MODULE 2

RESERVE BANK OF INDIA

Introduction

The Reserve Bank of India (RBI) is the Central Bank of the country. It has been established as a body corporate under the Reserve Bank of India Act, which came into effect from 1st April,1935. The Reserve Bank was started as share-holders bank with a paid-up capital of Rs.5 crores. On establishment it took over the function of management of currency from the Government of India and power of credit control from the then Imperial Bank of India.

The Reserve Bank was nationalized in 1949 soon after the countrys independence. The basic reasons for nationalization were as follows:

1) There was a trend towards nationalization of Central Banks of the country in all parts of the world after the end of the Second World War. Even the Bank of England was nationalized in the year 1946.
2) The inflationary tendencies have started right from the beginning of the Second World War, i.e., 1939. In order to control these tendencies effectively, it was thought proper to nationalize the Reserve Bank of India – the Central Bank of the country, responsible for credit and currency management.
3) The country had embarked upon a Planned Economic Programme after independence. Nationalization of the Reserve Bank of India was necessary to use it as an effective instrument for economic development of the country.

The Reserve Bank of India carries on its operations according to the provisions of the Reserve Bank of India Act, 1934. The act has been amended from time to time.

Features of RBI

1) RBI formulates implements and monitors the monetary policy.
2) RBI maintains public confidence in the system, protect depositors" interest and provide cost-effective banking services to the public.
3) To facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.
4) Togivethepublicadequatequantityofsuppliesofcurrencynotesandcoinsandingood quality.

Organizational Structure of RBI

The organizational structure of RBI consists of the Central Board and the Local Boards.

1) **Central Board:** The general superintendence and direction of the banks affairs is vested in the Central Board of Directors. The organzational structure of central board is shown in **figure 1.3**:

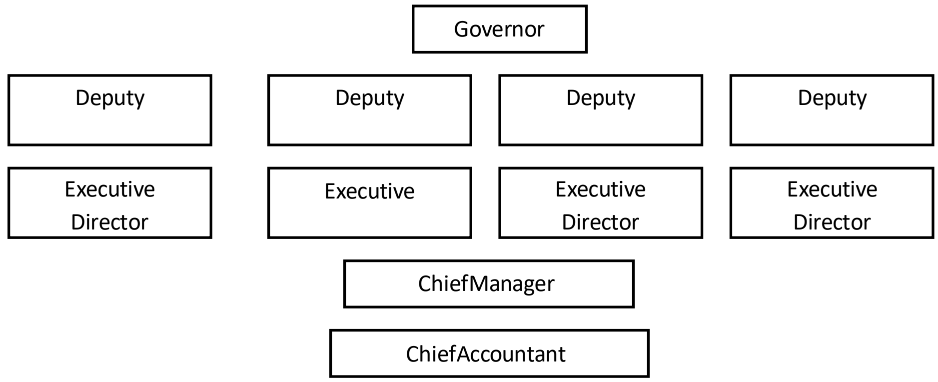

Figure1:Organization of the Reserve Bank of India

It comprises of a Governor, not more than four Deputy Governors, and fifteen Directors. All thesepersonsareappointed/nominatedbytheCentralGovernment.TheGovernorandDeputy Governors hold office for such periods not exceeding five years as may be fixed by the Central Government at the time of their appointed and are eligible for reappointment. As a matter of practical convenience the Board has delegated some of its functions to a committee called the Committee of the Central Board,consisting of the Governor,Deputy Governors,the Directors representing or resident in the area in which the meeting is held, the Director representingthegovernmentandotherDirectorsasmaybepresentattheplace at the relevant time.

2) **Local Board:** For each of the regional areas of the country viz. Western, Eastern, Northern and Southern, there is a Local Board with headquarters at Mumbai, Kolkata, New Delhi and Chennai. Local Boards consist of five members each, appointed by the Central Government. The functions of the Local Boards are to advise the Central Board on such matters as may generally be referred to them and to perform such duties as the Central Board may delegateto them.

Departments of RBI

There are sixteen departments of the Reserve Bank of India.These are:

1) **Issue Department:** This department undertakes the job of issuing paper currency and therefore it also makes arrangement for the distribution of paper currency. It maintains regular accounts of the notes printed at Nasik Press. Its branches are at Bangalore, Mumbai, Kolkata, Hyderabad, Kanpur, Chennai, Nagpur, New Delhi and Patna.
2) **Banking Department:** This department performs two primary functions,one of dealing with Government transactions and floating of loans on behalf of the Central and State Governments and arranging remittances of government funds from one place to another and the other regarding the maintenance of cash reserves of scheduled banks, extending financial assistance to them, whenever required and functioning as the clearing house for the scheduled banks.
3) **Banking Development:** This department is concerned with the expansion of banking facilities in the rural and semi-urban areas. It also imparts training to the scheduled banks.
4) **Banking Operations:** This department undertakes periodical inspections of the scheduled banks, analyzes their balance sheets, issues licenses for opening of new banks, considers requests for opening new branches, examines the requests of scheduled banks for increasing the paid-up capital, examines the possibilities for the amalgamation of existing banks and tenders advice to the scheduled banks in their day-to-day functioning.
5) **Agricultural Credit:** This department studies the problems connected with agricultural credit, conducts research on rural credit problems, formulates rural credit policy of the Reserve Bank, grants rural credit to State Governments and State Cooperative Banks and publishes reports on agricultural credit.
6) **Exchange Control:** This department regulates and controls the sale and purchase of foreign exchange.
7) **Industrial Finance:** This department extends financial assistance to small scale and medium scale industries and also tenders advice to various industrial financial corporations for their day-to-day working.

8) **Non-Banking Companies:** The headquarters of this department is at Kolkata and it is chiefly concerned with the supervision of the non-banking companies and financial institutions in the country.

9) **Legal Department:** This department tenders advice to the various departments of the Bank on legal matters, prepares directives and communiqués of the Bank and gives advice to the Bank on the proper implementation of legal matters relating to banking in the country.

10) **Research and Statistics:** This department undertakes research on problems in the areas of money, credit, finance, production, etc., collects statistics about the various sectors of the economy and publishes them; and tenders advice to the Government for the solution of various economic problems and in the formulation of its economic and financial policies.

11) **Department of Planning and Reorganization:** The department formulates new plans and reorganizes existing policies so as to make them more effective.

12) **Economic Department:** This department formulates banking policies for better implementation of economic policies of the Government.

13) **Inspection Department:** This department undertakes inspection of various offices of the commercial banks.

14) **Department of Accounts and Expenditure:** This department maintains proper records ofall receipts and expenditures of the Reserve Bank of India.

15) **RBI Services Board:** The Board deals with the selection of new employees for different posts in the Reserve Bank of India.

16) **Department of Supervision:** This department was set up on 22 December, 1993, for conducting proper supervision of commercial banks.

Role of Reserve Bank of India

Since its inception in 1935, the Reserve Bank of India has functioned with great success, not only as the apex financial institution in the country but also as the promoter of economic development. With the introduction of planning in India since 1951, the Reserve Bank formulated a new monetary policy to aid and speed up economic development. The Reserve Bank has undertaken several new functions to promote economic development in the country. The major contributions of the Reserve Bank to economic development are as follows:

1) **Promotion of Commercial Banking:** A well-developed banking system is a precondition for economic development. The Reserve Bank has taken several steps to strengthen the banking system. The Banking Regulation Act, 1949 has given the Reserve Bank vast powers of supervision and control of commercial banks in the country. The Reserve Bank has been using these powers:
    i) To strengthen the commercial banking structure through liquidation and amalgamation of banks and through improvement in their operational standards,
    ii) To extend the banking facilities in the semi-urban and rural areas, and
    iii) To promote the allocation of credit in favor of priority sectors, such as agriculture, small-scale industries, exports, etc.

    TheReserveBankisalsomakingvaluablecontributiontothedevelopmentofbanking systembyextendingtrainingfacilities,tothesupervisorystaffofthebanksthroughits „Bankers training colleges.

2) **Promotion of Rural Credit:** Defective rural credit system and deficient rural credit facilities are one of the major causes of backwardness of Indian agriculture. In view of this, the Reserve Bank, ever since its establishment, has been assigned the responsibility of reforming rural credit system and making provision of adequate institutional finance for agriculture and other rural activities. The Reserve Bank has taken the following steps to promote rural credit:

i) It has set up Agricultural Credit Department to expand and co-ordinate credit facilities to the rural areas.
ii) It has been taking all necessary measures to strengthen the co-operative credit system with a view to meet the financial needs of the rural people.
iii) In 1956, the Reserve Bank set up two funds. Namely, the National Agriculture Credit (long-termoperations)Fund and the National Agricultural Credit (stabilization) Fund, for providing medium-term and long-term loans to the state co-operative banks.
iv) Regional rural banks have been established to promote agricultural credit.
v) Some commercial banks have been nationalized mainly to expand bank credit facilities in rural areas.
vi) The National Bank for Agriculture and Rural Development has been established in 1982 as the apex institution for agricultural finance.

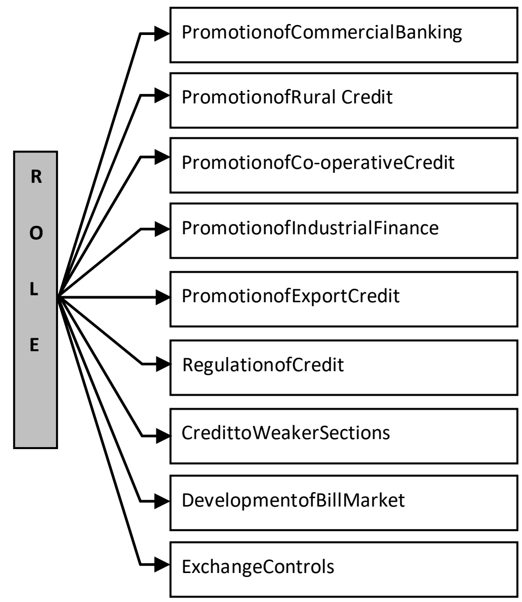

Figure2

As a result of the efforts made by the Reserve Bank, the institutional finance for agriculture has been increasing considerably over the years. The agricultural output has increased by leaps and bounds. Probably no other central bank in the world is doing so much to help, develop and finance agricultural credit.

3) **Promotion of Co-operative Credit:** Promotion of co-operative credit movement is also the special function of the Reserve Bank. On the recommendations of the Rural Credit Survey Committee, the Reserve Bank has taken a number of measures to strengthen the structure of co-operative credit institutions throughout the country. The Reserve Bank provides financial assistance to the agriculturists through the co-operative institutions. The Reserve Bank has, thus, infused a new life into the co-operative credit movement of the country.

4) **Promotion of Industrial Finance:** Credit or finance is the pillar to industrial development. The Reserve Bank has been playing an active role in the field of industrial finance also. In 1957, it has set up a separate Industrial Finance Department which has rendered useful serviceinextendingfinancialandorganizationalassistancetotheinstitutionsprovidinglong- term finance. It made commendable efforts for broadening the domestic capital market for providing the medium and long-term finance to the industrial sector. In this regard the ReserveBanktookinitiativeintheestablishmentofanumberofstatutorycorporationsfor

the purpose of providing finance, especially medium and long-term finance, to industries; Industrial Development Bank of India, Industrial Finance Corporation of India, State Finance Corporations, State Industrial Development Corporations and the Industrial Credit and Investment Corporation of India are some of the important corporations established in the country with the initiative of the Reserve Bank.

Thus, Reserve Bank has contributed to the share capital of these institutions and providing short-term advances also to some of them. The role of these corporations in providing financial help to industries is commendable. The Reserve Bank has played an active role in the establishment of the Unit Trust of India. The Unit Trust of India mobilizes the savings of people belonging to middle and lower income groups and uses these funds for investment in industries. By mobilizing the small savings of the people, the Unit Trust has been promoting capital formation which is the most important determinant of economic development. The Reserve Bank also has been encouraging commercial banks to provide credit to the small-scale industries. It has been encouraging credit for small industries through its "Credit Guarantee Scheme". Small-scale industries have been recognized as a priority sector. The Reserve Bank has also been, acting as a "developmental agency" for planning, promotingand developing industries to fill in the gaps in the industrial structure of the country.

5) **Promotion of Export Credit:** "Export or Perish" has become a slogan for the developing economies, including India. In recent years, India is keen on expanding exports. Growth of exports needs liberal and adequate export credit. The Reserve Bank has undertaken a number of measures for increasing credit to the export sector. For promoting export financing by the banks, the Reserve Bank has introduced certain export credit schemes. The Export Bills Credit Scheme and the Pre-shipment Credit Scheme are the two important schemes introducedbytheReserveBank.TheReserveBankhasbeenstipulatingconcessionalinterest rates on various types of export credit granted by commercial banks. The Reserve Bank has beeninstrumentalin the establishmentofExport-Import Bank.The EXIM Bank istoprovide financial assistance to exporters and importers. The Reserve Bank has authority to grantloans and advances to the EXIM Bank, under certain conditions.

6) **Regulation of Credit:** The Reserve Bank has been extensively using various credit control weapons to regulate the cost of credit, the amount of credit and the purpose of credit. For regulating the cost and amount of credit the Reserve Bank has been using the quantitative weapons. For influencing the purpose and direction of credit, it has been using various selective credit controls. By regulating credit, the Reserve Bank has been able:
   i) To promote economic growth in the country,
   ii) To check inflation trends in the country,
   iii) To prevent the financial resources from being used for speculative purposes,
   iv) Tomakefinancialresourcesavailableforproductivepurposeskeepinginviewthepriorities of the plans, and

7) **Credit to Weaker Sections:** The Reserve Bank has taken certain measures to encourage adequate and cheaper credit to the weaker sections of the society. The "Differential Rate of Interest Scheme" was started in 1972. Under this scheme, concessional credit is provided to

economically and socially backward persons engaged in productive activities. The Reserve Bankhasbeenencouragingthecommercialbankstogiveliberalcredittotheweakersections and for self employment schemes.

The Insurance and Credit Guarantee Corporation of India gives guarantee for loans given to weaker sections.

8) **Development of Bill Market:** The Reserve Bank introduced the "Bill Market Scheme" in 1952, with a view to extend loans to the commercial banks against their demand promissory notes. The scheme, however, was not based on the genuine trade bills. In 1970, the Reserve Bank introduced "New Bill Market Scheme" which covered the genuine trade bills representingsale or dispatch of goods. The bill market scheme has helped a lot indeveloping the bill market in the country. The bill market scheme has increased the liquidity of the money market in India.

9) **Exchange Controls:** The Reserve Bank has been able to maintain the stability of the exchange value of the "Rupee" even under heavy strains and pressure. It has also managed "exchange controls" successfully.

Inspite of the limitations under which it has to function in a developing country like India, the over all performance of the Reserve Bank is quite satisfactory. It has been able to develop the financial structure of the country consistent with the national socio-economic objectives and priorities. It has discharged its promotional and developmental functions satisfactorily and acted as the leader in economic development of the country.

Functions of Reserve Banks of India

The Reserve Bank of India is the Central Bank of India and therefore, it performs all those functions which a central bank is required to perform in a country. The function of central banks are broadlythe same all over the world, but the scope and content of policy objectives vary from country to country and from period to period depending upon a number of factors like development and the structure of the economy, goals to which the government is committed and the general economic situation.

Functions performed BY:

1) Central banking functions.
2) Supervisory functions.
3) Promotional functions.

Central Banking Functions

1) **Issue of Bank Notes:** The Reserve Bank has the sole right to issue bank notes of all denominations(exceptonerupeenoteswhichareissuedonlybytheGovernmentofIndia).This hasbeendonetogivetheReserveBankthecompleteanduniformcontroloverthecurrencyand thecreditsystemofthecountry.TheBankhasaseparate"IssueDepartment"forthispurpose.The Reserve Bank has made adequate arrangements for holding and distributing of currency notesandcoins.TheIssueDepartmentoftheReserveBankhasitsofficesinseventeen

important cities of the country. Moreover it is maintaining currency chests all over the country.

2) **Banker to Government:** The Reserve Bank of India acts as the Banker to Government. It accepts money for the account of Union and State Government in India, makes payment on theirbehalf,carriesouttheirexchange,remittanceandotherbankingoperationsandmanages thepublicdebt. Itmakes waysandmeansadvancestotheGovernmentfor90days. Itadvises the Government on all monetary and banking matters.

3) **Bankers' Bank:** The Reserve Bank of India acts as the bankers'' bank. The scheduled banks are required to maintain with the Reserve Bank as cash balance a certain percentage of their timeand demand liabilities.Everyscheduledbank was required to maintain with theReserve Bank a cash balance equivalent to 5 per cent of its demand liabilities and 2 per cent of itstime liabilities in India. It acts as a lender of the last resort to them. The scheduled banks can borrow money from the Reserve Bank on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting their bills of exchange. Byan amendment of 1962, the distinction between demand and time liabilities was abolishedand banks have been asked to keep cash reserves equal to 3 per cent of their aggregatedeposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

   Since commercial banks can always expect the Reserve Bank of India to come to their helpin times of banking crisis the Reserve Bank becomes not onlythe banker''s bank but also the lender of the last resort.

4) **Custodian of Foreign Exchange Reserves:** The Reserve Bank has been entrusted with the responsibility of maintaining the external value of the rupee and for this purpose the bank holds most of the foreign exchange reserves. Since India is a member of International Monetary Fund, the Reserve Bank has to maintain fixed exchange rates with all other member countries of the Fund. It, therefore, sells and buys foreign exchange to/from authorized persons at rates fixed by the Government.

5) **Controller of Credit:** The Reserve Bank also functions as the controller of credit. It can control by various methods the creation of credit by commercial banks.
   i) It can do so through changing the bank rate or through open market operations.AccordingtotheBankingRegulationActof1949,theReserveBankof India can ask any particular bank or the whole banking system not to lend to particular group or persons on the basis of certain types of securities.
   ii) Since1956, selective controls of credit .
   iii) The Reserve Bank of India is armed with manymore powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India; the license can be canceled by the Reserve Bank if certain stipulated conditions are not fulfilled.
   iv) Everybank will have to get the permission of the Reserve Bank before it can open a new branch.
   v) Each scheduled bank must send a weekly return to the Reserve Bank, showing in detail, its assets and liabilities.This power of the Bank to call for information isalso intended to give it effective control of the credit system.
   vi) TheReserveBank hasalsothepower to inspect theaccounts of anycommercial bank.

Supervisory Functions

In order to promote and develop a sound and efficient system of banking in India, the Reserve Bank has been given several supervisory powers over different banking institutions. These powers relate to licensing and establishment, branch expansion, liquidity of assets, management, working, amalgamation, reconstruction and liquidation of commercial and co-operative banks. The Reserve Bank carries out periodical inspections of these banks and calls for such information, which it considers necessary for effective performance of its functions.

1) **Obtain License:** Every bank wishing to commence banking business in India is required to obtainalicensefromtheReserveBankofIndia.TheReserveBank,afterbeingsatisfiedthatit willbeinapositiontopayclaimsofthedepositsasandwhentheyaccrueandthatitsaffairsare being conducted in a manner not detrimental to the interests of its depositors, will grant the licensetothebanktocommencebankingbusinessinIndia.

2) **Coverage of Bank Operations:** To ensure that banks are organized and conduct their business on sound financial footings of the banking. Regulation Act has prescribed the minimum paid up capital, reserves, cash reserves and other liquid assets depending upon the geographical coverage of a bank‟s operations. The Reserve bank is to see the fulfillment of these requirements.

3) **Liquidation of Weak Banks:** To strengthen the commercial banking structure in thecountry, the R.B.I. is empowered to order the compulsory liquidation of weak banks or their merger with the stronger one. It is empowered to inspect, make an enquiry and may take necessary action in order to improve the operational efficiencyof the bank. It may also order for the suspension of business.

4) **BranchExpansion:**Everybankinthecountryisrequiredtoobtainpermissionfromthe R.B.I. for its branch expansion programme. The R.B.I. can also direct a bank to open branches in a particular area especially in small towns and rural areas so as to improve the geographical coverage.

5) **Issue Directions On Credit Control:** Toimprovethefunctional coverage ofbanks, in order to improve the sectoral distribution of bank credit in favor of the priority sectors such as agriculture, small scale industries, self employed persons etc. and make more of it to the small borrowers. The R.B.I. can issue directions to commercial banks through its credit control measures.

6) **Training of Bank Personnel:** The R.B.I. has arranged for the education and training of different categories of bank personnel by setting up a number of training institutes in the country. The principal training institutes are Bankers Training College (Mumbai), the National InstituteofBankManagement(Mumbai),thecooperativeBankersTrainingCollege Pune, the College of Agricultural Banking, Pune, Staff Training College, Chennai, and zonal training centres for Staff at Mumbai, Kolkata, Chennai and New Delhi.

7) **RestrictLoansAndAdvances:**ByanamendmenteffectivefromFebruary1,1964,the R.B.I. is empowered to restrain control exercised by particular groups of persons over the affairs of banks and to restrict loans and advances as well guarantees given by banks to and

greater powers to the R.B.I. in the matters of appointment and removal of bank‟s executive personnel.

8) **Collect And Supply Information:** The Reserve Bank of India has been empowered to collect information in regard to credit facilities advanced by banks and other financial institutions to their constituents and to supply these banks and institutions such information, on application, in a consolidated form.

9) **Spreading Banking Habits:** In order to inspire greater public confidence, and spreadthereby banking habits in the country especially the lower section of the society, the R.B.I. has set up a Deposit Insurance Corporation in 1962 as a subsidiary of the R.B.I. In later year the scheme of deposit insurance was extended to cooperative and regional rural banks. The amount eligible for insurance cover has been revised from time to time. On July 1,1980, it was fixed at Rs.30,000 for each depositor in each bank.

With the nationalization of 20 major commercial banks in India (14 in July 1969 and 6 in April 1980), the Reserve Bank of India has been in a position to exercise better control over commercialbanks.Inrecentyears,withtheestablishmentofregionalruralbanksthebanking system in India has made a commendable progress both functionally and geographically because it is now easier for the R.B.I. to steer and direct the growth of banks in desired direction.

Promotional Functions

It not only controls the credit and currency in the economy or maintains internal/external value of the rupee

For ensuring price stability but also acts as a promoter of financial institutions, required for meeting specific financial requirements of the developing economy. At the time of establishment of the Reserve Bank of India in theYear1935,the country lacked a well-developed money market and a well-developed commercial banking system. Moreover, it was industrially a backward country. After independence, the country embarked upon a well-organized and planned economic development.Theprocessisstillcontinuing.AllthismadenecessaryfortheReserveBankofIndia to pursue appropriate monetary and credit policy and take all necessary steps required for a fast growth and development to fall sectors of the economy, keeping in view the guidelines and policies formulated by the Government.

The promotional steps taken by the RBI in this direction can be summarized as follows:

1) **Established the Bill Market Scheme:**It established the Bill Market Scheme in1952.

2) **Development of Specialized Financial Institutions:** It has taken up keen interest in setting up and development of specialized financial institutions. The number of such institutions in whose setting up the RBI is directly or indirectly involved is steadily growing. They include Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Industrial Development Bank of India (IDBI), Unit Trust of India (UTI), Deposit Insurance and Credit Guarantee Corporation of India (DICGC), and National Bank for agriculture and Rural Development (NABARD), etc.

3) **Promote Regional Rural Banks:** It has promoted Regional Rural Banks (RRBs) with the cooperation of the commercial banks to extend banking facilities to the rural areas.

4) **Promote National Housing Bank:** ItpromotedinJuly,1988,theNationalHousingBank,as its wholly owned subsidiary to organize and argument resources for housing. The National Housing Bank besides providing refinance to institutions engaged in housing finance willalso extend full support to industries that augment supplies of building materials and/or leading to construction at lower cost.
5) **Establishment of Export Import Bank of India:** It has helped in establishment of Export Import Bank of India (EXIM) to provide finance to exporters. It also helps the commercial banks in openingtheirbranches in theforeign countries forhelpingin theforeign tradeofthe country.
6) **Promotes Research:** The RBI also encourages and promotes research in the areas of banking.

RBI's Regulatory Environment

Prudential regulation and supervision have formed a critical component of the financial sector reformprogrammesinceits inceptionand Indiahas endeavoredtointernationalprudentialnorms and practices. These norms have been progressivelytightened over the years, particularlyagainst thebackdropoftheAsiancrisis.Bankexposurestosensitivesectorssuchasequityandrealestate have been curtailed. The Banking Regulation Act 1949 prevents connected lending (i.e., lending by banks to directors or companies in whom Directors are interested):

1) Periodical inspection of banks has been the main instrument of supervision, though recently there has been a move toward supplementary „on-site inspections" with „off-site surveillance".
2) The system of „Annual Financial Inspection" was introduced in 1992, in place of the earlier system of Annual Financial Review/Financial Inspections. The inspection objectives and procedures, have been redefined to evaluate the bank"s safety and soundness; to appraise the quality of the Board and management; to ensure compliance with banking laws and regulation; to provide an appraisal of soundness of the bank"s assets; to analyze the financial factors which determine bank"s solvency and to identify areas where corrective action is needed to strengthen the institution and improve its performance. Inspections based upon the new guidelines have started since 1997.
3) A high powered Board for Financial Supervision (BFS), comprising the Governor of RBI as Chairman, one of the Deputy Governors as Vice-Chairman and four Directors of the Central Board of RBI as members was constituted in 1994, with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies.
4) Asupervisorystrategycomprisingon-siteinspection,off-sitemonitoringandcontrolsystems internal to the banks, based on the CAMELS (capital adequacy, asset quality, management, earnings, liquidity and systems and controls) methodology for banks have been instituted. The RBI has instituted a mechanism for critical analysis of the balance sheet by the banks themselves and the presentation of such analysis before their boards to provide an internal assessment of the health of the bank. The analysis, which is also made available to the RBI, forms a supplement to the system of off-site monitoring of banks.