09.11.20

Credit Creation

Credit creation is a process by which commercial banks increased the credit or money supply in the economy. The total money supply under the credit creation process can be calculated by multiplying the cost of currency in circulation with the money multiplier (m) It is the reciprocal of the total Reserve Ratio commercial bank need to maintain e.g. if Reserve Ratio is 20% then m should be equal to 5, With a 100 Rps. currency total credit creation equals 500 Rps i.e. (100X5).

Credit Creation

Total Credit Creation = 500₹

	Bank	Loan
1	100	80
2	80	64
3	64	51
4	51	⋮
		Σ 400

Indian Banking System

Bank

A financial institution that is set up & licensed to provide specific financial services.

Types of Banks

1. Central Bank e.g RBI in India.
2. Commercial Banks
3. Scheduled Banks
4. Public Sector Banks (PSBs)
5. Private Banks
6. Foreign Banks
7. Co operative Banks
8. Regional Rural Banks
9. Refinanced Banks (NABARD)
10. Small Finance Banks
11. Payment Banks & others.

Functions of RBI

(From RBI webs)

Central Bank & its functions :-

(RBI)

PSB = Govt (≥51% Equity)

SCB = Govt + Other

Private Banks = ≥ 51% Non-Govt. Entity
Axis, HDFC, ICICI, KOTAK, YES, Industrial

Foreign = ≥ 51% Foreign Entity
HSBC

NBFC

NBFCs are the companies that provide financial services of different types but they can't accept Demand Deposits & issue a cheque book drawn on it. (NBFCs can take only term Deposits)

Moreover, Deposits with NBFCs are not covered by DICGC (Deposit Insurance & Credit Gurantee Corporation)

NBFCs in India play an important role particularly in unbanked areas & they are popularly doing following businesses —

I) Consumer Finance (Retail Loans)
II) Asset leasing
III) Insurance Business
IV) Chit Funds

v) Housing Finance & others.

One major problem with NBFCs in India is the problem of multiple regulation. e.g. Investment companies & mutual funds are regulated by SEBI, Chit fund companies by the State Govt. under the chit Fund Act 1982, Insurance companies by IRDA, & so on. Hence, there is an urgent requirement for a unified financial regulator for the NBFCs.

Chit Funds in India

Chit fund companies provide finance to the members on the cooperative basis without documentation, hence it is a convenient & popular method. But in several cases, State govts have failed to regulate the chit funds & after some big scams it is realised that chit funds should be regulated in some better way.

e.g. Central Regulator like SEBI can do better.

Ponzi Schemes

Ponzi schemes are the ~~frads~~ fraudulent schemes which offer huge income in short span of time which is based on the introduction of new members by the existing members without a product or a service. Since Ponzi schemes are illegal, hence they should not be regulated but banned.

Evolution of Banking in India

Modern Banking started with the establishment of Bank of Hindustan in around 1770 by the Europeans. Thereafter, no. of Indian & foreign banks came into existence & the Awadh Commercial Bank, established in 1881 was the 1st Indian Bank with limited liability. Punjab National Bank, established in 1894 is the oldest & existing to date.

At the beginning of 20th century, there were more than 1000 Banks in India but most of these failed after the 1st World War started because of having European Ownership

R.B.I came into existence in 1934 as an autonomous body but after its nationalisation in 1948 it became the Central Regulating Bank from Jan 1st, 1949

- State Bank of India Act was passed in 1955 to take over the business of Imperial Bank of India & later all the large private banks were nationalised in 1969 & later in 1980.

- After nationalisation more than 90% of Indian banking system came under Govt. umbrella. Public Trust on banking sector improved phenomenally, deposits increased manifold & govt. bank started penetrating into small towns & rural areas where private banks were not willing to go.

But After Nationalisation the following problems ~~as~~ emerge in the banking sector —

1. Poor Customer Service

2. Low Profitability

3. Low Efficiency

4. Lack of Competition

5. Corruption

6. Political Interference

7. Too much Regulation

8. Limited Banking Products & Services.

9. Concessional Lending

10. Non-Performing Assets.

Banking Reforms began in 1990s after the release of Narasimha Committee's Report in 1991 & 1998. Some important recommendations are given below →

1. Reduce SLR & CRR (Statutory Liquidity Ratio / Cash Reserve Ratio)

2. Improve Asset Classification Norms.

3. Allow private & foreign banks.

4. Greater transparency in Accounting

5. Give Autonomy to Public Sector Banks.

6. Improve capital Adequacy Ratio
7. Consolidate bank into 3 tiers structure.
8. Upgrade Technology.
9. Reduce NPAs
10. Training Staff.
11. Allow Universal Banking.
12. Strengthen the Recovery System
    - → Debt Recovery Tribunal
    - → Asset Reconstruction companies (ARCs)
    - → SARFAESI Act 2002
    - → IBC, 2016

After these reforms of 1990s & later we have seen both public sector banks & private banks to grow phenomenally & today India has presence of banks even in remote & rural areas although with the issues of NPAs.