

Money and Banking
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Lecture - 30

The thing I was trying to tell you yesterday is that RBI performs a number of functions, which are not traditional functions of a central bank. I started with the supervisory functions, some of which may be traditional. In the sense, other central banks also do may not do, but they are quite a few, which are other central banks do not. We started with something was supervisory functions, which where I explain that even to form a bank found, I mean create a bank commercial bank or a non bank also, non bank too, you need permission or a license to that.

Like in case of founding a company, we have to go to the securities and exchange board of India etcetera, etcetera a company laws. We have to file an application they have to be approved and many things, rules and regulations. There has to be restriction. They check our paid of capital, all such things. You frowned because hey you frowned because you think creating a company requires something more. You found something more, if you have more points to add, please do that raise your hand and add it. Now, in case of a bank, which is quite tricky because bank is going to start getting you know advertise and ask people to deposit money. So, right away, the responsibility increases a lot.

You are accepting people's money all the time and then you start giving out loans from that money, that money. So, licensing is not enough. Like incase of company, company got a license. So, opened stuff unless there is a major problem; you heard that major problem going on with d l f for instance big company. It is partly political, partly true. Now, the problem is unless to get through that level, where there is a newspaper exposure or something some investigation. People do not care much about a company.

Company can run on its own produces, does not produce whatever. So, continuous monitoring is not required and cannot be done. There are millions and millions of companies in a country, but there are the millions of millions of banks. A bank may have many branches together. They are millions. So, there is one bank and then another bank, then another bank. So, in case of a bank, the regulatory aspect becomes much more

important because they are dealing with people's money. If you say, a poor person's for instance who has one account in his life he could open. I have seen that in state bank who cannot even write and they give the thumb impression on cheques and often ask him them to put a finger. You know the thumb impression.

What am trying to say if a bank fails, we said a company failing, a small company, there is an enormous difference. So, supervisory functions are very important monitoring them. So, who does it? In our case, it is RBI. At least in books, they say that RBI has the responsibility of doing it, whether a bank is following or maintaining the CRR, whether a bank does business honestly or not the way they should. They commit periodic review just for financial statements everything customer services. If a bank cheats a depositor or somebody else, they are conformal complaints that can be lodged with the RBI.

Then, when it comes to banking detailed activities like what would be the personal structure, the manpower structure, a CEO, and then what, board of directors and a manager of each branch and then what else in the branch? What else at the head office? The structure manpower planning, this is often RBI comes themselves training banking activities. You get a job tomorrow straight out of IIT Kanpur. How would you know what bank want to do you to do? They have to be given training. A good bank itself has a school, a class kind of a thing where they send you off.

It is a stuff training college they call sometimes. IAS officers have, IAS officers has stuff field very important stuff training college. They go for rigorous training for a year or 2. In case of banks also, they may send you for 6 months, not 2 years. That is important. Now, suppose banks do not have people to train; the RBI will have to help them. So, the supervisory functions are very important. I will send you my notes to read up and Bholay's book is there and other books are there. Then, a bank wants to expand, wants to open more branches.

Is it really, I mean financially viable to open a branch because open a branch like open a branch of IIT Kanpur means what? Huge amount of fixed costs, overhead costs, and buildings you know. The area has to be bought, the geographical area or rented from somebody or leased. Then, the building will come up fixed cost. Then, all that amenities you know water supply, electricity everything. Then, the people have to be hired. They will run it. So, financial viability of opening a branch is very important. So, RBI does

that in spite that also. Now, RBI head ache is enormous. Of course, you can say that RBI is the highest monetary authority. RBI is advising the government, helping the government.

RBI is setting the monetary policy. You know prescribing monetary policy. RBI is also supervising the entire banking sector. From 1995, they have started supervising the non banks bits by bits, not the non banking sector. Non banking sector is mammoth, huge. Non banking sector, I think money terms it may not be bigger than the banking sector. But, in terms of share types and units and they are just not one type called commercial bank or another type called cooperative bank. There were so many kinds of non banks; so many types. So, that supervision is also becoming important because there business is expanding.

They are also often dealing with public money. So, there is whole lot of, then selection procedure of the bosses of a bank. Who will be the chairman of SBI is the very important task because once you select the right person, the entire unit functions probably. If you select the wrong person, the entire unit does malfunctioning. So, it is very important to select. So, RBI always gets involved with that. These are the supervisory functions it acts, which has been talked about yesterday.

Then and then comes the additional head ache that government of India has given RBI even if you call this is these are traditional. They should be with the central bank even if you say may be some countries do not use this kind of a detailed supervisory functions. Central banks do not have the some other agencies; government agencies may be doing them. But, in case of promotional functions, the second set that I talked about is entirely a head ache given to the RBI towards central bank by the government of India.

The entire promotional thing is with the perspective, with a view to development, now how many kinds of broadly development issues can be there? They are agricultural development, overall rural development, where agricultural and non agriculture sectors will come. You know, we have a huge problem of traditional industries, handicraft etcetera, lots of skilled people where there.

So, when the machine products came after industrial revolution, they got wiped out. Now, it is only the kind of you know what you call that it is like an artifact or like a luxury item, you acquire things like people procure painting they have. Lots of people

have lots of money. They procure a Picasso painting you know and boast about it paid millions of dollars just one painting.

So, our traditional skill industries, which are not daily, used or not used daily except a few like jaadhoos and some handmade fans and few traditional items, I see at households all are machine products company products these days. now what will those people do. So, that is the handicraft industries, old traditional industries also a huge problem in rural development. Then, of course, have infrastructure related issues in rural development. You come to urban development. Again, a set of whole range of industries are small scale, medium, large and heavy industries infrastructure that you know.

So, there are many things that are important. There you go to the export import sector. What I am trying to tell you is promotional activities in a country, which has been poor has been backward is enormous. Now, normal profit making organizations would not go and lend their often because they do not have any money to make. They know if they lend them even it is a small amount to a farmer 20,000 rupees, it will not come back probably. The farmer as soon as he gets the 20,000 eats up 5000 before putting the money in proper use. So, the capital is eaten up already by the end of the month. This is the state of affairs in India.

Then, you have this money to do the agriculture and then agriculture is always an uncertain business like investing a stock market whether it rained or not. If it does rain, when the rain came, comes. If it comes too late, it is useless. Then, it rained so heavily as it happened in some parts of India like Rajasthan, another places, that it washed away everything in Assam, north east it has happened. So, it is like investing in a stock market. You do not know whether you will make money.

Now, therefore, promotional activities require what we call, I will explain that in the next topic called social banking. Social banking is not private banking or profit making banking. Social banking is during charity work like NGOs do. Therefore, government has to step in because normally commercial banks would say; we are a profit making organization. Now, you are asking us to denote so much. We are not interested.

Then, RBI steps in, gives money. Use this money to do that. Then, they set also various kinds of credit policies, if you read Bholay and other books, older books. You will see from time to time, we had various credit policies. Strict instructions came from RBI to

these commercial banks. How much will be your priority lending? Out of priority lending, how much should go to the rural areas? How much will go as priority, priority lending to the urban areas? Then, you have the optional lending, which you would like to make where you think you can make money.

So, promotional activities and also RBI was given the promotional activities, which is called setting up of non banks, just not commercial banks. It did setup a range of commercial banks called region rural banks. I am coming to that in the next topic. Entire set of commercial banks were set up by RBI with the help of some big public sector banks like state bank of India etcetera called regional rural banks.

They were created. That did not exist. They are only 30, 40 years old regional rural banks. Then, they were not there before independence or even after independence for many years. For twenty years, they were not there. Then, they suddenly came, they were set up. But, also RBI has the headache in terms of promotional activities, not only giving money to commercial banks to do priority lending, they also have set up periodically big non banks IDBI, industrially construction bank of India, export import bank, Nabard, you name them the big guys in non banking sector.

They were all set up. It is a huge task. Tomorrow, I ask you to set up another IIT, can you believe how much work it will go into it enormous amount of work? IIT is not, was not created in 1 day, in 1 month, in 1 decade. It takes years to create these IITs. So, when you set up again another said engineering college, it requires an enormous amount, just not money expertise, planning, all sorts of things, the associations, collaborations, all sorts of things are required.

Even IITs were created with collaborations. Bombay had a German collaboration. IIT Kanpur had an American collaboration. Kharagpur also had an American Collaboration. I think they were all created. Kharagpur was independent, was the first, oldest. Bombay had a German collaboration. Kanpur had a US. Bombay did not have the German collaboration USSR. Sure, I was under a completely wrong impression. Madras was German collaboration.

So, anyway there is a whole lot of promotional activity, which RBI had the head ache to develop the modeling sector just not banks, non banks. Now, it is worrying about regulating the non banks for setting up non banks was a big business big task, either in

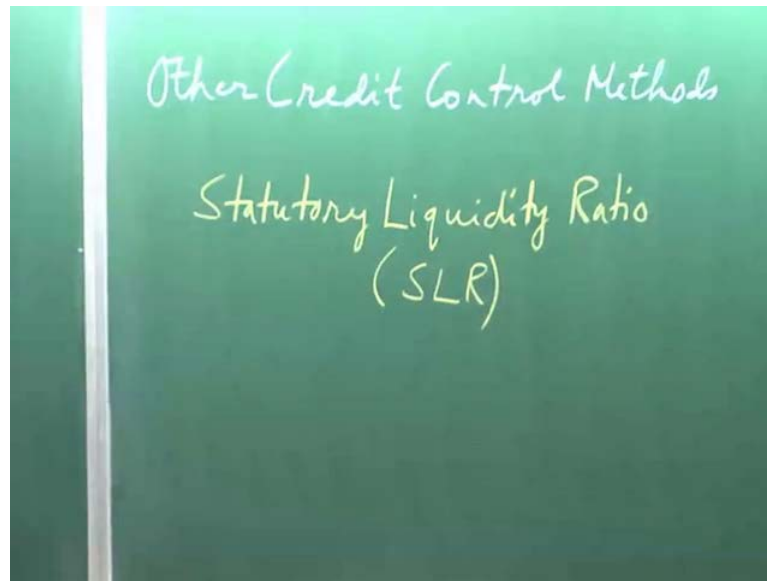
the 50s, 60s, and 70s. So, you had these non bank organizations that have come into existence. Then, they have various kinds of services that they have to provide technical services, consultancy services, RBI advisory, advisory services in some sense. Then, training manpower, I already said, I mean you set up an IIT, but it has to be run by proper people.

So, you have to select the proper people. If the proper people cannot be obtained, you train them to become proper people. The better you do that, the better the institution is. Then, you have the continuously industrial finance also money for in big industries going by the IDBI etcetera. Now, they have become independent. Are you sure you funding from RBI have become 0 non bank funding has become nearly 0? RBI does not require funding them anymore. They are doing. So, well touch wood. Hopefully, they would remain like that. Nabard, exim bank, IDBI require no funding for RBI. They are running autonomously now.

But, once upon a time, they required like refinancing a set of loan was given. Then, the loan was returned. Again, the new loan was sanctioned for the next 10 years in stuff. They are 4 national housing banks. Another great example of non bank activity of RBI is national housing bank that was set up. So, the promotional activities for a growing economy for a economy coming out of third world, third country economy to second world economy requires a whole lot of effort. Our central bank plays those functions, has those functions.

So, they have been doing an enormous amount of nontraditional duties performing enormous amount of nontraditional duties, which normally are in the third, in the first world. The central bank does not do look up trend, bank of England; they do not do that not a lot. Now, I come to the part, which is very important from monetary policy point of view. It is the RBI unlike other central banks has developed some credit control instruments or mechanisms, which are not at all available in other countries. So, let me talk about that. So, the third set of functions is nontraditional functions.

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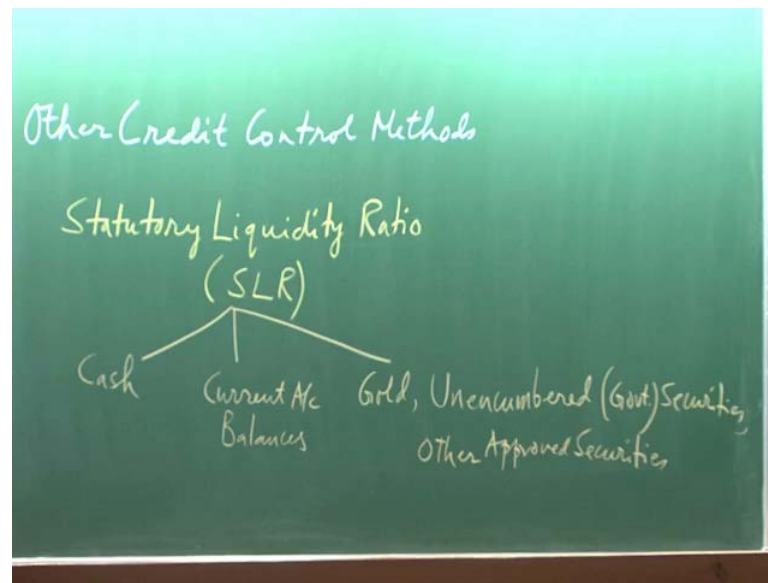


I am going to talk about is the other credit control methods, other credit control methods. The first one that I am going to talk about is the famous SLR. SLR is our creation. SLR is RBI's creation, government of India's creation. It is not foreign country. First, I am going to talk about statutory liquidity ratio, SLR the famous SLR. Now, SLR is different from CRR.

Some of the things are similar. They give a fortnight to show SLR, we have to show SLR, this is the difference. You do not have to keep SLR with RBI. In CRR, you have to keep the cash fortnight to show that is maintained on a weekly basis. Let me explain first what SLR is. Then, I would tell you how SLR is used therefore, as a credit control instrument, which is monetary policy instrument.

Credit control means what? Through SLR, like CRR, it can control indirectly how much credit banks created. CRR, amount of credit banks and will go down immediately. Immediately, banks would have more cash. They will create more credit. It is like using a one liver to control that SLR is the credit control method very unconventional. Now, what is SLR? There are three items in an SLR, which are very important.

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One is similar to CRR, one is similar to CRR, one is similar to CRR, which is cash. But it is just not cash. Then, it has very interesting current account balances. Now, what is current account balances? It says that a bank and this cash is in addition to CRR, the CRR cash is different. Now, you are talking about another amount of cash from the deposits and t l, which you have to hold the percentage changes the distribution of this within the SLR change. That is why 25 percent someday, sometimes it may increase it to 30 percent or whatever the percentage distribution within the SLR.

In the basket, how much is the apple? How much is the orange? How much are the bananas? It may change. That time, it may be 25, 25, 50 and other thing, there are 3 items, and sometimes it may be 30, 30, 60 and 40 whatever. This is the additional cash you are talking about. Then, you have current account balances, which are very interesting with the SBI, nobody else with SBI, its subsidiaries, other nationalized banks and RBI. SBI, its subsidiaries current account balances.

So, you have to open account and keep cash there with SBI your cash there like I open an account and I have my cash with SBI. I have some money with standard chartered. I have some money with bank of Baroda. Now, here we are saying you have to open account with SBI, its subsidiaries. It may not be all, but some of them at least other nationalized banks which are called public sector banks.

You know other banks; they are 20 of them other banks, 19 or 20 of them you know in

India. Then, we have 2 on campus public sector banks, SBI and what is the other bank? It is union bank. I forget. RBI banks can have a current account with the central bank. That is was centralize clearing etcetera I think current account very important, current account. Third is a group of things. At least, my notes are saying gold unencumbered government securities, unencumbered government securities and other approved securities.

Gold you understand gold you understand of course. Unencumbered securities government securities; government securities are what two types. It can be short term money market securities treasurables. It can be government dated securities long term. Unencumbered means the securities that you have not used up in borrowing money from RBI; they are fresh securities. Securities can be used by banks in repo transactions. For instance, you learn repo to borrow from another bank.

Unencumbered basically means securities, which you have not used up, which are untouched lying in a vault. That amount, you have to show, not the securities that are temporary lying with another bank. So, you have borrowed money, the repo market or something or from the RBI itself. They have borrowing programs for commercial banks against securities where they use the rediscount rate. Everybody Pruthvi, Akansha, are you following or sleeping? Is that boring?

So, unencumbered securities, government securities, and then you have other approved securities. Other approved or approvals given by RBI, which are rather approved securities and typically, they are semi government organizations or government department securities. Suppose Air India issues the bond. State electricity board issuing bonds, railway bonds, infrastructure bonds, various kinds of other approved securities can be there. It can also improve some commercial papers of some companies.

If they are good companies, commercial papers can also be there. So, do you have now other approved securities 3 together forms sub item? Of course, current account balances with various SBI's subsidiaries of nationalized banks and RBI and of course, cash all together is called is are called SLR. Thus, SLR number roughly in India is around 25 percent. It goes down the little bit by 24 and then goes to up 25. Now, look what, therefore RBI has done, which has been in favor of Indian economy. That is why Indian monetary system did not crash.

You are saying 7, 8 percent CRR cash deposit, net time and demand liabilities. Net time and demand liabilities, you calculate. That means, you subtract if you have interbank deposits. CRR is meant. Now, then demand and target is at 25 percent, the 20 plus 7, 32 percent gone. 25 percent will be partly cash whatever the ratio is 2 is to 3 is to whatever, partly cash 2 is to 3 is to 5 may be, I do not know. Partly cash, partly current account, that percentage number is partly current account balances with the other banks etcetera RBI and then partly is securities business and gold.

So, it is forcing banks to invest in securities because in SLR, these components are must. Do you understand what I am saying? Holding cash is not enough. So, it creates a captive market for government securities. You are forced to invest in government securities, other securities because you have to meet the SLR requirement. RBI people will come and count in head office branch. Every bank has a head office.

So, it will just have to go and check with head office with the numbers is with computerized etcetera. Now, it is wonderful. They have all the numbers, all the time available central at a central place. Do you understand what I am saying? So, it creates a captive market for government investments. So, government is easily getting money this. They have also done with nonbanks. I remember once upon a time, I was reading of LIC investment policies.

When LIC collects your and my premium by selling insurance policies, what do they do with the money? They created an enormous amount of captive market too. So, LIC is a rich source of money for government, borrowing money. You are borrowing money. This is not tax money. This is called borrowed money. The borrowing of the government and which is dangerous too. Borrowing means death. Tax is no death. Tax is collected by government.

Borrowing means you have to return the money. It is tricky too. So, I am not going to get into public finance, but do not think will you borrow with interest internal death, public death? So, that is also quite notorious. So, these three things they use. Now, you imagine 25 plus 7, 32 percent gone. Then, bank has to keep cash for the withdrawal. This is my account, your account. Suppose, this is savings account; I can withdraw cash.

So, you will have to decide how much to keep aside for withdrawal and then fixed deposit. They know the term of the fixed deposit 1 year, 2 years, and 3 years whatever.

Very short terms fixed deposits are there. Very long term fixed terms are also there. It varies from above 1 year to 10 years or something I think. If you go to the state bank, there is a board behind the cash counter, where the passbooks are updated.

Check that out yourself and the interest rates are mentioned. You can check it out yourself. So, what effectively you have done? You have given very little freedom to the banks to create credit. Highly conservative country and conservative financial system has helped India lot in these difficulties. You go to a foreign country SLR bank monetary policy instrument CRR ineffective, 1 percent, 0.1 be CRR. Now, when the system wanted money, it has misused, it is malfunctioning. It is not ready to help. So, where did they get the help?

Did you realize what happened with the US economy and what is happening with the Europe, European economy government; that government death when it increases too much, they do not know where to go. In case of Europe, they are trying to create a European central bank, which is continuously funded by 1 or 2 rich countries like Germany and France to bail out Greece, Spain, and Portugal. Who knows who members all in trouble are? In US, they are now inviting China to buy. China is the biggest investor in US, US Treasury bill to fund their deposit. China now helps out US. US with a rich economy, with worlds successiveness planning, unregulated financial system has just nearly destroyed the country.

Now, they show on the TV, those miles after miles, somebody driving a reporter showing all industry shut down, which reminds in West Bengal in the 70s, I used to go, travel by local trains. Sometimes, I have some work industry after industrial shut down. They show a similar thing with US. I cannot believe is that US they are talking about? A British journalist, a BBC journalist made a video; I mean a documentary recently they showed. So, this is what they have done.

So, effectively, they are saying banks, you are very little way with expertise. You use the deposits highly regulated, very strict regulations. SLR is 25 percent. Can you believe? 25 percent, 25 percent of n d t l is a huge number and the CRR 7 percent say 6.5. How many 1000 crores that it system has they tell you on t v extra liquidity? So, this is what they have. Now, what they do that SLR has three things therefore. Remember, of course, it is a credit control instrument like a monetary policy instrument like CRR or bank rate.

But, it is also an instrument, which ensures investment in government securities, which I used the term captive market for government securities. It has created a captive market for government securities and semi government organizations securities. If nobody there to buy banks will be forced to buy because they have an SLR to meet every week with a fortnight's cap. Finally, it of course, ensures solvency of banks, which I am trying to say that conservative policies like this or instruments like this ensures solvency.

Banks will always have cash and not get into a bank holiday like a situation. Bank holiday means bank will shut down. It will never happen if they misplace, mis plan credit. It is too much of n p a, non performing assets. There will always be a backup in our commercial banks not to go, not to become bankrupt. It will, they will always be a solvency. Banks will not have any problem. Now, up to 1985, I am not so sure here. I have a problem here.

I bring that question even though it is maintained on a weekly or it is maintained on a fortnightly basis. This SLR may be slightly different. Can anybody ask, anybody knows anybody working in a bank or RBI anybody's parent, your father, uncle working in a bank can ask SLR may be maintained on a fortnightly basis? Can you check that please? I thought it is a weekly basis like CRR. Can somebody check that information if anybody knows anybody working with say the RBI here in Kanpur or their zonal offices city offices also? The SLR what the requirement is now, it was used to be weekly basis. But, it may have changed to a fortnightly basis.

Can somebody find out that information, small technical information? Good to know that. May be it is maintained on a fortnightly basis. SLR need not be maintained on weekly basis, may be on a fortnightly basis. It is maintained because here I have, it seems to be my notes are indicating that it is maintained on a fortnightly basis because I have written presently. It is held as a fraction of banks net, n d t l that is n d t l on a fortnightly basis. Till 1985, it was maintained on a weekly basis, may be fortnightly. Please somebody check that or open an internet or something. Sometimes, you see this minor information is just not available.

They would tell you the SLR number if you open RBI, but they would not tell whether it is maintained on a weekly basis or fortnightly basis. Here, I get struck because am not in Bombay. Neither have I had energy to go to Kanpur city. Once, I went to this bank, I

remember I was preparing a similar course in the middle mid 1990's. I went to the bank and talked to somebody who I used to know.

When I came out, I came out completely confused because I realize these fellows who work at Bank and they sit on desks have no responsibility towards these monetary policy regulations. RBI said the big guys who are doing at head office, head office; they collect the information from them. But, they do not tap the technical details at all. So, that is it. They do not think. They also do not know this economics or regulatory issues very well.

They have somebody handling cash, somebody handling foreign exchange you know. How would they know what the SLR and CRR? They had heard of them, but they do not know the details. So, I got totally confused. I said no way I am going to ask this. Initially, I thought, I can go, walk into a bank and ask anybody and get the information. It is not at all like that.

So, you have to go to the right person in a bank to ask preferred in the head office or in a zonal office where there is somebody in charge who would does this work. So, the other people in the bank, they did not know banking operation is multi kind of front operation. So, the way is like a chest doctor need not be an ENT specialist. So, they have heard of ENT can give you some idea, but will give something. If you ask him too much, they will give you incorrect information because he is a chest specialist. He cannot know much about ENT.

So, this kind of a thing experience I had. So, I had no idea. Where to go, you can ask them and this small information, sometimes not available. But, I have got in somewhere hopefully. So, I am not passing on incorrect information. SLR can vary from 20 to 40; sometimes you can reach 40, but very few periods. Like CRR, they also had an incremental SLR. That is there is a SLR on total net than that you have to show.

Now, deposits have increased by some amount x over previous weeks suppose. So, next, the extra SLR will be added like an income tax we will be paid. We pay and the income tax on the entire thing. Then, the tax amount, a 2 percent of that is added again. Whatever tax I am paying as assets, government collects that, government of India from me and other fix in term of people. I do not know that whether they do that with the companies, person income tax. They do for a number of funding education. There may be educational schemes for primary schools etcetera. They do that. They collect some tax

from us. So, is that incremental tax? Is that incremental SLR they had? Then finally, well in 1994, 1992, they had incremental SLR.

Then finally, they review the incremental SLR. If some SLR is kept with the banks, we might adopt that SLR; if say unlike CRR, if you fail to report SLR proper amount of SLR, there is no penalty. But, RBI will watch that and RBI does this refinancing business with banks. RBI helps on banks with cash for various things. It starts restricting that amount, not a penalty. In CRR, in case of failure, in maintaining CRR, it is given to something. In case of SLR, so far I know there is no penalty. That is with the CRR, but RBI can say RBI helps you manage your own finances. We would not help you much. This can be concluded that they can be constricting with the bank repeatedly failing to report the true amount of SLR to maintain SLR.

So, at times, it has gone too merely upper limit, 40 percent, 35 percent it became SLR. In the 1990s, it has happened most economic years at the high. This I told one day, I do not understand this worst economic situation make highest SLR. Recently, it has happened to control incision. They raised CRR raised CRR raised CRR. Now, the economy has all economy is no economy, which is truly protected in. It should not much relaxed monetary policy to the maximum credit. So, the companies can get cheap loan and keep investing. So, today Indian economy, IIM reporters come and give me. It has protected India's GDP growth rate in the financial year to be 4.9 with a sub second line.

The conditions may deteriorate farther; this is the statement just I saw before leaving home. How many in the world today? Over 5 percent growth rate from 7 percent, it may have from 8 percent. It may have done. I mean just said 4.9 to the percentages and conditions. They could have appointed. India was so well protected with the conservative monetary system, if they had just the right to just check the inflation. The head of the policies is called contraction modules restrictive module policies anyway. So, this is the SLR business I talked about, but I have not concluded all nontraditional functions. So, what we had are more important things coming up. So, today we are running out of time. Can we talk about that on Thursday? Very good.