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# SHARP'S

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(Central Banking)  
(Paper - II)

**M. Com. - I, (Sem. - I)**

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# Syllabus

## M.Com.- I (Sem. - I) Advanced Banking & Finance Central Banking (Paper - II)

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# **SHARP'S**

## **NOTES ON**

### **ADVANCED BANKING & FINANCE**

#### **(Central Banking) (Paper-II)**

##### **M.Com. - I (Sem. - I)**

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# Changing Role and Need of Central Banking

**UNIT**

**1**

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**Q.1. Explain in detail about the Origin and Evolution of Central Banking in the World.**

**Ans: Introduction:**

From the evolution of money, the modern banking business evolved through the amalgamation of functions of the trader, the moneylender and the English goldsmith. Gradually coins of precious metals gave way to paper currency issued by banks. Due to many disturbances in issue of bank notes, it was thought necessary to regulate the issue of notes and the banking business to safeguard the interest of depositors. The nature of banks being social it was thought necessary that some kind of control over them was necessary. The central bank regulates the monetary and banking system of a country.

**Origin and Evolution of Central Banking:**

The central bank stands on a different footing as compared to commercial banks. Its object is social good and not for profit. It is given many regulatory powers. To carry out its responsibility. Therefore its functions are different and they evolved according to the needs of time and place and not through any conscious thought and planning. It has close contact with the Government and today it is considered to be a part of Government's regulatory system.

**1) History of Bank of England:**

The evolution of central banking can be best understood by studying the history of the Bank of England. It was established in 1694 as a private bank on joint stock basis by the authority of a special act of parliament. It was initially given partial monopoly of note issue within a radius of 65 miles from London but to avoid chaos in note issue and to achieve economies of scale, the bank was given monopoly of note issue in 1844.

**2) Bank for Government Transactions:**

Later the government needed and obtained loan from the Bank of England in return for which it got some special rights and deposits accounts of the government. Government transactions were carried out through it. It thus

became government's banker. It was the biggest commercial bank with government connections and so it got added prestige. In 1751 it was entrusted with work of floating government loans and managing them.

**3) Banker's Bank:**

In due course, many small banks were established. To facilitate interbank transactions, these small banks started keeping deposits with the Bank. From this developed the function of banker's bank. These deposits were used to help a bank in difficulty. Bank of England also functioned as a clearing House. Later the bank was empowered to compel banks to keep a certain proportion of deposits with it in cash. The CARR became an instrument of credit control.

**4) Centre of Monetary and Banking System:**

During the crises of 1847 and 1960s many banks failed. It was argued that the Bank should act as guardian of banks and lender of the last resort and it has become its legal obligation. The Bank of England came to be known as the centre of monetary and banking system. It was expected to be guided by public welfare rather than profit.

**5) Conclusion:**

During the Second World War it managed foreign exchange regulations, took care of the exchange rate. The Bank of England was formally nationalized in 1946. It will thus be seen that the Bank of England represents the evolution of central banking functions.

**Q.2. Explain Evolution of Reserve Bank of India.****Ans: Introduction:**

In fact, the RBI was established in 1935 by a Special Act and was modeled on the pattern of Bank of England. A full-fledged central bank was established overnight and one cannot speak of its evolution. However, we can discuss the central banking arrangements existing in India prior to 1935.

**Evolution of Reserve Bank of India:**

Evolution of Reserve Bank of India explained with following points:

**1) First Commercial Bank:**

The first commercial bank in India Bank of Hindustan was established in 1770. Warren Hastings had recommended the establishment of a central bank in 1773, but it was considered to be a premature suggestion.

**2) Establishment of Three Banks:**

During 1806 to 1843, three Presidential Banks were established with Government participation and encouragement. The Government contributed 20% of their capital and they worked as bankers to the Government and held its balances. They were also given right of note issue for some time.

**3) Imperial Bank as Central Bank:**

In 1921, the three presidency banks were amalgamated and the new Imperial Bank of India has almost become the central bank. It held Government accounts, acted as its representative, gave short term loan to Government and other banks kept their deposits with it.

**4) Establishment of RBI:**

The Hilton Young Commission (1926) and the Central Banking Enquiry Committee strongly recommended establishment of a separate central bank for India. In keeping with the then prevailing thought the RBI was established in India as central bank in 1935 as private shareholders bank with a view to keeping it away from political interference. However, it was to act in public interest and there was limitation on profit distribution. It started doing all the functions of a central bank.

It was nationalized in 1948 and started working as a state owned and state regulated central bank from 1-1-49. However this change of ownership was only formal. There was no material change in its functions.

Right from its inception the RBI was asked to strive to improve agricultural credit. This promotional function was extended after nationalization. It was burdened with additional promotional responsibilities of industrial finance export finance, rural credit foreign exchange controls in addition to regulating and supervising both commercial and co-operative banks. It manages the huge issue of public debt of both the State and Central governments.

**5) Establishment of Apex Institutions:**

In order to relieve it of its overburden new institutions like DEBI, NABARD. Exam Bank was established to work as Apex institutions in their respective areas. Thus, RBI has been helping India's developmental efforts through its traditional and promotional functions.

**6) Organisation of RBI:**

The RBI was constituted as a private shareholder's bank with a share capital of Rs. 5 crore. A very small part of it was owned by the central government to enable it to represent on the Board of Directors. Care was taken to see that the shares of RBI do not get concentrated in a few hands. The shares were allotted equally in five regions. There was ceiling on maximum voting rights of shareholders.

The RBI was nationalized in 1948 and the entire share capital was owned by the central govt. The nationalization of central banks was the world trend after the 11 world war. The RBI is now managed by a Central Board of Directors consisting of Governor and not more than 4 Day. Governors appointed by the Central Govt. for a period not exceeding five years. Four Directors are

nominated by the Central Government one each from the four Local Boards of the regions. Their term of office depends on the tenure of the membership on the Board. Three directors are nominated by the Central Govt. for a period of 4 years. One Govt. official from the finance ministry is nominated by the Central Govt.

There is an Executive Committee from among the members of the Central Board, which takes routine decisions in the light of the policy laid down by the Central Board. Besides the Central Board of Directors, there are local B cards for the four regions with Head Quarters at Bombay, Calcutta, Chennai and New Delhi. Each local Board consists of five members appointed for a term of 4 years to represent territorial and economic interests including those of co-operative movement. These boards are of advisory nature and they perform such duties as may be assigned to them by the Central Board. Generally, branch expansion programs for the regions are recommended by them.

The RBI has its Head Quarter in Bombay and branches at capital cities of the states. It manages clearing houses through its branches and where, there is no RBI branch, the state Bank of India acts as its representative. It also has currency chests throughout the country through which currency needs of the public are met.

**Q.3. The need for Central Banking arises out of the functions it performs  
Assess the statement.**

**OR**

**The Need and Rationales of a Central Bank are well out in the functions that any Central Bank Performs? Justify.**

**Ans: Introduction:**

Prior to 1925, the banking business in India was not regulated properly. In 1925, the Hilton Young Commission was appointed, although the terms of reference did not provide anything about the establishment of a central Bank in the country. The commission in its report submitted in 1926, strongly recommended establishment of central Bank in the country. It also suggested that it should be called the Reserve Bank of India and that it should take over the central banking functions that the Imperial bank had been performing so far. In compliance with the recommendation a bill was introduced in the Legislative Assembly in January 1927. Unfortunately, the bill was abandoned on account of disagreement between the Government and the Assembly.

**Need and Rationales of a Central Bank:**

Need and rationales of a central bank explained with following points:

**1) Management of Monetary System:**

The monetary system requires management. Money will not manage itself. There must be a central authority to regulate money supply in accordance with the requirements of the economy to maintain and promote economic stability. That central authority is the central Bank.

**2) Central and Regulation of Banking System:**

The banking system requires control and regulation. Cheque and bank deposits constitute bank money and bank money constitutes an overwhelming proportion of total money supply in the country. Hence too much credit reaction by banks will generate inflationary pressures. So, a central authority directing the banks to pursue policies appropriate under particular economic situation is quite necessary. That central authority is the central Bank.

**3) Development Banking Facilities:**

The question assumed importance in 1931 when the Central Banking Enquiry Committee recommended the creation of a Reserve Bank at the earliest possible date with a new in developing banking facilities in India and bringing about rapid economic development in the country.

**4) The Improve Credit Facilities:**

It is establishment to strive to improve agricultural credit. This promotional function was extended after nationalization. Now it is burdened with additional promotional responsibilities of industrial finance, export finance, and rural credit, foreign exchange control in addition regulating and supervising both commercial and co-operative banks. It manages the huge issue of public debt of both the state and central Govts.

**Q.4. Explain the Emerging Role of Central Bank in Emerging Economies.****Ans: Introduction:**

The Reserve Bank, established through the Reserve Bank of India Act, 1934 commenced its operations in 1935. It draws its powers and responsibilities through other legislations also such as the Banking Regulation Act, 1949. The Reserve Bank has over the years been responding to changing economic circumstances and these organizational developments have been documented in a recent Report on Currency and Finance for the year 2004-05, the theme of which was "The Evolution of Central Banking in India"..

**Emerging Role of Central Bank in Emerging Economies:**

Emerging role of central bank in emerging economies explained with following points:

**1) Adaptation of New Economic Realities:**

First, compared with several countries which introduced rapid reforms in central banking law and governance in the last about two decades, the Indian

experience reflects an evolution or adaptation of central banking to new economic realities. These changes were brought about both through some legislative measures and changes in operating procedures.

**2) Greater Autonomy to the Central Bank:**

Second, this evolution has inter alia contributed to imparting some autonomy to the central bank, de facto, particularly in the areas of monetary management and financial regulation.

**3) Increased Public Credibility:**

Third, in sharp contrast to the situation before 1991, since then, apart from a transparent communications policy and a broad based consultative approach to policy making, Governors' speeches and appearances on the electronic media and the press have been substantial, having significant influence on markets and opinions. In the process, the Reserve Bank has gained reputational bonus and public credibility.

**4) Efficient and Resilient:**

Fourth, thanks to related developments in the last 15 years, financial and external sectors in India have also become relatively more efficient and resilient.

**5) Effective Policy Framework:**

Fifth, while the effectiveness of monetary policy has improved significantly to meet the evolving demands, some constraints are persisting, which impact the choice and effectiveness of our policy framework.

**6) Introduction of Sterilization Mechanism:**

In the era of globalization, India is following flexible exchange rate policy where the exchange rate is market determined but the government reserves the provision to intervene in extreme cases. It is known as dirty float mechanism. When there is an excess inflow of the foreign fund in the economy as Foreign Institutional Investors (Fijis) are penetrating into Indian Market in order to enjoy the interest rate arbitrage, as an immediate effect, there will be an appreciation of the home currency.

**7) Shift from Direct Fiscal Support to Development Activities:**

The RBI has gradually withdrawn from the practice of providing concessional finance or refinance for specified sectors such as agriculture, industry and export, though the legal provisions continue to enable it. In the same view, as part of strengthening monetary management, only notional provisions are made out of RBI profits for Agriculture, Industrial and Housing Credit Funds. No doubt, there are persistent demands on RBI to reverse the process, but the RBI advocates direct fiscal support to development activities so, as to be transparent, accountable and quantifiable rather than through monetary operations of RBI, which would tantamount to quasi-fiscal operations.

**8) Other Changing Paradigm:**

The RBI practice is now subject to the current legal framework and operates as a monetary authority with multiple objectives and multiple functions assigned to it. Within such a mandate, efforts are made to (a) articulate the hierarchy of objectives in a given context (b) impart transparency through enhanced communication, emphasis participative nature of decision making in its activities, including monetary management, through advisory committees and (c) move towards greater autonomy in operations relating to monetary policy while ensuring harmony in macro policies in co-ordination with the government.

**Q.5. Explain the Autonomy of Central Banks.****Ans: Introduction:**

In recent years there is a strong demand for central bank independence. Monetary policy independence is not necessary primarily in order to protect a 'conservative' central banker from the influence that a less 'conservative' government might seek to bring to bear, but rather to enable central bankers with a longer-term decision horizon (and/or a lower rate of time preference) to assert their authority when faced with a government with a shorter planning "horizon (and/or a higher rate of time preference).

**Autonomy of Central Banks:**

Autonomy of Central Banks explained with following points:

**1) Goal Independence:**

The definition of the goals of monetary policy includes not only the choice between price stability and nominal GDP, but also a definition of the time horizon for their realisation, the definition of concrete indices, their numerical target values and the definition of escape clauses.

Thus, 'goal independence' can take various different forms. It can include a framework wherein the central bank has complete freedom on all these issues, as well as a framework wherein it can decide on only some of these issues. In reality, one can find three variants of the definition of goal independence.

In the USA monetary policy seeks to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. But 'stable long-term interest rates' is not compatible with the standard definition of the goals of monetary policy. Long-term interest rates are, at best, an intermediate target.

The European Central Bank is granted a somewhat more limited degree of goal independence. Similar arrangements are found in Japan and, to some extent, in Sweden.

A low degree of goal independence characterises the central bank legislation of the United Kingdom, Canada, and New Zealand. In these countries, the central bank legislation defines price stability as the main goal of monetary policy, but gives the government the right to determine the concrete target values.

The most important prediction of both theoretical and empirical literatures is that a central bank should have instrument independence, but should not have goal independence.

There are no permanent trade-offs between price stability and other macroeconomic targets. Therefore, there is no real choice that 'elected officials' could make for the population in the long run. In the short-term, supply shocks make it necessary to allow for deviations from a medium-term inflation target. But entrusting the government or the parliament with this decision could clearly lead to the risk of an inflation bias. This leads to a possible trade-off between:

- a) A more flexible response of monetary policy in the case of supply shocks, but only if the central bank is overly committed to price stability.
- b) Reduced political independence of monetary policy with all the attendant risks.

## **2) Instrument Independence:**

Instrument independence implies that a central bank is able to set its operating targets without any interference from the government. It includes three important elements:

- a) Control of the short-term interest rate as the most important operating target of monetary policy.
- b) Control of the exchange rate, which can be used as an additional operating target, especially in a relatively open economy.
- c) Restrictions of central bank credits to the government, which could undermine the control over the monetary base and, thus, over short-term interest rates.

Instrument independence constitutes an indispensable element of stability-oriented central bank legislation. Inflation targeting seems to be the most effective and it leads to the most democratically accountable policy-making when the central bank is instrument independent but not fully goal dependent.

In most countries monetary policy can determine interest rates in an autonomous way. However, as in the case of goal independence, there are countries where the government can still override the central bank's decisions.

As far as the control over the exchange rate is concerned, there is at present no central bank that has unlimited responsibility for this target of monetary policy. Only the ECB makes a distinction between formal exchange arrangements and a policy of managed floating.

The central banks in all other countries have very limited responsibilities in the field of exchange rate policy. All central bank acts assign this responsibility' without qualifications to the government.

A third element of instrument independence concerns the explicit limitations for central bank lending to the government. This relates exclusively to direct lending to the public sector. It is, therefore, perfectly compatible with the EC Treaty.

By purchasing government bonds from the commercial banks as part of its open-market policy a central bank can easily bypass the prohibition on deficit financing and conduct its money market management essentially on outright open-market operations.

In other central bank acts, no similar regulations can be found. However, it is 'conceivable that a monetary policy geared to price stability might be guaranteed simply by giving a politically independent central bank the power to decide of its own accord when and how much to lend to public sector borrowers'.

But then there is always the danger of a central bank giving in to political pressure and thus promoting inflationary financing of government-expenditure.

### **3) Personal Independence:**

Even if central bankers are granted instrument and/or goal independence, the government could try to exert some informal pressure on monetary policy. For instance, if the central bank governor could be dismissed at any time, and without specific reasons at the discretion of the government, he or she would be in a rather weak position vis-a-vis the minister of finance or the head of the government.

A strong informal influence on the central bank can also be exerted if only one person, i.e., the governor, is in charge of monetary policy decisions. In this case it is sufficient that the government sends a depicted partisan to the top of the central bank.

To sum up, there is an inherent inflation bias mainly due to a short-term time horizon of politicians. This calls for a central bank legislation that provides central bankers with independence from politicians and with long-terms of office, which is a very efficient means of insulating central bankers from the government.

# Advanced Banking And Finance (Central Banking)



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