

## MONETARY SYSTEM (continued)

### Types of Monetary System

#### 1. **Contractionary Monetary Policy or Dear Money Policy**

- It is pursued to control Inflation
- CRR is increased. Due to this increase lending capacity of the banks decrease
- SLR is also increased
- Bank rate is increased. This leads to RBI charging higher rate of interest on bank lending due to which banks borrow less from RBI.
- Repo Rate is increased
- Reverse Repo Rate is also increased. This leads to, RBI paying more interest on Banks deposits. Thus Banks prefer to deposit extra money with RBI instead of giving loans to public.
- It is called Dear Money Policy as loans get expensive for the public

#### Difference between Bank Rate and Repo Rate

- **Bank rate** is that interest rate at which banks borrow from RBI against First Class Securities, Securities of private companies and re-discounting.
- **Repo Rate** is that rate at which Banks borrow from RBI against Government Securities.

#### 2. **Expansionary Monetary Policy or Cheap Money Supply**

- This policy is adopted to increase money supply in the economy in order to stimulate economic growth.
- It is also pursued to overcome recession.
- CRR, SLR, Repo Rate, Re Repo Rate, Bank Rate should be reduced.
- It is called Cheap Money policy as interest rates are low thus borrowing money becomes cheap.

#### Objectives of Monetary Policy

1. To Stimulate Growth
2. To Control Inflation

Since 2010 RBI has adopted Contractionary Money Policy. In 2009 to stimulate economic growth after global recession, RBI adopted Expansionary Monetary Policy.

## FINANCIAL INSTITUTIONS and BANKING

- Financial Institution is any institution or company which raise funds from the public for lending purpose.
- They promote capital formation which is crucial for economic growth
- FIs are classified in three broad categories:-
  - Bank
  - Development Finance Institutions (DFI)
    - NABARD
    - SIDBI
  - Non-Banking Financial Institutions (NBFIs) or Non-Banking Financial Companies (NBFCs)

### Banks

- Banks can be classified into four types:-
  - Cooperative Banks
  - Commercial Banks
  - Regional Rural Banks (RRB)
  - Local Area Banks (LAB)

#### **Functions of Banks**

1. Acceptance of deposits from the public
2. Provide demand withdrawal facility
3. Lending facility

**Cooperative Banks**

- These banks are organised under state government's act
- They give short term loans to agriculture sector and other allied activities
- Main goal of Cooperative Banks is to promote social welfare by providing concessional loans
- They are organised in the 3 tier structure
  - Tier 1 (State Level) – State Cooperative Banks (regulated by RBI, State Govt, NABARD)
    - Funded by RBI, government, NABARD. Money is then distributed to public
    - Concessional CRR, SLR is applicable to these banks. (CRR- 3%, SLR- 25%)
    - Owned by state government and top management is elected by members
  - Tier 2 (District Level) – Central/District Cooperative Banks
  - Tier 3 (Village Level) – Primary Agriculture Cooperative Banks

**Commercial Banks**

- Organised under the Banking Companies Act, 1956
- They operate on commercial basis and its main objective is profit.
- They have unified structure and are owned by government, state, or any private entity.
- They tend to all sectors ranging from rural to urban
- These banks do not charge concessional interest rates unless instructed by the RBI
- Public deposits are the main source of funds for these banks

**Regional Rural Banks**

- These are special type of commercial Banks that provide concessional credit to agriculture and rural sector.
- RRBs are established in 1975 and are registered under a Regional Rural Bank Act, 1976.
- RRBs are joint venture between Central government (50%), State government (15%) and a Commercial Bank (35%).
- 196 RRBs have been established from 1987 to 2005.
- From 2005 onwards government started merger of RRBs thus reducing the number of RRBs to 82
- One RRB cannot open its branches in more than 3 geographically connected districts.

**Local Area Banks**

- Introduced in India in the year 1996
- These are organized by private sector
- Earning profit is the main objective of Local Area Banks
- Local Area Banks are registered under companies Act, 1956
- At present there are only 4 Local Area Banks all which are located in South India

**Development Finance Institutions**

- Prime objective of DFI is economic development of the country
- These banks provide financial as well as technical sector to various sectors
- DFIs do not accept deposits from people
- They raise funds by borrowing funds from governments and by selling their bonds to general public
- Types of Finance provided are – Medium (1 – 5 years) and Long term (>5 years)
- It also provides guarantee to banks on behalf of companies and subscription to shares, debentures etc.

- Underwriting enables firms to raise funds from the public. In Underwriting a financial institution guarantees to purchase a certain percentage of shares of a company which is issuing IPO if it not subscribed by Public.
- They also provide technical assistance like Project Report, Viability study and consultancy services.

**Some Important DFIs (Sector Specific)**

➤ **Industry**

- IFCI – 1<sup>st</sup> DFI in India. Industrial Corporation of India established in 1948.
- ICICI – Industrial Credit and Investment Corporation of India Limited established in 1955 by an initiative of World Bank.
  - It established its subsidiary company ICICI Bank limited in 1994.
  - In 2002, ICICI limited was merged into ICICI Bank Limited making it the first universal bank of the country.
  - Universal Bank – Any Financial institution performing function of Commercial Bank + DFI
  - It was established in private Sector and is still the Only DFI in private sector.
- IDBI – Industrial Development Bank of India was set up in 1964 under RBI and was granted autonomy in 1976
  - It is responsible for ensuring adequate flow of credit to various sectors
  - It was converted into a Universal Bank in 2003
- IRCI – Industrial Reconstruction Corporation of India was set up in 1971.
  - It was set up to revive weak units and provide financial & technical assistance.
- SIDBI – Small Industries development bank of India was established in 1989.
  - Was established as a subsidiary of IDBI
  - It was granted autonomy in 1998

➤ **Foreign Trade**

- EXIM Bank – Export Import Bank was established in January 1982 and is the apex institution in the area of foreign trade investment
  - Provides technical assistance and loan to exporters

➤ **Agriculture Sector**

- NABARD – National Bank for agriculture and rural development was established in July 1982
  - It was established on the recommendation of Shivraman Committee
  - It is the apex institution in the area of agriculture and rural sectors
  - It functions as a refinancing institution

➤ **Housing**

- NHB- National Housing Bank was established in 1988.
  - It is the apex institution in Housing Finance

**HDFC Bank** – Housing Development Finance Corporation. It is only a private sector bank and not an apex institution.

**NON BANKING FINANCIAL INSTITUTIONS**

**1. Mutual Funds**

- Mediators between people and stock exchange
- Money collected from people by selling their units is called corpus
- Oldest Mutual Fund company in India is UTI ( Unit Trust of India)
- Mutual Funds nearly provides all the considerations

**Risk is less in case of Mutual Funds** as firstly investment is made by experts and secondly it is diversified investment

**2. Insurance Companies**

- Collect money from public through sale of insurance policies

**Investment Considerations of a person**

1. Safety of the Investment
2. Returns on Investment
3. Liquidity of Investment

- There are two types of Insurance – Life Insurance and General Insurance
  - General Insurance includes Loss of property, car, house etc.
  - It also includes Health Insurance

**LIC – Life Insurance Corporation**

- Set up in 1956 by the government by nationalising all the existing private sector life insurance companies
- This was done due to large scale defaults

**GIC – General Insurance Corporation**

- It was established in 1973
- Subsidiaries of GIC are:-
  - NICL – National Insurance Company of India Limited
  - United India Insurance Company Limited
  - Oriental Insurance Company of India Limited
  - New India Insurance Company of India Limited

**ULIP – Unit Linked Insurance Plans**

- Mixture of Insurance and Mutual Funds

**3. Hedge Funds**

- These are mutual funds for rich investors
- Funds are raised through sale of their unit to High net worth Individuals and Institutional Investors
- Units of these are usually sold in chunks/groups
- There is a lock –in period for Hedge funds before which funds cannot be withdrawn
- Corpus is investment in risky instruments with a long term perspective

**4. Venture Capital Firms/ Companies**

- They provide finance and technical assistance to firms which undertake business project based on innovative ventures
- They provide finance for commercial application of new technology

**5. Merchant banks ( Investment Banks)**

- Merchant banks provide financial consultancy services
- They advise firms on fund raising, manage IPO of firms, underwrite new issues and facilitate demat trading.

**6. Finance Companies (Loan Companies)**

- Financial Institutions raise funds from public for lending purpose
- e.g. – Muthoot Finance, Cholamandalam

**7. Micro Finance Institutions (MFI)**

- Raise funds from public for lending to weaker sections
- In India they mainly raise funds from banks
- e.g. - Basix, Bandhan, SKS Micro Finance.

**8. Vulture Funds**

- These funds buy stocks of companies which are nearing bankruptcy at a very low price.

**In different sectors, companies are different**

**Life Insurance Companies**

- LIC
- ICICI prudential

**General Insurance Companies**

- GIC
- ICICI Lombard

**IRDA Act, 1999 – Insurance Regulatory and Development authority Act**

- Insurance companies were opened up for private companies
- Objective was to promote competition
- FDI was allowed upto 26% (Recently increased to 49%)
- IRDA was established as the regulator of insurance sector

- After purchasing such stocks they initiate the recovery process to increase the price of shares and sell it at a later point of time

**9. Islamic Banks**

- These banks provide loans on the basis of Islamic laws called sharia.
- In law of Sharia Interest cannot be charged on the loans

**10. Leasing Companies**

- They purchase equipment and machinery and provide the same to companies on a lease.
- These companies charge rent on these machinery which is similar to EMI

**SECURITIES**

- Can be broadly classified into
  - Bonds
    - Government Bonds
      - ✓ Treasury Bills – Short Term
      - ✓ Dated Securities – Long Term
    - Corporate
      - ✓ Debentures \_ Bonds issued by companies to general public against loans
  - Equities (Shares)
    - Ordinary Shares (Equity Shares)
    - Preference Shares

<b>FORMS OF BUSINESS ORGANISATION</b>	
<p><b>1. Proprietorship</b></p> <ul style="list-style-type: none"> <li>➤ Single person ownership</li> </ul> <p><b>2. Partnership</b></p> <ul style="list-style-type: none"> <li>➤ Two or more owners</li> </ul> <p><b>3. Hindu Undivided Family (HUF)</b></p> <ul style="list-style-type: none"> <li>➤ Similar to Partnership</li> <li>➤ Partners are members of family</li> <li>➤ Eldest member is called Karta.</li> </ul> <p><b>4. Limited Liability Partnership (LLP)</b></p>	<p>Similarity between the first three types is:-</p> <ul style="list-style-type: none"> <li>➤ Company and Owners are same entity</li> <li>➤ If company become bankrupt then property of owners can be sold off for recovery</li> </ul>
<p><b>5. Private Limited Company</b></p> <ul style="list-style-type: none"> <li>➤ Cannot issue its shares to general public i.e. IPO</li> <li>➤ Shares are held by few share holders</li> <li>➤ Number of shareholders is less</li> </ul> <p><b>6. Public Limited Company</b></p> <ul style="list-style-type: none"> <li>➤ Can issue shares to general public</li> <li>➤ Maybe be in Private sector or Public Sector</li> <li>➤ E.g. of Public Limited Company in Private Sector are TCS, Reliance</li> <li>➤ E.g. of Public Limited Company is Public Sector are IOC, SAIL, GAIL, NTPC</li> </ul>	<p><b>Limited</b> means liability of the owners is limited to their subscribed capital as company and owners are regarded as separate entity</p>