Reserve requirements of the NBFC'S in India – A Study

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Abstract

The present paper looks at various mechanism to which RBI imposes management of CRR and SLR. Credit is an important part of monetary policy. It plays an important role in the settlement of monetary and business transactions of all kinds, and thus represents a powerful force for good or evil. The regulation of credit is the main function of a Central Bank. "It is the function", observes a celebrated writer on Central Banking, "which embraces the most important questions of Central Banking policy and the one through which practically all other functions are united and made to serve a common purpose^". Credit control fulfils the three main objectives of monetary policy: exchange stabilization, price stabilization and economic stabilization. There are following methods available for the Central Bank to regulate or adjust the credit: The lowering or raising of its discount rate (bank rate , SLR) with a view of lowering or raising money rates generally and encouraging the expansion or contraction of credit, i.e. regulation of the size and flow of credit through changes in the bank rate. Open market operations in securities, investments and bills, i.e. the buying and selling of securities or bills of exchange in the open market with a view of putting additional funds into the market or withdrawing funds from there and thus expanding.

Varying the reserve requirements of the banking system, i.e. the lowering or raising of minimum reserves to be kept by the commercial banks in the form of credit balances with the Central Bank to expand or contract the CRR capacity of the commercial banks. Reserve Bank and its Statutory Powers Central Banking Enquiry Committee in 1931 expressed the hope that "the establishment of such a bank would be mobilization of the banking and currency of India in one hand, tend to increase the volume of credit available for trade, industry and agriculture and to mitigate the SLR of fluctuating and high charges for the use of such credit caused by seasonal stringency". With such pious hopes and aspirations, the Reserve Bank is constituted by its framers, "to regulate the issue of Bank Notes and the keeping of reserves with a view to securing monetary stability in India adequately to operate the currency and credit system of the country, to its advantage". To meet this gracious objective in the most expedient manner, the Bank was vested with statutory powers to buy and rediscount eligible commercial paper, to extend loans and advances against the security of eligible documents, to purchase and sell government securities, to maintain the cash reserves of the eligible banks to publish from time to time its bank rate, at which it is prepared to buy or rediscount bills of exchange or other eligible commercial paper.

Keywords— CRR, Reserve Bank of India, SLR, Banking, commercial paper, government securities,

Introduction

The Reserve Bank of India Act, while giving the Bank such powers, has defined the 'eligible paper", which the Bank can accept for rediscount. These are: (i) bill drawn on and payable in India, arising out of Bonafede commercial or trade transaction and bearing the priorendorsement of either a scheduled bank or a state Cooperative Bank, (ii) bill drawn and payable In India for purposes of financing seasonal agricultural operations or the marketing crops, endorsed by either a scheduled bank or a state cooperative bank (iii) bills drawn and payable in India for the purposes of financing the production or marketing activities of cottage and small scale industries approved by bank and supported by either a state Cooperative Bank or a State Financial Corporation and guaranteed by the State government (iv) bills drawn and payable in India for the purpose of holding or trading in government securities, (v) bills (including Treasury Bills) drawn in any place in any country outside India, which is a member of the International Monetary Fund (I.M.F.) and endorsed by a scheduled bank. Consistent with the technique of Central Banking, the Reserve Bank is authorized to publish from time to time its Bank rate-the standard rate at which it is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase or rediscount. The Bank has also an explicit power to engage in open74

market operations involving purchase and sale of Central Government securities or state government securities of any maturity and of such securities of local authorities as may be specified in this behalf by the Central Government. Besides, these powers, the Reserve Bank Act provided for an 'escape clause' by which the bank could, if a special occasion arose for regulating credit in the interest of Indian trade, commerce, industry and agriculture, resort to direct discounts and direct loans without the meditation of a scheduled or a state cooperative bank.The Reserve Bank of India provides credit to banks in two forms:(a) as advances against eligible securities, such as government securities and 'other approved securities' and (b) as rediscounts of eligible bills under its Bills Rediscounting Scheme of 1970. Credit is provided to banks partly in fulfillment of the traditional Central banking functions and partly for promoting certain new policy objectives. The Reserve Bank of India also uses its lending power to banks (a) to influence their credit allocation and (b) to develop a genuine bill India. It does the former under its refinance facilities to banks and the latter under its Bills rediscounting scheme, and both at concessional rates of interest. The Bank Rate principle is divided into two:75

(i) Operation of the bank rate as a weapon of control of money supply according to it, an increase in the bank rate by raising the cost of borrowed reserves, other things being the same, discourages bank borrowings from the Central Bank. The reserve is supposed to happen when the bank rate is lowered. This varies the rate to expansion of High-powered Money (H) and so of Broad Money (M3), assuming the money multiplier to remain unchanged. But the success of this effect will depend on several factors such as (a) the degree of banks dependence on borrowed reserves, (b) the sensitivity of banks demand rates and borrowing rates, (c) the extent to which the other rates of interest have already changed or change subsequently, and (d) the state of the demand for loans and the supply of funds from other sources, etc.(ii) The other part of the bank rate theory relates to the effect of the bank rate changes on the domestic level and structure of interest takes ands thereby on the level of economic activity and the balance of payments of the country. An increase in the bank rate is supposed to be followed by a rise in the market rates of interest all along more so and rapidly on the end then on the short

from it against the government and other approved securities at the Bank rate. However, the effectiveness of the Bank rate dwindled sharply with the emergence of differential interest rates system initially in the form of a quota-cum-slab system based on net liquidity position of borrowing banks in September 1964 as also the absence of genuine bill market. In the post nationalization phase, with increased emphasis being bestowed on priority sector lending and concessional lending, the Bank rate lost much of its significance till the announcement of resurrecting it was made in April 1997. The Bank rate was changed nine times during 1951-74 and only thrice during the period 1975-96 despite the substantial growth of the financial sector and the pressures on liquidity exerted at different points of time over the 45 years between 1951 to 1996 and from 1997 to onwards the Bank rate is continuously ondecline with the exception of January 17, 1988 and July 2000.

Objective:

This paper aims to explore the CRR and SLR concepts as imposed by RBI and the CRR influence the SLR through which the RBI management is exercised

CRR AND SLR : statute and state

In consonance with the statute, it prescribed lending rates with a view to influencing the demand for credit and imparting an element of discipline in the use of credit. This was sought to be achieved by stipulating minimum lending rates introduced in October 1960, and occasionally by clamping ceiling ratesfor either dampening credit growth exercised in September 1964 or protecting a certain economic activity/borrowers e.g., on exports credit stipulated in March 1968. With regard to deposit rates, prior to September 1964, these were governed by a voluntary agreement amongst the most important Indian and Foreign Banks fixing ceilings on interest rates on deposit barring for a short period during September 1960 - February 1961 when the Reserve Bank stipulated the came into being from September 1964. Effective from September 1969, the Reserve Bank prohibited interest payment on current accounts and on deposits 14 days. Subsequently, 1970s, coupled with the increasing proliferation of directed credit arrangements, multiple interest rate prescriptions based on variety of criteria such as economic activity, commodity, location, specific group of borrower etc., and the resultant cross subsidization created a very complex administered interest rate structure with virtually no role for market forces to play in pricing and allocation of credit. A major reform81

was initiated with a view to simplifying complex lending rate structure effective From September 22, 1990: "The structure was characterized by a multiplicity of rates with in the interest rate dependent on numerous criteria such as, size of loan, nature of a sector, location of activity, programme specific lending of borrowers, and so on."

Post-Liberalization Period:

The unprecedented balance of payments crisis during the summer of 1991 emanating from high and prolonged fiscal and balance of payments deficits prompted the government to take a number of policy measures. These policies of financial stabilization and structural adjustments helped the economy to quickly recover and facilitate integration of the Indian economy with the world economy. In thefinancial sector, reforms were initiated following the recommendation of the committee on the financial system under the chairmanship of Shri. M. Narsimham, which submitted its report in 1991. The reform measures addressed a number of issues such as:

(i) Improving the external constraints, having a bearing on the profitability of the banks.

(ii) Strengthening banks and financial institutions through application of prudential norms, and

(iii) Improving the competitiveness of banks and financial institutions. The transition from a planned economy to a market economy in the 1990s has sharpened the Reserve Bank's monetary management dilemma of providing credit to both the government and the commercial sector at a reasonable cost, while at the same time containing inflationary pressures.

While sudden external shocks required a hardening of monetary conditions in order to ensure orderly conditions in the financial markets, the growth objective presaged a softer interest rate regime. In view of the increasing complexities the Reserve Bankadopted a multiple indicator approach in which a host of macro economic variables are monitored for the process of the monetary policy formulation. Furthermore, the monitory authority had to simultaneously hone up an array of monetary policy instruments - quantum and rate-in order to harness monetary conditions to the desired macro objectives in this environment of uncertainties. Monetary Instrument -Open Market Operations:Open Market operations relate to the dealings of the Central Bank directly with the market on its own initiatives with a view to affecting necessary variations in the supply of money. These dealings consist of a deliberate and direct purchase or sale by the Central Bank of its83

INSTRUMENTS OF MONETARY assets- bills, securities, bonds.

Gold, Silver and foreign exchange generally. But dealings in government and other gilt- edged securities, both long term and short term have been undertaken by Central Bank in such huge amounts and so frequently that open market operations have, by practice, come to confined to those referring to government securities only. However, a purchase or sale of assets may be of government securities only by the Central Bank constitute a direct method of aiming at the desired expansion or contraction of money and of general economic activity. This is done in two ways. In the first place, purchases and sales of securities by the Central Bank tend directly and immediately to increase or decrease the quantity of money in circulation and the cash reserves of the commercial banks. This increase or decrease in the supply of bank cash, on which depends the credit creating capacity of the commercial banks tends stillfurther to increase or decrease the quantity of money thereby bringing about relative changes in the money rates and credit conditions. Secondly, a purchase or sale of securities by the Central Bank affects, to some extent, the prices of government securities and, therefore, influences the long-term rates of interest. Through both these Central Monetary Authority is able to introduce the desired adjustments in the domestic levels of prices, costs, production, trade84

and employment. The policy of rediscounting brings about an on money credit through primary changes in short-term money rates and secondary repercussions on long-term interest rates or yields, where as open market policy of the Central Bank has a direct and immediate effect on the volume of money and credit as well as money and interest rates. The open market operations posses a degree of superiority over rediscount policy because of the fact that the Initiative is In the hands of the monetary authority, whereas Bank Rate is passive because its effectiveness depends upon the response of the commercial banks and their customers. In fact the open market policy has two doors, onethrough which to enter and another one by which to get out again. But the open market operations are by no means intended to do entirely away with the bank Rate policy, but rather a useful and indispensable complement of each other. Open market operations may be used to make the bank rate effective or to prepare the ground for a change in bank rate; to support government credit or to prepare the market with the issue of new loans or the conversion of existing loans; to create and maintain conditions of cheap money as an aid to business recovery; to effect the movements in the balance of payments; to offset seasonal movements in the economy and thus to control the

money market generally. Thus open market policy of the Central Bank is an important technique of monetary .The open Market operation has been helping the monetary management even from the past. The bank sheet rates (rates purchase) of the govt, securities have increased over the years. The trends in Banks purchases, sales and not sales of the govt, securities during 1990-91 to 2006-07 can be shown in the table 3.3 the extent that netsales were positive and have increased substantially during this period, OMOs, have helped in the regulation of the flow of the bank credit to private sector.86

Statutory powers of RBI for Open Market Operations:

The nature and the quality of the assets in which the Reserve Bank of India could operate are originally defined in section 17 of the Reserve Bank of India Act, 1934. There are two principal ways the Reserve Bank to influence the money markets directly by its operations. The first is the traditional form of the purchase and sale of bills of exchange, promissory notes, treasury bills and government securities.

Sections 17 (2) and 17 (3) of the Act authorize the Bank "to purchase and sell bills and promissory notes out of commercial or trade transactions or for the purpose of seasonal operations". The bank is also authorized to purchase and sell bill of exchange and treasury bills of any foreign country, which may be a member of the International Monetary Fund. The second instrument of operation in the open market policy of the Reserve Bank is provided by section 17 (2) of the reserve Bank of India Act, whereby the bank is authorized to purchase and sell Gold coin and bullion and foreign exchange. Open market operations in these assets has potentially unlimited scope provided they are available in the market. When the Reserve Bank of India was inaugurated in April 1935, it had in its banking department, the government securities to the value of Rs. 5 crores which the government of India had contributed towards the reserve fund of the bank. Soon after its inauguration, the money marketwas caught into stringency and the Reserve Bank, entered into the market and purchased the securities to ease the situation. Thus the open market operation is being used (upto 1970s) as an instrument of monetary control right from the beginning. But for this instrument to be

successful at least three conditions must be satisfied/ (i) the market for government securities should be well organized and developed, that is broad, deep and resilient (ii) the Central Bank should have enough capacity to buy and sell securities and (iii) the Central Bank in its conduct of these operations should not be weighed down by weightier consideration than monetary control. Of these, only condition (ii) is well satisfied and the other two conditions are not well satisfied. The Indiangilt-edged market is not well developed. The Treasury Bill Market representing the short end of the market is practically under developed- it is limited largely to the RBI itself and scheduled commercial banks. The market for government bonds, on the demand side Is largely a captive market, comprising mainly financial institutions such as commercial banks, the Life Insurance Corporation (LIC) the General Insurance Corporation (GIC) and subsidiaries and provident fund. These institutions are required by law to interest a certain minimum proportion of their total liabilities in government securities and certain "other approved securities". On the supply side, the RBI Is the main reservoir of government securities and enjoys a near monopolist position. The other reason for the relative unimportance of open as an instrument of a monetary control is that they are weighed heavily of considerations of public-debt management.

SLR and CRR the recommendations

The Third Working Group on Money supply (Chairman: Dr. Y.V. Reddy), which submitted its Report in June 1998, found that the output response to monetary policy operating through the interest rate channel tends to be stronger and

more persistent than that through the credit channel. With pricing decisions left increasingly to market forces, the interest rate and exchange rate gained in importance visa-vis quantity variable. Accordingly, RBI gradually switched over to a more broad-based multiple indicator approach and an Interim Liquidity Adjustment Facility (ILAF) was introduced initially in April 1999. This later transited into afull fledged LAP, put in place on June 5, 2000. Thus, the monetary regulation in the system is carried out through open market operations in the form of outright purchases / sales of government securities and repo and reserve repo operations under Liquidity Adjustment Facility (LAF). The LAF enables the Reserve Bank to modulate short-term liquidity under varied financial market conditions in order to ensure stable conditions in the overnight (Call) money market. It operatesthrough daily repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. Although there is no formal targeting of overnight interest rates, LAF operation has enabled the Reserve Bank to de-emphasized the targeting of bank reserves and focus increasingly on interest rates. At present, there is a multiplicity of rates at which liquidity is absorbed/injected. In an interest rate corridor framework, with thesystem being in surplus mode, it is generally witnessed that there are

normally two rates through which liquidity is absorbed and one rate through which liquidity is injected, and vice-versa when the system is In deficit mode. Since the repo rate has emerged as the policy-signalling rate, its relative position within the corridor becomes important. The cross-country experiences show that policy signalling rate is place in the middle of the corridor. However, in the present framework, the repo rate has been acting as both the policy rate as well as the rate for passive sterilization of excess liquidity emanating from capital flows. It depicts the above explanations.As the repo rate provides the floor for call rates, it has createdsome infirmities in the system. The RBI's LAF repo operations have the tendency to substitute market activities in call/notice money, term money and market repo operations. Banks may have less incentive to lend fully in call/notice market in a scenario of narrow spread between call rate and repo rate. After taking into account relative credit risk, bank may prefer to lend even at a marginally lower rate by repoing with RBIthen lending in call. This combined with substantial improvement in liquidity has caused call/notice money turnover to shrink from Rs. 35, 144 crore during 2001-02 to Rs. 19, 920 crore during April—October 2003.

Conclusion

Open market operations were not used as an active instrument of monetary management as the functioning of the monetary system in India had not been the subject of comprehensive review, the Reserve Bank of India appointed a committee in December 1982 under the chairmanship of Professor Sukhmoy Chakravarty to review the working of the monetary system and suggest measures for improving the effectiveness of monetary policy as an instrument for promoting the basic objectives of planned economic development. The committee submitted its report inApril 1985, which formed the basis for the changes in monetary policy. A working Group on the Money market under the Chairmanship of Shri N. Vaghul was formed to examine certain recommendations of the Chakarvarty Committee relating to the development of the money.

The Working Group submitted its report in January 1987, following which several money market measures were undertaken in the late 1980s. The 182-day Treasury Bill was introduced on an auction basis. The Discount and Finance House of India (DFHI) was set up to promote a secondary market in various money market instruments. From May 1, 1989 all interest rate ceilings on money market instruments were withdrawn. In order to encourage the use of commercial bills and short-term liquidity in the banking system, inter- bank participation certificates, certificates of deposit (CD) paper (CP) were introduced. Interest rates on CDs and CPs were left to be determined by the market.Though the reforms were initiated in late 1980s, but the unprecedented balance of payments crisis during 1991 and prolonged fiscal deficits prompted the government to take a number of policy measures.

However, subsequently the repo rate was brought down in stages to 6 percent from April 30, 1998.As a result of greater reliance of the Reserve Bank on open market operations the net sales of Government securities were much higher at Rs. 10, 435 crore in 1996-97 as against Rs. 583 crore during 1995-96 when tight monetary conditions prevailed in the economy.The volume of securities available for open market operations was enhanced by convincing special securities of value aggregating Rs. 20, 000 crore at 4.6 percent into marketable securities of different maturities and interest rates: 10 year, 8 year, 7 year and 5 year maturities were compared at 13.05 percent, 12. 59 percent, 11.19 percent and 11.15 percent on June 3, 1997, June 18, 1997, August 12, 1997 and September 1, 1997 respectively. Net sales of securities were lower at Rs. 3, 154 crore during the financial year 1997-98, than that of Rs. 8, 071 crore for the corresponding period of fiscal 1996-97. The open market operations including repo activities went a long way in neutralizing excess liquidity in the banking system. Reflecting this, thenet sales of Government securities during 1998-99 till February 5, 1999 remained at a very high level of Rs. 25031 crore against Rs. 3151 crore in the corresponding period of 1997-98.

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