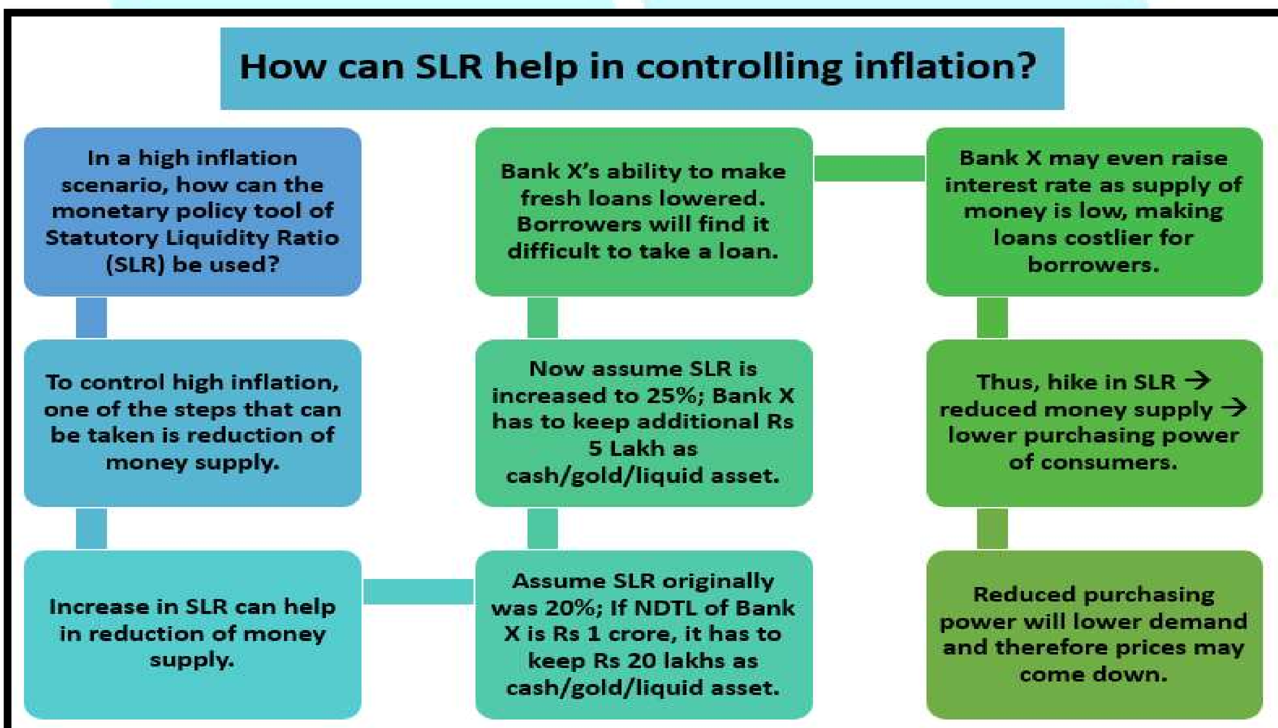
Main components of DTL are -

- **Demand deposits** (held in current and saving accounts, margin money for LCs, overdue fixed deposits etc.)
- **Time deposits** (in fixed deposits, recurring deposits, reinvestment deposits etc.)
- **Overseas borrowings.**
- **Foreign outward remittances in transit** (FC liabilities net of FC assets)
- **Other demand and time liabilities** (accrued interest, credit balances in suspense account etc.).

3.1.2 Statutory Liquidity Ratio

Now that we have understood CRR, Statutory Liquidity Ratio too should not be difficult. Like CRR, Statutory Liquidity Ratio too serves dual purpose – it helps ensure solvency of banks, and it can also be used to control inflation. Let us read more about it.

- Every bank must have a specified **portion of their Net Demand and Time Liabilities** (NDTL) in the form of **cash, gold, or other liquid assets** by the day's end. The **ratio of these liquid assets to the demand and time liabilities is called the Statutory Liquidity Ratio (SLR).**
- The **Reserve Bank of India** has the authority to **increase this ratio by up to 40%. An increase in the ratio constricts the ability of the bank to inject money into the economy.**
- Section 24 and Section 56 of the Banking Regulation Act 1949 mandates **all scheduled commercial banks, local area banks, Primary (Urban) co-operative banks (UCBs), state co-operative banks and central co-operative banks** in India to maintain the SLR.
- RBI employs **SLR regulation to have control over the bank credit**. SLR ensures that there is **solvency in commercial banks** and assures that **banks invest in government securities.**
- RBI raises SLR to **control the bank credit during the time of inflation**. Similarly, it **decreases the SLR during the time of recession to increase bank credit.**
- **Banks earn returns** on money parked as SLR.
- If a **banking company fails to maintain** the required amount of SLR, it shall be **liable to pay to RBI in respect of that default, the penal interest** for that day at the rate of **three per cent per annum above the Bank Rate** on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of **five per cent per annum above the Bank Rate for the number of days of default on the shortfall.**



- There are some **reasons behind introducing Statutory Liquidity Ratio**. The main objectives for maintaining the Statutory Liquidity Ratio (SLR) are the following:
  - SLR is maintained in order to **control the expansion of bank credit**. By changing the level of SLR, Reserve Bank can increase or decrease bank credit expansion.
  - SLR in a way ensures the **solvency of commercial banks**.
  - By determining SLR, RBI, in a way, compels the commercial banks to **invest in government securities like government bonds.**

3.1.3 Key differences between CRR & SLR

It is important to note the difference between CRR and SLR. While both can be clubbed under the head of 'reserve requirement ratio', these are two very different concepts. Let us see how.

Form of Reserve

- The CRR requires banks to have **only cash reserves with the RBI.**
- In the case of SLR, banks are asked to have **reserves of liquid assets** which include **cash, gold and government securities.**

Return

- Banks **don't earn returns** on money parked as **CRR**.
- Banks **earn returns** on money parked as **SLR**.

Purpose

- The Central Bank **controls the liquidity** in the Banking system with **CRR**.
- SLR is used to **control the bank's leverage for credit expansion**.

Holding

- In **CRR**, the **cash reserve** is maintained by the banks **with the Reserve Bank of India**.
- In the case of **SLR**, the **securities** are kept **with the banks themselves** which they need to maintain in the form of liquid assets.

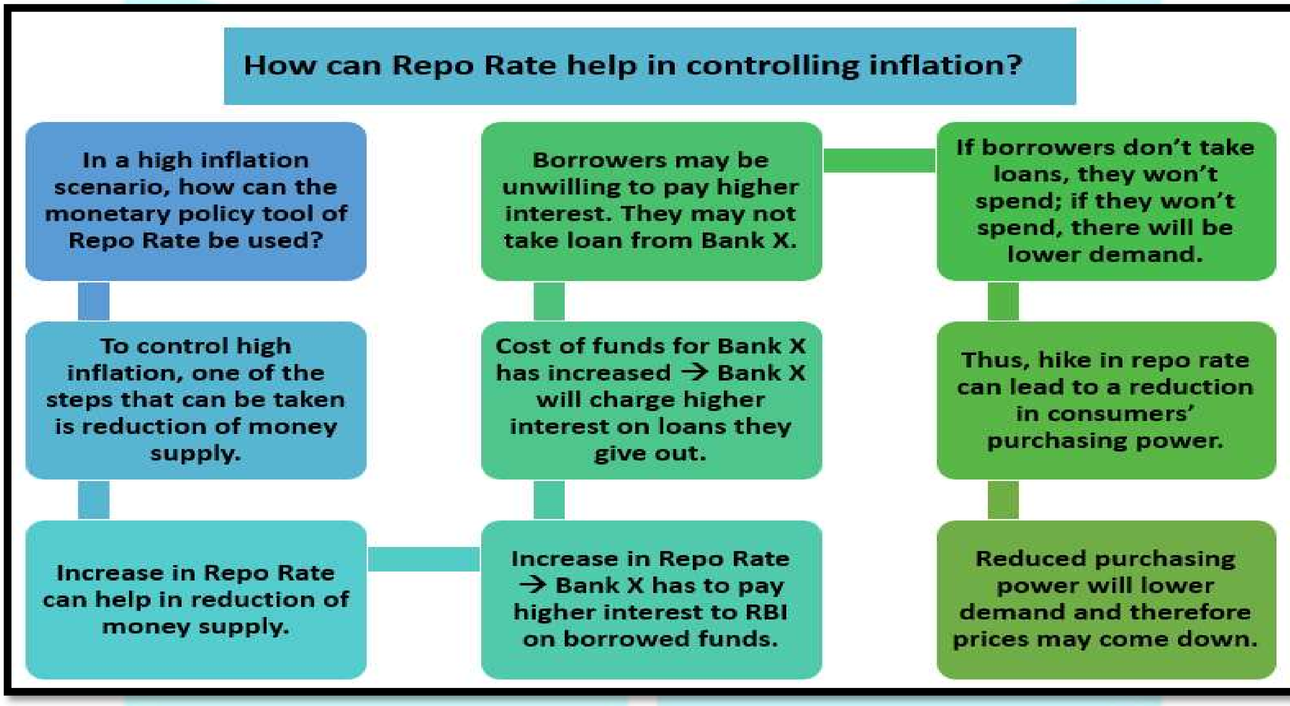
> Note:
> The **minimum and maximum levels of CRR** were prescribed at **3% and 20%** of demand and time liabilities (**DTL**) of the bank respectively, under **Reserve bank of India Act of 1934**. However, an **amendment to the Act in 2006 removed the floor and ceiling limits** with effect from April 2007, enabling RBI to stipulate the CRR at its discretion. Similarly, the **minimum and maximum SLR** were prescribed at **25% and 40% of DTL** respectively, under the **Banking Regulation Act of 1949**. An **amendment to the Act** has **removed** the **minimum requirement** with effect from **January 2007**, allowing greater flexibility to RBI.

3.1.4 Repo Rate

We have already learnt that if commercial banks are in need of money, they can borrow it from the RBI. We have called RBI as the 'lender of last resort' for playing this role of being a lender to commercial banks. Does RBI give money for free to the commercial banks? No, it does not. It charges an interest – called as repo rate – for lending money to banks. Repo rate is also a quantitative tool of monetary policy. Let us see how it can be used to control inflation.

- Repo or repurchase option is a **collaterised lending** i.e., **banks borrow money from Reserve bank of India** to meet short term needs by **selling securities to RBI** with an **agreement to repurchase the same at predetermined rate and date.**
- The **rate charged** by RBI for this transaction is called the **repo rate**. Repo operations therefore **inject liquidity into the system.**

- **To put it in very simple terms**: It is the rate at which RBI lends money to commercial banks against securities in case commercial banks fall short of funds.
- A **high repo rate** signals that **access to money is expensive** for banks and **lesser credit will flow** into the system.
- Repo Rate in India is the **primary tool in the RBI's Monetary and Credit Policy.**
- Repo Rate is the **most significant rate for the common man too**. Everything from interest rates on loans to **returns on deposits** is influenced by this crucial rate set by the RBI, which is why interest rates on **home loans, car loans and other kinds of borrowings** go up and down based on the direction of Repo Rate change. Similarly, banks adjust **savings account, fixed deposit returns** based on this benchmark.



3.1.5 Long Term Repo

Aimed at **promoting enhanced lending** and **cutting the cost of short-term funds** for the banks, in a first of its kind move, in **February 2020** (6th Bi-monthly Monetary Policy of 2019-20), the RBI announced to offer **long term repo operation (LTRO) of ₹1.50 lakh crores at a fixed rate (i.e., at the Repo rate).** The **tenure** of the LTRO will be from **one to three years.** This was aimed at ensuring **permanent and deeper liquidity in the financial system** together with enhancing lending by cutting cost of funds for the banks (enabling them to lend cheaper loans).

RELATED CONCEPT: MCLR

As per the RBI, 'for monetary policy transmission to occur, lending rates of banks have to be sensitive to the policy rate (repo rate)'. But this was not occurring by now. During 2015–16, the RBI reduced the policy rate by a total of 1.25 per cent. But in comparison, banks reduced the lending rate by maximum 0.6 per cent. By now, banks have been using either of the following three methods to compute their Base Rate (minimum rate below which banks are not allowed to lend to its customers):

1. average cost of funds
2. marginal cost of funds
3. blended cost of funds (liabilities).

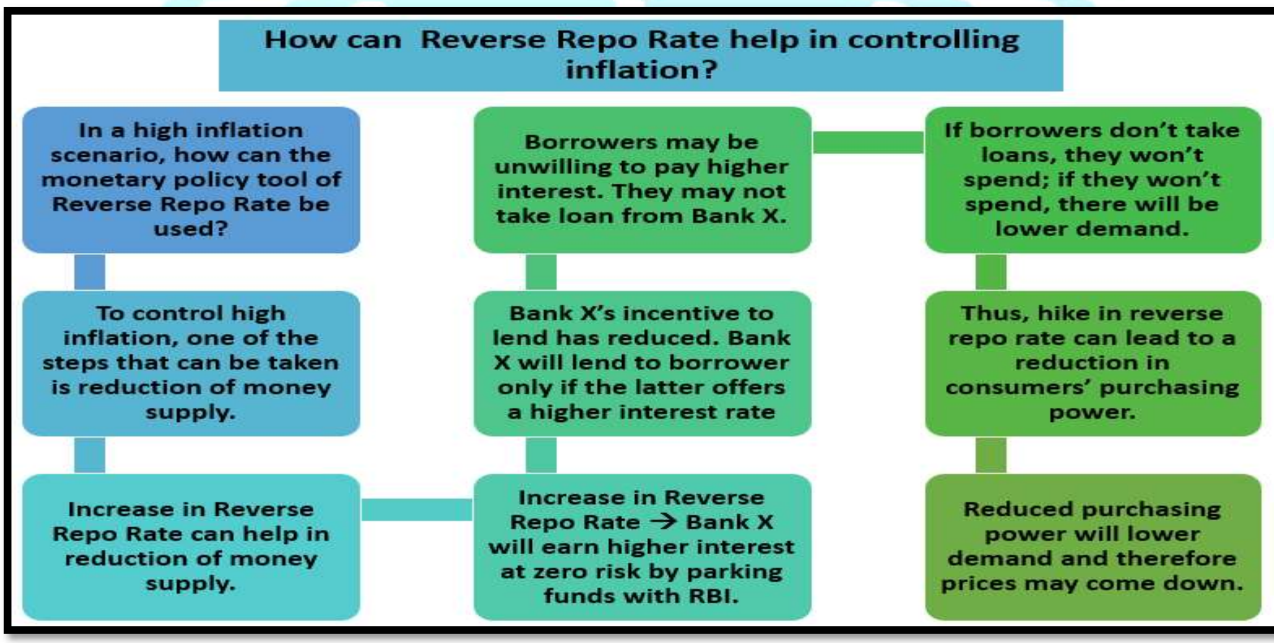
From the financial year 2016–17 (i.e., from 1st April, 2016), banks in the country have shifted to a new methodology to compute their lending rate. The new methodology—MCLR (Marginal Cost of funds based Lending Rate)—which was articulated by the RBI in December 2015. The main features of the MCLR are—

- it will be a tenor linked internal benchmark, to be reset on annual basis.
- actual lending rates will be fixed by adding a spread to the MCLR.
- to be reviewed every month on a pre-announced date.
- existing borrowers will have the option to move to it.
- banks will continue to review and publish 'Base Rate' as hitherto.

3.1.6 Reverse Repo Rate

If you and I have surplus cash, we can conveniently deposit the same with a commercial bank and earn interest. What happens if a bank has surplus cash that it cannot easily lend? Does the bank need to compulsorily hold that cash with itself? Or can the bank deposit that cash with the RBI? Answer is yes. Bank can deposit their surplus cash with RBI. Does bank earn any interest on its deposit? Yes, it does. It is called 'reverse repo rate'. Reverse repo can also be used as a quantitative tool of monetary policy to control inflation. Let us see how.

- Reverse repo operation is when **banks deposit their money with the RBI.**
- The **interest rate paid by RBI** in this case is called the **reverse repo rate**.



- Reverse repo operation therefore **absorbs the liquidity in the system.**
- The **collateral** used for repo and reverse repo operations are **Government of India securities**.
- A **high reverse repo rate** implies that **banks can get safe returns** if they park their **money with RBI**; therefore, Banks may either park their money with RBI or they may lend at a still higher rate of interest to borrowers. Thus, **high reverse repo rate** either **constricts credit**, or **makes it expensive**.

3.1.7 Liquidity Adjustment Facility

The Liquidity Adjustment Facility is the **principal operating instrument** of Reserve Bank's monetary policy. While **CRR and SLR** help **changes** in the stance of **monetary policy** on a more **permanent basis**, **LAF** is used to monitor **day-to-day liquidity** in the market.

As the name suggests, this is a facility that **helps in the adjustment of liquidity**. If banks need liquidity, they can access it; if banks have surplus liquidity, they can park it safely through LAF. **Repo and reverse repo**, which we discussed in the preceding section, are basically the **two channels of LAF** that help banks in liquidity adjustment. Let us read specifically about LAF.

- A LAF is a monetary policy tool, primarily used by the RBI, to **manage liquidity and provide economic stability.**
- LAF's **include both repos and reverse repo agreements.**
- The RBI introduced a LAF as a result of the **Narasimham Committee on Banking Sector Reforms (1998).**
- LAF's can **manage inflation** by **increasing and reducing the money supply.**
- The RBI can use the liquidity adjustment facility to **manage high levels of inflation**. It does so by **increasing the repo rate**, which **raises the cost of servicing debt**. This, in turn, **reduces investment** and **money supply** in India's economy.
- Conversely, if the RBI is trying to **stimulate the economy** after a period of **slow economic growth**, it can **lower the repo rate to encourage businesses to borrow**, thus increasing the money supply.
- Through **LAF**, **banks are permitted to borrow only a certain percentage of its Net Demand and Time Liabilities (NDTL)**. In case the **Bank requires more funds**, beyond what is permissible under LAF, it can **access another window called Marginal Standing Facility (MSF).**
- Since **October 2013**, the Reserve Bank has introduced **Term Repo (repos of duration more than a day)** under the Liquidity Adjustment Facility (LAF) for **14 days and 7 days tenors** for banks **(scheduled commercial banks other than RRBs)** in addition to the existing **daily LAF (repo and reverse repo)** and MSF.
- While **banks** can engage in **repo transactions** with other **banks/institutions**, **LAF** refers **exclusively to repo transactions with RBI.** Bids have to be submitted for a minimum amount of Rs 5 crore and in multiples of Rs 5. Crore thereafter.

3.1.8 Marginal Standing Facility

Banks can borrow a certain amount of money from the RBI under repo mechanism. But what if banks are in need of even greater liquidity than what is available through repo mechanism? Is there any facility that banks can tap and get access to this additional liquidity? Yes, there is. It is called Marginal Standing Facility. Let us discuss about Marginal Standing Facility and also see what role it plays in controlling inflation.

- Marginal Standing Facility (MSF) is a **new scheme announced by the RBI** in its **Monetary Policy (2011-12)** and refers to the **penal rate at which banks can borrow money from the central bank over and above what is available to them through the LAF window.**
- It is a facility under which scheduled commercial banks can borrow **additional amount of overnight money** from the Reserve Bank by pledging their **Statutory Liquidity Ratio (SLR) portfolio** up to a limit at a **penal rate of interest**.
- **MSF**, being a **penal rate**, is always **fixed above the repo rate**. The MSF would be the **last resort for banks once they exhaust all borrowing options** including the liquidity adjustment facility by pledging government securities, where the rates are lower in comparison with the MSF.
- This provides a safety valve against **unanticipated liquidity shocks** to the banking system.
- MSF represents the **upper band of the interest corridor** with **repo rate at the middle** and **reverse repo as the lower band.**

So, the correct decreasing order becomes: MSF > REPO RATE > REVERSE REPO RATE

3.1.9 Liquidity Management Framework

A liquidity management framework (LMF) was **provisioned by the RBI in 2014** to check **volatility in the inter-bank call money market** (CMM) and allow banks manage their **needs of short-term capital**. As per the last revision done by the RBI in February 2020, the LMF guidelines were as given below—

- The **combined repo borrowings of all banks** put together on a day **cannot be more than 1 per cent** of the **combined NDTL** of the banks (known as the upper ceiling on repo borrowing).

- **Individual banks** can borrow **not more than 1 per cent of their NDTL** under repo operation—**0.25 per cent of it as overnight repo (i.e., overnight borrowing for a day)** and rest of the **0.75 per cent as term repo for 7/14/28 days** (**i.e., borrowing for 7/14/28 days**).
- After exhausting the option of the various repos, banks can **borrow upto 2 per cent of their NDTL directly from the RBI for one day (called overnight) under the marginal standing facility (MSF).**
- The long-term repo started by the RBI in February 2020 is an extra window over and above the 1 per cent upper cap on the repo operation.

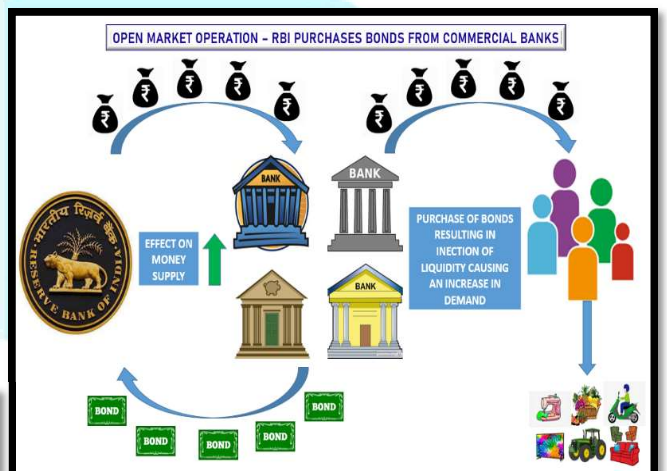
3.1.10 Bank Rate

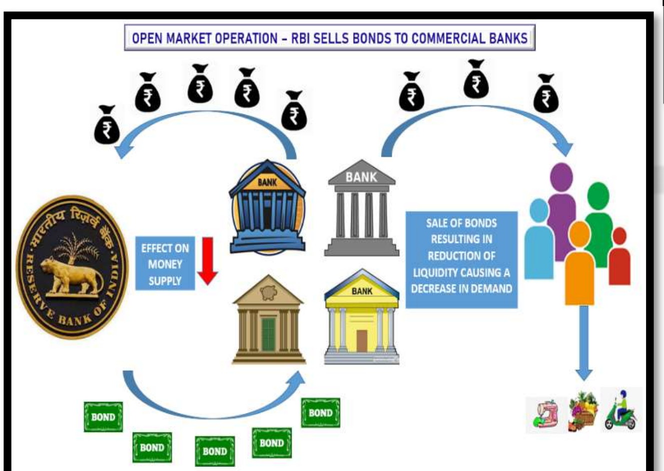
While this is an outdated concept, we still discuss about Bank Rate just so that there are no gaps in our understanding.

- Bank rate is also referred to as the **discount rate**.
- It is the **rate** at which the Reserve Bank is ready to **buy or rediscount bills of exchange or other commercial papers.**
- The Bank Rate is published under **Section 49 of the Reserve Bank of India Act, 1934.**
- This **rate has been aligned to the MSF rate** and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.
- The **role of the bank rate** as an instrument of monetary policy has been **very limited** in India because of these basic factors:
    - The **structure of interest rates** is **not automatically linked to the bank rate.**
    - Commercial banks enjoy specific refinance facilities, and not necessarily rediscount their eligible securities with RBI at bank rate.
    - The bill market is under-developed and the different sub-markets of the money market are not influenced by the bank rate.

3.1.11 Open Market Operation

Open Market Operations are one of the most potent tools available with the RBI for liquidity management. Through these operations, RBI can absorb and release huge sums of money from and into the economy. So, depending upon the inflation-growth scenario, RBI may decide to release money or absorb money. For either of these course of action, open market operations are very useful. Let us read more about these.





- These include both, outright **purchase and sale of government securities by the RBI**, for **injection and absorption of durable liquidity, respectively.**
- What happens when the **securities are purchased? There is more money in the economy** as the RBI purchases security and gives money. This leads to more money in the market, leading to more demand and thus higher growth rate.
- What happens when the **securities are sold? There is less money in the economy** and thus less demand leading to lowering of prices.

3.1.12 Market Stabilization Scheme

There are certain tools that have been created for use in extra-ordinary times. Market Stabilization Scheme is one such arrangement. Let us read more about it.

- Market Stabilization scheme (MSS) is a **monetary policy intervention by the RBI to withdraw excess liquidity (or money supply) by selling government securities** in the economy.
- The MSS was **introduced in April 2004.**
- The issued securities are government bonds and they are called as **Market Stabilization Bonds (MSBs).** Thus, the bonds issued under MSS are called MSBs.
- These securities are **owned by the government** though they are issued by the RBI.
- For the issue of MSS, there is a MoU between the government and the RBI about the total limit of MSBs to be issued by the RBI during a year.
- The **securities or bonds/Treasury bills issued under MSS are purchased by financial institutions**. They will **get an interest for purchasing the securities.**
- Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The mobilised cash is held in a separate government account with the Reserve Bank. The instrument thus has features of both, SLR and CRR.
- In the wake of **demonetization**, the **government has increased the amount of MSBs to be issued** to Rs 6 lakh crores from just 0.3 lakh crores.
- **After demonetization, huge deposits were put into the banking system.** At the same time, banks can't lend it to customers as it is just temporary money. The RBI has instructed banks to keep all the additional deposits as CRR. But here, the banks will suffer losses as they have to pay interest to the depositors. To compensate banks, the MSS policy is revived. Here, banks can put the excess money obtained from deposits in MSBs. They can get an interest payment as well.
- The intention of MSS is essentially to **differentiate the liquidity absorption of a more enduring nature by way of sterilization** from the **day-to-day normal liquidity management operations**.

3.1.13 Standing Deposit Facility Scheme

The new scheme has been proposed by the Union Budget 2018–19. Such a tool was proposed by the RBI in November 2015 itself. The scheme is aimed at helping RBI to manage liquidity in a better way, especially when the economy is flush with excess fund (as was seen after the demonetization of the high value currency notes post- November 2016).

3.1.14 Summary of Quantitative Tools

Tool	To Combat Inflation	To induce inflation/ combat disinflation/ combat deflation
CRR	Increase	Decrease
SLR	Increase	Decrease
REPO RATE	Increase	Decrease
REVERSE REPO RATE	Increase	Decrease
MSF	Increase	Decrease
BANK RATE	Increase	Decrease
OPEN MARKET OPERATIONS	RBI sells Government Securities	RBI buys Government Securities

3.2 Qualitative Tools of Monetary Policy

Having gone through the Quantitative tools of Monetary Policy, it is time to turn our attention to Qualitative tools of Monetary Policy. These tools help in ensuring that prudent practices are followed in the financial sector, while also ensuring that credit is channelized in the right direction.

- **Qualitative tools are direct and specific in nature.**
- **Qualitative tools** include persuasion by the Central bank in order to make commercial banks discourage or encourage lending which is done through **moral suasion.**
- Qualitative also called **selective credit control instruments** work through regulation of **margin requirement, credit rationing, regulation of consumer credit and direct action.**

3.2.1 Credit Rationing

- Rationing of credit is another method of selective credit control. It is done by **regulating the purposes for which the loans are given** among the various member banks. To **ensure overall development** of a nation, **development of various sectors is a must**. Finance is to be distributed to various sectors as per these requirements.
- **Priority sector** should be given **preference in lending loans.**
- For others, minimum attention only will be given in this respect. It paves way for the optimum utilization of money.

3.2.2 Loan to Value Ratio

- It is the **amount of loan that is given against a fixed value of collateral**.
- Loan-to-Value is calculated as follows: **Financial institutions calculate LTV of a borrower using given method: (Amount borrowed / Value of property) x 100 = LTV ratio in percentage**
- For example: Suppose a person wants to get a loan by **mortgaging its gold worth Rs.1 lakh.**
- The **LTV is 60%,** then the amount of loan the **person will receive is Rs. 60,000.**
- By using this method, during the period of **inflation** with a view to **control credit**, the **RBI lowers the LTV Ratio** and during **deflation** it **raises the LTV to expand the credit.**

3.2.3 Moral Suasion

- Moral suasion aims at strengthening natural confidence and understanding between the monetary authority and the banks as well as financial institutions. It is not a statutory obligation.
- Moral Suasion is just as a **request by the RBI to the commercial banks** to take certain actions and measures as per the trend of the economy.
- RBI may **request commercial banks not to give loans for unproductive purpose** which does not add to economic growth but increases inflation.

3.2.4 Direct Action

- This step is **taken by the RBI against banks that don't fulfill conditions and requirements**.
- RBI may **refuse to rediscount their papers** or **give excess credits** or charge a **penal rate of interest** over and above the Bank rate, for credit demanded beyond a limit.

3.3 Priority Sector Lending

Priority Sector Lending is an important role given by the RBI to the banks for providing a **specified portion of the bank lending to few specific sectors** like agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low-income groups and weaker sections. This is essentially meant for an **all-round development of the economy**.

3.3.1 Categories under Priority Sector Lending

1. **Agriculture**: The activities covered under Agriculture are classified under various **sub-categories** viz. **Farm credit, Agriculture infrastructure and Ancillary activities, Small and Marginal Farmers etc.**

2. **Micro, Small and Medium Enterprises**: For classification under priority sector, **no limits are prescribed** for bank loans sanctioned to Micro, Small and Medium Enterprises engaged in the **manufacture** or production of goods under any industry. Bank loans to Micro, Small and Medium Enterprises engaged in providing or rendering of **services** and defined in terms of investment in equipment under **MSMED Act, 2006**, irrespective of loan limits, are eligible for classification under priority sector, **w.e.f. March 1, 2018**.

3. **Export Credit:** Export credit under agriculture and MSME sectors are allowed to be classified as PSL in the respective categories viz. agriculture and MSME. Export Credit (other than in agriculture and MSME) will be allowed to be classified as priority sector.

4. **Education**: **Loans to individuals** for **educational purposes** including **vocational courses** upto **₹ 20 Lakh** irrespective of the sanctioned amount are eligible for classification under priority sector.

5. **Housing**: Loans to individuals **up to ₹3.5 million in metropolitan centres** (with **population of ten lakh and above**) and loans **up to ₹ 2.5 million** in **other centres** for purchase/construction of a dwelling unit per family, are eligible to be considered as priority sector provided the **overall cost of the dwelling unit** in the **metropolitan centre** and at other centres does not exceed **₹ 4.5 million and ₹ 3 million**, respectively.

6. **Social Infrastructure**
   a. Bank loans up to a **limit of ₹5 crore** per borrower for setting up schools, drinking water facilities and sanitation facilities including construction/ refurbishment of household toilets and water improvements at household level, etc. and loans up to a limit of **₹10 crore per borrower** for building health care facilities including under 'Ayushman Bharat' in Tier II to Tier VI centres. In **case of UCBs**, the above limits are applicable only in centres having a population **of less than one lakh.**
   b. Bank credit to **Micro Finance Institutions** (MFI) extended for on-lending to individuals/ members of **(Self-Help Groups) SHGs/ (Joint Liability Group) JLGs** for **water and sanitation facilities** is also eligible for classification as priority sector loans **under 'Social Infrastructure'** subject to certain criteria.

7. **Renewable Energy**
   a. Bank loans up to a **limit of ₹30 crore** to borrowers for purposes like solar based power generators, biomass-based power generators, wind mills, micro-hydel plants and for non-conventional energy based public utilities, viz., street lighting systems and remote village electrification etc., will be eligible for Priority Sector classification.
   b. For **individual households**, the **loan limit is ₹ 1 million per borrower.**

8. **Others**
   a. **Bank credit to MFIs (NBFC-MFIs, societies, trusts, etc)** extended for **on-lending to individuals and also to members of SHGs/JLGs** is eligible for categorisation as **priority sector advance** under respective categories viz., **Agriculture, Micro, Small and Medium Enterprises, Social Infrastructure and Others**

3.3.2 Priority Sector Lending Certificates (PSLCs)

Priority Sector Lending Certificates (PSLCs) are a **mechanism to enable banks to achieve the priority sector lending target and sub-targets** by purchase of these instruments in the event of shortfall. This also incentivizes surplus banks as it allows them to sell their excess achievement over targets thereby enhancing lending to the categories under priority sector. Under the PSLC mechanism, the **seller sells fulfilment of priority sector obligation** and the **buyer buys the obligation** with **no transfer of risk or loan assets.** The rate of interest on bank loans will be as per directives issued by the **Department of Banking Regulation of RBI**, from time to time. **Priority sector guidelines do not lay down any preferential rate of interest** for priority sector loans.

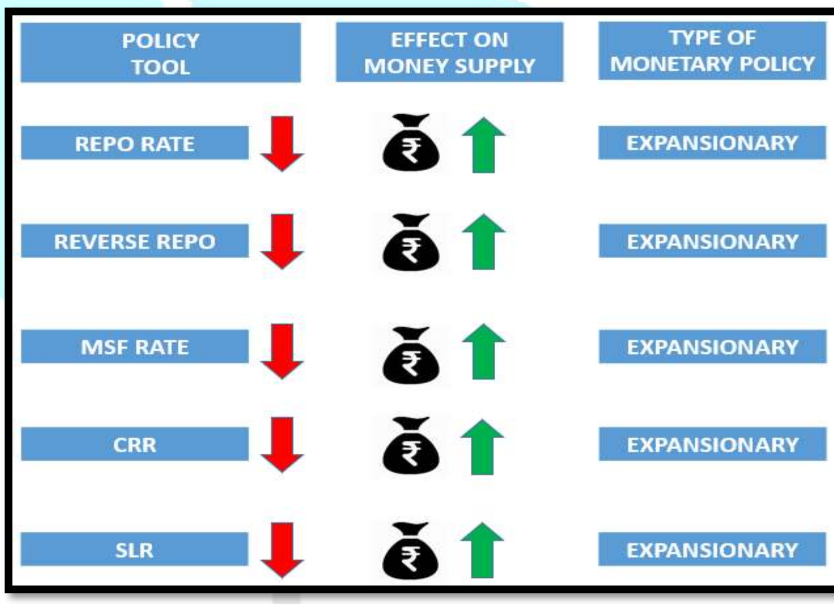
4 Part IV: Types of Monetary Policy

Monetary policy can be broadly divided into two types – expansionary and contractionary. Expansionary monetary policy, as the name suggests, helps in increasing the supply of money in the economy, whereas contractionary monetary policy help in reducing the supply of money. As discussed in the preceding parts, central banks usually reduce supply of money in a bid to control inflation, whereas they increase the supply of money to boost demand thereby the GDP growth rate. In the forthcoming sections we will learn the interrelationship between these two types of monetary policies and the various monetary policy instruments that we read in the preceding parts.

4.1 Expansionary Monetary Policy

Expansionary monetary policy or **easy money** results if the **RBI increases the money supply** and **lowers interest rates** and is the recommended policy to **counter a slowdown in GDP growth.** Expansionary moves include:

- **The decreases in the repo rate/Bank rate/MSF rate:** As these rate falls, corporations and consumers can borrow more cheaply.
- **Purchases of government securities:** As RBI purchases government securities from financial institutions, it increases money supply in the market.
- **Reductions in the reserve ratio (CRR/SLR):** The central bank seeks to encourage increased lending by banks by decreasing the reserve ratio, which is essentially the amount of capital a commercial bank needs to hold onto when making loans.



Expanding the money supply results in **lower interest rates** and borrowing costs, with the goal to **boost consumption and investment.**

This type of policy is also called as Easy / Loose / Accommodative / Dovish Monetary Policy.

4.2 Contractionary Monetary Policy

Contractionary monetary policy or **tight money** occurs if the **RBI decreases the money supply** and **raises interest rates** and is the recommended policy to **reduce inflation.** Contractionary moves include:

- **The increases in the repo rate/Bank rate/MSF rate:** As these rate rises, corporations and consumers borrowings become more expensive.
- **Sales of government securities:** As RBI sells government securities to financial institutions, it decreases money supply in the market.
- **Increase in the reserve ratio (CRR/SLR):** The central bank seeks to discourage increased lending by banks by increasing the reserve ratio.

Contracting the money supply results in higher interest rates and borrowing costs, with the goal to control inflation.

Calibrated tightening is a version of contractionary monetary policy – it means interest rates can only move upward.

TYPE OF MONETARY POLICY	EFFECT ON MONEY SUPPLY	POLICY TOOL
CONTRACTIONARY	↓	↑ REPO RATE
CONTRACTIONARY	↓	↑ REVERSE REPO
CONTRACTIONARY	↓	↑ MSF RATE
CONTRACTIONARY	↓	↑ CRR
CONTRACTIONARY	↓	↑ SLR

This type of policy is also called as **Tight / Hawkish / Restrictive Monetary Policy**.

Note: Neutral stance means interest rates may move either way—upward or downward.

5 Part V: Financial Institutions in India

5.1 Non-Banking Financial Companies

Bank is a financial institution engaged primarily in **mobilizing deposits** and **forwarding loans**. The deposits and loans are highly differentiated in nature. **Banks** are **regulated by the Central bank** of the country—in case of India, the **RBI**. Another category of financial institution—the **Non-Banking Financial Companies** (NBFC)—is almost similar in its functions but main difference (though, highly simplified) being that it **does not allow its depositors to withdraw money** from their accounts.

NBFCs are fast emerging as an important segment of Indian financial system. It is a **heterogeneous** group of institutions (other than commercial and co-operative banks) performing **financial intermediation** in a variety of ways, like **accepting deposits, making loans and advances, leasing, hire purchase**, etc. They cannot have certain activities as their principal business—**agricultural, industrial and sale-purchase or construction of immovable property.**

They **raise funds** from the public, directly or indirectly, and **lend them to ultimate spenders**. They advance loans to the various **wholesale and retail traders, small-scale industries and self-employed persons**. Thus, they have **broadened and diversified** the range of products and services offered by a **financial sector**. Gradually, they are being recognised as **complementary to the banking sector due to their—**

- customer-oriented services;
- simplified procedures;
- attractive rates of return on deposits; and
- flexibility and timeliness in meeting the credit needs of specified sectors.

RBI, the regulator of the NBFCs, has given a very wide definition of such companies (a kind of 'umbrella' definition)— "a **financial institution** formed as a **company** involved in **receiving deposits or lending** in any manner."

5.2 Regional Rural Banks

The Regional Rural Banks (RRBs) were first set up on the recommendations of the **Narasimhan Committee** on **2 October, 1975 (only 5 in numbers)** with the aim to take **banking services to the doorsteps of the rural masses** specially in the remote areas with no access to banking services with twin duties to fulfil

1. to provide **credit to the weaker sections** of the society at **concessional rate of interest** who previously depended on private money lending, and
2. to **mobilise rural savings** and **channelise** them for **supporting productive activities** in the rural areas.

The **Government of India**, the **concerned state government** and the **sponsoring nationalised bank** contribute the share capital of the RRBs in the proportion of **50 per cent, 15 per cent and 35 per cent**, respectively. The **area of operation** of the RRB is limited to **notified few districts in a state.**

Following the suggestions of the **Kelkar Committee**, the **government stopped opening new RRBs in 1987**—by that time their total number stood at 196. Due to excessive leanings towards **social banking** and catering to the highly **economically weaker sections**, these banks started incurring **huge losses by early 1980s.** For restructuring and strengthening of the banks, the governments set up two committees—the **Bhandari Committee (1994–95)** and the **Basu Committee (1995–96).** Out of the total, 171 were running in losses in 1998–99 when the government took some serious decisions:

(i) The **obligation of concessional loans abolished** and the RRBs started charging commercial interest rates on its lendings.

(ii) The target clientele (rural masses, weaker sections) was set free now to **lend to anybody**.

After the above-given policy changes, the RRBs started coming out of the red/losses. The **Committee on the Financial System – CFS** – has recommended to get them merged with their managing nationalised or public sector banks and finally make them part of the would-be three-tier banking structure of India. By April 2020, as per the RBI, there were 53 RRBs operating in the country (over 13 of them were under the process of amalgamation with their parent PSBs)—in coming times to be fully replaced by the Small Banks. E.g., Allahabad U.P Gramin Bank etc.

5.3 Cooperative Banks

Banks in India can be broadly classified under **two heads—commercial** banks and **co-operative** banks. While **commercial banks** (nationalised banks, State Bank group, private sector banks, foreign banks and regional rural banks) account for an **overwhelming share of the banking business**, **co-operative banks** also play an important role. Initially set up to **supplant indigenous sources of rural credit**, particularly money lenders, today they mostly serve the needs of **agriculture and allied activities, rural-based industries** and to a lesser extent, **trade and industry in urban centres**. Co-operative banks have a **three-tier structure—**

1. **Primary Credit Societies-PCSs (agriculture or urban),**
2. **District Central Co-Operative Banks-DCCBs, and**
3. **State Co-Operative Banks-SCBc (at the apex level).**

Urban Co-operative Banks (UCBs): Primary credit societies (PCSs) in urban areas that meet certain specified criteria can apply to RBI for a banking license to operate as UCBs. They are registered and governed under the **co-operative societies acts of the respective states** and are covered by the **Banking Regulation Act, 1949**—thus are under **dual regulatory control**. The **managerial aspect**s of these banks—**registration, management, administration, recruitment, amalgamation, liquidation**, etc. are controlled by the **state governments**, while the matters related to **banking** are regulated by **RBI**.

Traditionally, the area of operation of the UCBs is confined to **metropolitan, urban or semi-urban centres** and caters to the needs of small borrowers including **MSMEs, retail traders, small entrepreneurs,**

professionals and the salaried class. However, there is **no formal restriction** as such and today UCBs can conduct business in the **entire district** in which they are registered, **including rural areas**.

As they are **covered by the RBI Act, 1934 (2nd Schedule)** they have certain **rights and obligations**—rights of **obtaining refinance and loans** from the RBI and obligations such as **maintenance of cash reserves, submission of returns to the RBI etc.**

DCCBs & SCBs: As their names suggest, they **operate at the district and state levels**. **One district** can have no more than **one DCCB** with a number of DCCBs reporting to the SCB. They were under **supervision of the RBI—later on this function was delegated to the NABARD. E.g., Saraswat bank, COSMOS bank etc.**

5.4 Small and Payment Banks

By mid-July 2014, the RBI issued the draft guidelines for setting up small banks and payment banks. The guidelines said that both are **'niche' or 'differentiated' banks** with the common objective of furthering **financial inclusion**. It is in pursuance of the announcement made in the Union Budget 2014–15. The details regarding the provisions to set up such banks and their operational criteria are as given below: The **guidelines to set up both the banks are same**—

- The **minimum capital requirement** would be **₹100 crore**.
- Promoter should hold a minimum of **40% of the paid-up voting equity capital for five years**. If the initial promoter shareholding is above 40%, it should be **brought down to 40% within a period of five years, 30% within 10 years, and 15% in 15 years.**
- **Foreign shareholding** in these banks will be as per **current FDI policy**.
- Voting rights to be line with the existing guideline for private banks.
- Entities **other than promoters will not be permitted** to have **shareholding in excess of 10 per cent.**
- The bank should comply with the **corporate governance guidelines**, including **'fit and proper' criteria for Directors as issued by RBI.**
- Operations of the bank should be **fully networked and technology driven** from the beginning.

5.4.1 Small Finance Bank

The purpose of the small banks will be to provide a whole suite of basic banking products such as deposits and supply of credit, but in a **limited area of operation**. The objective of the Small Banks to **increase financial inclusion** by provision of savings vehicles to **under-served and unserved sections** of the population, supply of **credit to small farmers, micro and small industries,** and other **unorganised sector entities** through **high technology low-cost operations**. Other features of the small banks are as follows:

1. **Resident individuals with 10 years of experience in banking and finance**, companies and Societies will be eligible as promoters to set up small banks. **NFBCs, microfinance institutions (MFIs), and Local Area Banks (LABs)** can convert their operations into those of a small bank. Local focus and ability to serve smaller customers will be a key criterion in licensing such banks.
2. The **area of operations** would normally be restricted to **contiguous districts in a homogenous cluster of states or union territories** so that the Small Bank has a 'local feel' and culture. However, if necessary, it would be allowed to expand its area of operations beyond contiguous districts in one or more states with reasonable geographical proximity.
3. The bank shall primarily undertake basic banking activities of **accepting deposits** and **lending to small farmers, small businesses, micro and small industries, and unorganised sector entities**. It **cannot set up subsidiaries to undertake non-banking financial services activities**.
4. The promoters' **other financial and non-financial services activities**, if any, should be **distinctly ring-fenced** and not co-mingled with banking business.
5. A robust risk management framework is required and the banks would be **subject to all prudential norms and RBI regulations** that apply to existing commercial banks, including **maintenance of CRR and SLR.**

6. The **maximum loan size and investment limit** exposure to a single and group would be restricted to **10 per cent** and **15 per cent** of its capital funds, respectively.
7. **Loans and advances of up to ₹25 lakhs**, primarily to micro enterprises, should constitute at least **50 per cent of the loan portfolio.**
8. For the **first three years, 25 per cent of branches** should be in **unbanked rural areas**. E.g., A U Small Finance Bank etc.

5.4.2 Payments Bank

The objective of payments banks is to **increase financial inclusion** by providing **small savings accounts, payment/remittance services** to migrant labour, low-income households, small businesses, other unorganised sector entities and other users by enabling **high volume-low value transactions** in deposits and payments/remittance services in a **secured technology-driven environment.**

- Those who can promote a payments bank can be a **non-bank Prepaid Payment Instruments (PPIs), NBFCs, corporate's, mobile telephone companies, super market chains and public sector entities.** Even **banks** can take equity in Payments Banks.
- Payments Banks can **accept demand deposits (only current account and savings accounts).** They would initially be restricted to holding a **maximum balance of ₹200,000 per customer**. Based on performance, the RBI could enhance this limit.
- The banks can offer **payments and remittance** services, issuance of **prepaid payment instruments**, **internet banking**, functioning as **business correspondent** for other banks.
- Payments Banks **cannot set up subsidiaries to undertake NBFC business.**
- As in the case of small banks, **other financial and non-financial services activities of the promoters should be ring-fenced.**
- The Payments Banks would be **required to use the word 'Payments' in its name** to differentiate it from other banks.
- **No credit lending is allowed** for Payments Banks.
- The **float funds** can be parked **only in less than one year G-Secs**. E.g., India Post Payment Bank, Airtel Payment Bank etc.

5.5 MUDRA Bank

As per the Government of India, **large industries** provide **employment to only 1.25 crore people** in the country while the **micro units** employ around **12 crore people**. There is a need to **focus** on these **5.75 crore self-employed people (owners of the micro units)** who use **funds of ₹11 lakh crore**, with an average **per unit debt of merely ₹17,000**. **Capital is the key to small entrepreneurs.** These entrepreneurs depend heavily on the local money lenders for their fund requirements.

Looking at the importance of these enterprises, the **Government of India launched (April 2015) the Micro Units Development and Refinance Agency Bank (MUDRA Bank)** with the aim of funding these unfunded non-corporate enterprises. This was launched as the **PMMY (Prime Minister Mudra Yojana).** Important features of the MUDRA Bank are as given below:

- Under this banking model, the **micro units** can avail up to **₹10 lakh loan through refinance route** (through the **Public and private sector banks, NBFCs, MFIs, RRBs, District Banks, etc).**
- The products designed under it are categorized into three buckets of finance named **Shishu (loan up to ₹50,000), Kishor (₹50,000 to ₹5 lakh) and Tarun (₹5 lakh to ₹10 lakh).**
- Though the scheme covers the traders of fruits and vegetables, in general, **it does not refinance the agriculture sector.**
- There is **no fixed interest rate in this scheme**. **Interest rates** on the loans are supposed to **vary** according the **risk involved** in the enterprises seeking loans. There is **no general subsidy** offered on interest rates except if the loan is linked to some other government scheme.