

Evolution of central banking in india finance essay

[Finance](#), [Banks](#)



The term paper discusses the role that the Reserve Bank of India has played in the Indian banking system. In the start it talks about the evolution of the bank and its preliminary functions. Then the role of the bank in the last two decades has been studied taking into account structural changes made by the bank so as to adapt to the changing needs of the banks in the dynamic economic environment. It can be observed that the role of the Central bank has changed from being a mere controller to an enabler where it is in a position to make the banking industry make significant contribution to the country's economy. The paper also discusses the supervisory role of RBI where it is trying to implement the Risk Based method to supervise banks. The paper concludes with the future outlook on the banking industry and how the RBI should evolve further when compared to Central Banks in developed economies across the world.

The Reserve Bank of India

Evolution of Central Banking in India

Reserve bank of India is central bank of India and regulates all the banks of the country. It all started in late 18th century when first time in the history of India Warren Hastings felt that there is need of centralized bank in India. His recommendation didn't reach at a thoughtful conclusion of creating a central body to regulate the banking in India. Later when demand of central bank increased in the 20th century and Lord Keynes also recommended setting up a central bank. Three Presidency banks Presidency bank of Bengal, Presidency bank of Bombay and Presidency bank of Madras merged to form Imperial bank of India to make central bank of India. A bill was brought in the assembly to establish RBI as central bank in in India in 1927 but got refused.

In the third round table conference held in the year 1933, it was recommended to set up a free body to control the banking system in India. Due to all these fresh recommendations a fresh bill tabled in the parliament on 22 December 1933 and got passed in year 1934. Reserve bank started its function from April 1 1935 under the Reserve bank of India Act 1934.

Evolution of Role and Functions

Role of RBI is evolved over the period of time. In the initial stages it performed two basic functions. First, it acted as a central point of reserves for Indian banks and timely lend to the banks as they required funds for the operations in the emergency case. Second, it functioned as a regulator for the Indian banks and made sure that they perform their activities in the interest of the depositors. In the years before the independence, banking network and scenario in India was not spread properly all over the country. They were divided in the foreign banks and domestic banks. Foreign banks mostly served to the British companies in India. Domestic banks were only engaged with domestic groups and overall banking intermediation among the banks and the customers was weak.

The Reserve Bank of India (RBI) or the Central Bank is the backbone of the Indian financial system. It was set up under the Reserve Bank of India Act, 1934. RBI was initially started with 5 crores of capital and governed by directors of central bank. Since its inception in the year 1935, the functions undertaken by the bank have not only increased but have also undergone changes in accordance with the changing needs of the Indian economy. It was in the year 1949 that the bank was nationalized.

The role and functions of RBI became critical after independence and worked in order to increase the saving habit in India to generate more wealth for growth of the country. More the people will save and more will be the investment in the projects. Its roles were primarily on the basis of this hypothesis that the poor were unable to save and increase funds on their own. RBI was assisting government to establish institutions to serve the public by providing funds for specific functions.

After second five year plan in 1956 government of India came up with decision of establishing financial institutions with assistance of RBI. These institutions were Industrial development bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India (IFCI). They will make credit available and perform their functions at central level and work as apex institutions for such state level and regional institutions. The role of RBI became concentrated after the establishment of these institutions. The Functions of RBI evolved with expansion of banking. RBI played a vital role to make the banking facilities available in the concerned areas. Banking reached to remote areas of the country. SBI was formed in 1955. Imperial bank of India was converted in State bank of India in the year 1955. Then came the period of very critical moves of the Indian banking history when 14 banks were nationalized in 1969 and in 1980 when 6 more banks were nationalized. These bold moves led to the increased network in the rural areas of the country where most of the population was based. The traditional credit was for agriculture and a specialized institution being established in 1963 with name of Agriculture Finance Corporation (AFC) which later converted into NABARD in 1982. The role of RBI expanded

after these institutions as these institutions helped the country to evolve with better banking facilities.

Functions of Reserve Bank of India

These are some basic roles which RBI performs in the country:

Issue currency notes: RBI is only authorized government body to issue notes in the country. It has one issuing department to issue notes of 2, 5, 10, 20, 50, 100, 500 and 1000. One rupee note is issued by the finance ministry of central government.

Bank of the Government: RBI is known as the banker or Agent of central government. It holds deposit of the government and pays on the demand of government. It also gives timely advice to the government on the financial policies. RBI issues bonds for the government and manages debt for them with appropriate charges.

Bank of the banks: RBI also performs the job of banker for the all the banks in India. All banks who came under RBI act, have to put their cash reserves at the rate called CRR with RBI. RBI will regulate and supervise the operations of banks as soon as they are incorporated under the RBI Act.

Banking System Regulator: RBI is responsible for the regulation of Indian banking system. All banks who comes under RBI Act 1949 are bound follow the guidelines issued by RBI. RBI has powers of licensing, management, expansion, inspection and direction in this regard.

Clearing House: RBI is responsible for the settlements among the banks. It runs clearing houses in major cities to for the settlements and smooth transaction of cash between banks.

Credit Control: Credit Control is another important role that RBI performs. RBI performs credit control duty with the help of qualitative and quantitative instruments. Some qualitative measures are selective credit control, rationing of credit, moral persuasion and direct action. Bank Rate, Cash Reserve Ratio, Statutory Liquidity Ratio, Repo & Reverse Repo and Open Market Operations are quantitative instruments to control credit.

THE ROLE OF THE BANK POST 1990:

In the early 1990s, the country was faced with the crisis of maintaining its diminishing foreign exchange reserves. There was a need to put in place a new economic framework and policies so as to deal with this situation. This period saw the introduction of economic reforms which made the environment more conducive for the functioning of the private sector. During this period it was the Reserve Bank of India which was entrusted with the task of regulating the new system that was put in place, bringing in technology to strengthen, modernize and make the functioning of banks more efficient, introducing varied monetary policy instruments and management of currency.

As of today, keeping in line with the changes that need to be incorporated in the functioning of the Central Bank, the bank is divided into 27 departments where each department is responsible for policy making in a particular area

assigned to it. Depending on the requirement the bank has in the past added new departments and closed down some of the existing departments.

The Central Board has the responsibility of the proper functioning of the Central Bank. The aim of the Central Bank is to ensure stability of prices while supporting economic growth. The role of the central Bank has evolved over the years from being the implementer of the monetary policy to include other functions such as regulation and supervision of the country's banking system. Moreover it has also gained greater autonomy in its functioning with regards to managing its own personnel, financing expenditure for the government where the RBI (rather than the government) can decide the amount of funding provided to the government, this further means that the monetary policy can be implemented independently of the fiscal policy and the new instruments introduced by RBI give it more flexibility so to better respond to changing macroeconomic environment.

Post 1990, various changes have been made by the bank in its structure and operations to deal with the responsibilities thrust on it. In the year 1994 the Board for Financial Supervision was formed and was given that task of regulating, auditing and supervising banks, NBFCs, and financial institutions. Although the body exists under the RBI it is independent in its functioning which is not the case for many Central Banks across the world. In the year 1995, Bhartiya Reserve Bank Note Mudran Private Limited was formed as a subsidiary of RBI. The reason for its formation was the management of the bank's two printing presses so as to handle the supply of currency in the economy when needed. The Financial Markets Committee (FMC) has been

established in the year 1997 and is responsible for providing inputs on a daily basis with regards to the same. The Technical Advisory Committee (TAC) has been formed in July 2005 where its role is to advise the bank on the actions that it should take while reviewing the monetary policy. Also introduced in the second half of 2005 were the pre – consultation meetings and resource management discussions (conducted every year) where apart from the Indian Bank’s Association, representatives from other banking and financial institutions are also present so as to give their opinions and views regarding which direction the economy is headed before the monetary policy review. Such interactions will make the policy review inclusive and transparent. Another area of change in the recent past is more interaction by the bank with the journalists and the media resulting in better dissemination of information.

NEW MONETARY POLICY INSTRUMENTS INTRODUCED AFTER 1990:

Apart from the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR), the bank in the last decade has introduced other instruments such as Open Market Operations (OMO) and Liquidity Adjustment Facility (LAF) to manage short term liquidity requirements for banks, also introduced in 2004 was the Market Stabilization Scheme (MSS) for managing excess liquidity because of inflow of capital into the country from abroad. The portfolio of monetary policy tools that the bank has, gives it the required flexibility to deal with the changing macroeconomic conditions and make monetary policy transmission more efficient and effective.

To protect the monetary policy from being impacted by the fiscal policy (fiscal deficit monetization), the Fiscal Responsibility and Budget Management Act was passed in the year 2003, this has given more autonomy and control to the bank with respect to the monetary policy. The bank has also given its view with regards to inflation where according to it the upper limit on the inflation should be around 5 %. This has influenced the acceptable level of inflation to come down. The RBI has had the freedom to make changes with respect to the mandatory provisions that banks have to make (such as CRR and SLR which are direct monetary policy tools) and the assignment of risk weights as and when needed.

EVOLVING SUPERVISORY ROLE:

There has been a gradual shift in the supervisory and regulatory roles that RBI had been assigned. Initially the Central bank was mainly concerned with maintaining solvency of banks operating in the system where it issued directives and guidelines with regards to granting of licenses, the level of reserves to be maintained, specifying interest rates for lending and deposits, requirement of capital. Whereas now the RBI is trying to put in place processes which take into account the country's economic condition and are in line with those followed by Central banks across the world.

The Central Bank has successfully handled the role of a supervisor for the changing Indian banking industry. Earlier Central Bank was more concerned with ensuring that the banks in the system were adhering to the all the safeguards laid down by it. The approach used gave more importance to a bank's financial statements and checking for any incidence of non -

compliance (offsite, onsite inspections, CAMELS method). Under this approach the information that could be obtained from the bank's financial statements was used as the criterion by the auditors to form any judgment about the bank. This approach had been sufficient in the recent past when the banks in the system had limited their business to lending out and getting deposits. However post 2000; the banking industry has seen the arrival of technology and the introduction of extremely complex financial instruments or products (for instance Securitization, Derivatives) which have linkages across different markets. This has made the supervisory role of the bank even tougher. With the complexity and the risk in the banking system increasing the earlier method of supervising the banks is no longer sufficient. It fails to take an overall view of the bank's business. It does not look at how much risk the bank is facing, whether it is able to understand it and is in a position to manage it.

Thus the Central bank is now focusing on the Risk Based method for supervising banks. This is still an ongoing process. Through this method the level of risk associated with a particular bank can be estimated and a specific supervisory plan can be developed for the bank. The following diagram shows the steps involved in risk based assessment.

SUPERVISION CYCLE:

Understanding the bank profile and developing a Risk Matrix based on inputs from offsite monitoring and surveillance, internal capital adequacy assessment, audit reports, market intelligence

Planning the supervisory action to be taken, defining its scope and objective and communicating it to the management of the bank

Discussion with management, Monitoring action plan, mitigation of risk, required level of supervision

Surveillance Review and Evaluation Process, Assessment of Capital, onsite inspection and determining the risk rating

The Risk Assessment Matrix combined with the Risk Impact Rating gives the level of supervision needed for the bank.

The Risk Assessment Matrix is as given below:

Risk Group

Weights

Risk (Net)

85%

Risk(OG) 15%

Risk (inherent)

Risk (control)

Risk associated with governance and oversight

Credit Risk (CR)

30%

70%

30%

Market Risk (MR)

20%

70%

30%

Operational Risk (OR)

20%

70%

30%

Liquidity Risk (LR)

20%

70%

30%

Pillar 2 Risk (P2)

10%

70%

30%

Now for any group say Credit Risk

Risk Credit = $0.7 * \text{Risk Inherent} + 0.3 * \text{Risk Control}$

Similarly it can be calculated for all other groups.

Now the Risk (Net) = $0.85 * (0.3 * \text{Risk Credit} + 0.2 * \text{Risk Market} + 0.2 * \text{Risk Operations} + 0.2 * \text{Risk Liquidity} + 0.1 * \text{Risk Pillar2}) + 0.15 * \text{Risk OG}$

Risk of Failure = $0.2 * (\text{Risk (Net)}^2 + \text{Capital available})$

The risk of failure is arranged on a linear scale from 0 to 4. The score obtained above is then combined with the Impact Rating (again arranged on a scale from 0 to 4) to get the necessary supervisory action to be taken for the bank. The impact rating is dependent on the following factors:

Size

Interconnectedness

Cross Jurisdictional activities

Complexity

Infrastructure

Each factor is again assigned a weight and is further dependent on impact indicators.

Risk Impact Index Matrix

Risk Failure

Impact Rating

16

64

144

256

9

36

81

144

4

16

36

64

1

4

9

16

$$\text{Risk Impact Index} = (\text{Risk Failure})^2 * (\text{Impact Rating})^2$$

For the matrix shown above in column 1 Risk Failure = 1 and Risk Impact varies between 1 to 4, similarly in column 2 Risk Failure = 2 and Risk Impact again varies between 1 to 4. Each bank will lie in one of the boxes and the different colors indicate the type of supervision needed for a particular bank.

The type of supervision recommended by the Central Bank is as follows:

Color

Supervision Needed

Baseline Monitoring

Close Monitoring

Active Oversight

Corrective Action

The level of monitoring becomes more stringent as we move down the above table. For banks with high risk of failure (say 4) the action is stringent irrespective of the impact rating.

Future Outlook

Comparison of RBI with other central banks of the world

On comparing RBI with other central banks of the world, we see that each bank adopts different tools despite having similar objectives. The difference in the same can be seen in the structure of the balance sheet of the respective countries.

Some of the salient features of major world banks are:

FED

In USA, the central bank controls the fund rates through Open Market Operations or OMO by infusing or absorbing liquidity through the purchase or selling of US treasuries. Other tools used are Discount rate facility and Reserve requirements which help control the banks. FED also introduced certain new tools such as term deposit facility, primary dealer credit facility etc. after the 2008 crisis where poor regulations were attributed to the market crash. USA is thus follows an active market based system.

ECB

ECB on the other hand follows more of a bank based approach. Though ECB also adopts OMO, it follows a different approach where it produces money and lends it to banks similar to a repo transaction where the preferred collateral is government bonds.

This difference can also be attributed to the history of the nation with USA traditionally being a supporter of open market. Hence during the crisis, the FED responded by providing liquidity to entities such as Mutual funds,

Primary dealers etc. while ECB s approach was centered on the various central banks.

Comparison with RBI

On comparison of the above banks with RBI, we clearly see certain similarities as well as differences. India being a developing nation does not hold the power of developed nations and hence RBI uses both Repo transactions as well as OMO purchases to control the financial system of the nation.

India predominantly follows a bank based system where the RBI controls the banks and lays down guidelines for its operation. This has helped put in place a strong foundation for the growth of the nation but looking forward with the development of financial markets in India, the RBI would need to ease down regulations in order to help the nation progress. Currently the banking industry in India is unattractive for players to enter due to stiff competition as well as guidelines from the RBI.

The comparison of the balance sheet of RBI with other central banks revealed some interesting insights. For the analysis, we compare RBI's balance sheet with balance sheets of central banks of both developed and developing nations. The banks we have taken into consideration are the USA's Federal Reserve, European Central Bank, Swiss National Bank (SNB) and Brazil's Banco Central Do Brazil (BCB). For Europe, balance sheet of ECB and 17 other national banks have been combined to give a better idea. This has been named as ESCB or European System of Central Banks.

From the diagram we see that central banks of developed economies rely more on bank reserves for creating liquidity (Bank Reserves 2% to 53% in 2011 for Fed). The share in currency during the period has decreased. For RBI we see that there has been no major change during the years.

Analysis of the graph above shows that for developed economies, domestic assets form the largest share of assets while for India the share of domestic assets has increased over the years. From the above analysis, we see how having good regulations helped India ride out the 2008 crisis without any major losses while we see significant changes for developed nations.

India is thus heading in the right direction in terms of how the central bank is molding itself to propel India's growth in the future.

Bond Market in India

The corporate bond market in India is currently underdeveloped with high financing costs acting as a hindrance for firms to raise money through this avenue. On analyzing the financing policies of firms from 2000-01 to 2010-11 we see that of the total debt raised by companies the proportion of debt raised from banks has increased from 14% to 18% while the debt from bond markets has stagnated and rose only marginally from 3.5% to 3.9%.

Even though the corporate bond market in India is underdeveloped at the moment, it is clear that in order for India to be a developed nation bond markets have to be come up in order to ease the capital pressure on the banks. In this context the role of RBI going forward will change. Currently we see that there is lag whenever RBI announces a policy since banks take time

in responding to directives like say a cut in interest rate while an active bond market will ensure such lag is eliminated. A cut in interest rate by the RBI will increase the bond prices in the market and thus help in faster policy implementation.

ROAD AHEAD

From the above analysis we see how the role of RBI has changed over the years and how it fares in comparison to other central banks of the world. The measures taken by the RBI has ensured we have a strong financial foundation which has helped propelled the growth of the nation.

Going forward, with the development of financial markets (strong equity market and inevitable development of bond market) RBI should change its role to attract investors and bring in more capital to help fuel the growth of India. RBI thus needs to ease regulation in a way which would make banking attractive and promote the good institutions in the system but at the same time learn from the mistakes committed by developed nations in ensuring we have strong regulations which help prevent potential crisis. The RBI can thus ensure that the late entry of India can thus work in its favor in ensuring that the banking industry keeps pace with the growth of the nation and helps India become a developed nation in the near future.