Dear Readers,

As per the demand of students who have cleared the RBI Grade B phase I, we bring to you the compilation of notes for the subject ***Finance for RBI Grade-B (Phase-II).***

The subject Finance is an optional subject, which deals with finance and economy. Keep in mind that the portion management is not covered in this section. You will have to manage the management portion on your own.

These notes more or less cover all the topics that are expected to come for the Subject Finance.

So go through them quickly so as to get a good idea before the exams.

REGULATORS OF BANKS AND FINANCIAL INSTITUTIONS:

The financial system in India is regulated by independent regulators in the field of banking, insurance, capital market, commodities market, and pension funds. However, Government of India plays a significant role in controlling the financial system in India and influences the roles of such regulators at least to some extent.

The following are five major financial regulatory bodies in India:- (We have given links for these bodies. For more details about these you can click and visit such websites)

(A) Statutory Bodies via parliamentary enactments:

1. Reserve Bank of India : Reserve Bank of India is the apex monetary Institution of India. It is also called as the central bank of the country.

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

It acts as the apex monetary authority of the country. The Central Office is where the Governor sits and is where policies are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India. **The preamble of the reserve bank of India is as follows:**

"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

2. Securities and Exchange Board of India : SEBI Act, 1992 : Securities and Exchange Board of India (SEBI) was first established in the year 1988 as a non-statutory body for regulating the securities market. It became an autonomous body in 1992 and more powers were given through an ordinance. Since then it regulates the market through its independent powers.

3. Insurance Regulatory and Development Authority : The Insurance Regulatory and Development Authority (IRDA) is a national agency of the Government of India and is based in Hyderabad (Andhra Pradesh). It was formed by an Act of Indian Parliament known as IRDA Act 1999, which was amended in 2002 to incorporate some emerging requirements. Mission of IRDA as stated in the act is "to protect the interests of the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto."

(B) Part of the Ministries of the Government of India :

4. Forward Market Commission India (FMC):: Forward Markets Commission (FMC) **headquartered at Mumbai, is a regulatory authority which is overseen by the** Ministry of Consumer Affairs, Food and Public Distribution, Govt. of India**. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952 This Commission allows commodity trading in 22 exchanges in India, out of which three are national level.**

5. PFRDA under the Finance Ministry : Pension Fund Regulatory and Development Authority : **PFRDA was established by Government of India on 23rd August, 2003. The Government has, through an executive order dated 10th October 2003, mandated PFRDA to act as a regulator for the pension sector. The mandate of PFRDA is development and regulation of pension sector in India.**

1. Financial Sector Development Council(FSDC):

Financial Stability and Development Council is the apex-level body constituted by Government of India. The idea to create such a super regulatory body was first mooted by Raghuram Rajan Committee in 1998. The recent global economic meltdown has put pressure on governments and institutions across globe to regulate the economic assets. This council is seen as an India's initiative to be better conditioned to prevent such incidents in future.

PRESENT CHAIRMAN:

ABOUT RBI

RBI is the **central Bank of India** and controls the entire money issue, circulation the entire money issue, circulation and control by its monetary policies and lending policies by periodical updates or corrections to discipline the economy.
The central bank of India, founded in **1935**, which maintains the monetary policy of its national currency, the rupee, and the nation's currency reserves.

It is also known as the **Bank of last resort/Banker's bank/Government's bank.**

Establishment:

The reserve bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank of India was initially established in Calcutta but was permanently moved to Mumbai in 1937. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

MAIN FUNCTIONS OF RBI:

1) **Monetary Authority:** Formulates implements and monitors the monetary policy.
2) **Regulator and supervisor of the financial system:** Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
3) **Manager of Foreign Exchange:** Manages the Foreign Exchange Management Act, 1999.
4) **Issuer of Currency:** Issues and exchanges or destroys currency and coins not fit for circulations.
5) **Development role:** Performs a wide range of promotional functions to support national objectives.
6) **Bankers to the Government:** performs merchant banking function for the central and the state governments; also acts as their banker.
7) **Bankers to banks:** maintains banking accounts of all scheduled banks.

Central Board of RBI:

The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. They are appointed/nominated for a period of four years

Official Directors:

Full-time : Governor and not more than four Deputy Governors
Currently:

- Dr. Raghuram Rajan (Governor)
- Shri H.R. Khan (Deputy Governor)
- Dr. Urjit R. Patel (Deputy Governor)
- Shri R. Gandhi (Deputy Governor)
- Shri S. S. Mundra (Deputy Governor)

Subsidiaries of RBI:

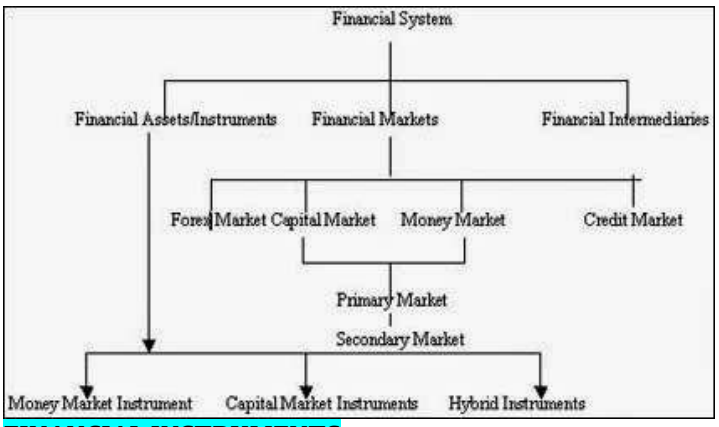
Fully owned: Deposit Insurance and Credit Guarantee Corporation of India(DICGC), Bharatiya Reserve Bank Note Mudran Private Limited(BRBNMPL)
.

Other Important facts related to RBI:

- Reserve Bank of India Act passed in 1934.
- Reserve Bank of India (RBI) established on 1 April 1935.
- Reserve Bank of India (RBI) established on the recommendation of Hilton-Young Commission.
- RBI is the sole authority in India to issue Bank notes in India.
- Emblem of RBI: Panther and Palm Tree.
- Chintaman Dwarkanath Deshmukh (C D Deshmukh) was the governor of RBI at the Time of nationalization of RBI in 1949.
- 1st women Deputy Governor of RBI -K.J.Udeshi.
- RBI is not expected to perform the function of accepting deposits from the general public
- The first Governor of the Reserve Bank of India from 01.04.1935 to 30.06.1937 was Sir Osborne Smith
- RBI decides the following rates namely; Bank rate, repo rate, reverse repo rate and cash reserve ratio.

FINANCIAL MARKET:

The term "finance" in our simple understanding it is perceived as equivalent to 'Money'.Finance exactly is not money, But it is the source of providing funds for a particular activity. The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other.



FINANCIAL INSTRUMENTS

Money Market Instruments
The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below:

1. Call /Notice-Money Market
Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "Call Money". When money
is borrowed or lent for more than a day and up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.

2. Inter-Bank Term Money
Inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call/Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

3. Treasury Bills.
Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue(91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

4. Certificate of Deposits
Certificates of Deposit (CDs) is a negotiable money market instrument and issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period.

5. Commercial Paper
CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces.

Capital Market Instruments
The capital market generally consists of the following long term period i.e., more than one year period, financial instruments; In the equity segment Equity shares, preference shares, convertible preference shares, non-convertible preference shares etc and in the debt segment debentures, zero coupon bonds, deep discount bonds etc.

Hybrid Instruments
Hybrid instruments have both the features of equity and debenture. This kind of instruments is called as hybrid instruments.
Examples are convertible debentures, warrants etc.

FINANCIAL MARKETS

Financial market is a market where financial instruments are exchanged or traded and helps in determining the prices of the assets that are traded in and is also called the price discovery process.

TYPES OF FINANCIAL MARKETS

Forex Market - The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe

MONEY MARKET:
The money market is a market for short-term funds, which deals in financial assets whose
period of maturity is up to one year. It should be noted that money market does not deal in
cash or money as such but simply provides a market for credit instruments such as bills of
exchange, promissory notes, commercial paper, treasury bills, etc.

CAPITAL MARKET
Capital Market may be defined as a market dealing in medium and long-term funds. It is an institutional arrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities. So it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue various securities such as shares debentures, bonds, etc. The market where securities are traded known as Securities market. It consists of two different segments namely primary and secondary market The primary market deals with new or fresh issue of securities and is, therefore, also known as new issue market; whereas the secondary market provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

CREDIT MARKET

Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.

According to Economic Survey 2012-13, at the end of March 2012, there were four institutions regulated by Reserve Bank of India as all-India Financial Institutions:

- Export - Import Bank of India (Exim Bank)
- National Bank for Agriculture and Rural Development (NABARD)
- Small Industries Development Bank of India (SIDBI)
- National Housing Bank (NHB)

A)Export-Import Bank of India is the premier export finance institution in India, established in 1982 under the Export-Import Bank of India Act 1981. Since its inception, Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, Exim Bank of India has, over the period, evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium Enterprises, in their globalization efforts, through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.[2]

Organization

Exim Bank is managed by a Board of Directors, which has representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, a financial institution, public sector banks, and the business community.

The Bank's functions are segmented into several operating groups including:

- Corporate Banking Group which handles a variety of financing programmes for Export Oriented Units (EOUs), Importers, and overseas investment by Indian companies.
- Project Finance / Trade Finance Group handles the entire range of export credit services such as supplier's credit, pre-shipment Agriculture Business Group, to spearhead the initiative to promote and support Agricultural exports. The Group handles projects and export transactions in the agricultural sector for financing.
- Small and Medium Enterprise: The group handles credit proposals from SMEs under various lending programmes of the Bank.
- Export Services Group offers variety of advisory and value-added information services aimed at investment promotion.
- Export Marketing Services Bank offers assistance to Indian companies, to enable them establish their products in overseas markets. The idea behind this service is to promote Indian export. Export Marketing Services covers wide range of export oriented companies and organizations. EMS group also covers Project exports and Export of Services.
- Besides these, the Support Services groups, which include: Research & Planning, Treasury and Accounts, Loan Administration, Internal Audit, Management Information Services, Information Technology, Legal, Human Resources Management and Corporate Communications.

B)National Bank for Agriculture and Rural Development (NABARD) is an apex development bank in India having headquarters based in Mumbai (Maharashtra)[3] and other branches are all over the country. The Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up by the Reserve Bank of India (RBI) under the Chairmanship of Shri B. Sivaraman, conceived and recommended the establishment of the National Bank for Agriculture and Rural Development (NABARD). It was established on 12 July 1982 by a special act by the parliament and its main focus was to uplift rural India by increasing the credit flow for elevation of agriculture & rural non farm sector and completed its 25 years on 12 July 2007.[1] It has been accredited with "matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India". RBI sold its stake in NABARD to the Government of India, which now holds 99% stake.[5] NABARD is active in developing financial inclusion policy and is a member of the Alliance for Financial Inclusion

History

NABARD was established on the recommendations of Shivaraman Committee, (by act 61, 1981 of Parliament) on 12 July 1982 to implement the *National Bank for Agriculture and Rural Development Act 1981*. It replaced the Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of Reserve Bank of India, and Agricultural Refinance and Development Corporation (ARDC). It is one of the premier agencies to provide credit in rural areas. NABARD is India's specialized bank for Agriculture and Rural Development in India.

The initial capital of NABARD was Rs. 100 crore. Consequent to the revision in the composition of share capital between Government of India and RBI, the paid up capital as on 31 March 2013, stood at 4000 crore with Government of India holding 3,980 crore (99.50%) and Reserve Bank of India 20.00 crore (0.50%). As on 31 March 2014, NABARD paid up capital stood at Rs. 4700 crore (Rs. 4680 Crore of GoI and Rs. 20 Crore of RBI).

International associates of NABARD ranges from World Bank-affiliated organizations to global developmental agencies working in the field of agriculture and rural development. These organizations help NABARD by advising and giving monetary aid for the upliftment of the people in the rural areas and optimizing the agricultural process. [7]

Role

NABARD is the apex institution in the country which looks after the development of the cottage industry, small industry and village industry, and other rural industries. NABARD also reaches out to allied economies and supports and promotes integrated development. And to help NABARD discharge its duty, it has been given certain roles as follows:

1. Serves as an apex financing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas
2. Takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.
3. Co-ordinates the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India (RBI) and other national level institutions concerned with policy formulation
4. Undertakes monitoring and evaluation of projects refinanced by it.
5. NABARD refinances the financial institutions which finances the rural sector.
6. The institutions which help the rural economy, NABARD helps develop.
7. NABARD also keeps a check on its client institutes.
8. It regulates the institution which provides financial help to the rural economy.
9. It provides training facilities to the institutions working in the field of rural upliftment.
10. It regulates the cooperative banks and the RRB's, and manages talent acquisition through IBPS CWE.

NABARD's refinance is available to State Co-operative Agriculture and Rural Development Banks (SCARDBs), State Co-operative Banks (SCBs), Regional Rural Banks (RRBs), Commercial Banks (CBs) and other financial institutions approved by RBI. While the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, State-owned corporations or co-operative societies, production credit is generally given to individuals. NABARD has its head office at Mumbai, India.

NABARD Regional Office[RO] has a Chief General Manager [CGMs] as its head, and the Head office has several Top executives like the Executive Directors[ED], Managing Directors[MD], and the Chairperson. It has 336 District Offices across the country, one special cell at Srinagar. It also has 6 training establishments.

NABARD is also known for its 'SHG Bank Linkage Programme' which encourages India's banks to lend to self-help groups (SHGs). Because SHGs are composed mainly of poor women, this has evolved into an important Indian tool for microfinance. By March 2006, 22 lakh SHGs representing 3.3 core members had to be linked to credit through this programme.[

NABARD also has a portfolio of Natural Resource Management Programmes involving diverse fields like Watershed Development, Tribal Development and Farm Innovation through dedicated funds set up for the purpose.

Rural innovation

NABARD role in rural development in India is phenomenal.[9] National Bank For Agriculture & Rural Development (NABARD) is set up as an apex Development Bank by the Government of India with a mandate for facilitating credit flow for promotion and development of agriculture, cottage and village industries. The credit flow to agriculture activities sanctioned by NABARD reached Rs 1,57,480crore in 2005-2006. The overall GDP is estimated to grow at 8.4 per cent. The Indian economy as a whole is poised for higher growth in the coming years. Role of NABARD in overall development of India in general and rural & agricultural in specific is highly pivotal.

Through assistance of Swiss Agency for Development and Cooperation, NABARD set up the Rural Innovation Fund. Vrajlal Sapovadia Rural Infrastructure Development Fund (RIDF) is another noted scheme for

the bank for rural development.[10] Under the RIDF scheme Rs. 51,283 crore have been sanctioned for 2,44,651 projects covering irrigation, rural roads and bridges, health and education, soil conservation, water schemes etc. Rural Innovation Fund is a fund designed to support innovative, risk friendly, unconventional experiments in these sectors that would have the potential to promote livelihood opportunities and employment in rural areas.[11] The assistance is extended to Individuals, NGOs, Cooperatives, Self Help Group, and Panchayati Raj Institutions who have the expertise and willingness to implement innovative ideas for improving the quality of life in rural areas. Through member base of 25 crore, 600000 cooperatives are working in India at grass root level in almost every sector of economy. There are linkages between SHG and other type institutes with that of cooperatives.

The purpose of RIDF is to promote innovation in rural & agricultural sector through viable means. Effectiveness of the program depends upon many factors, but the type of organization to which the assistance is extended is crucial one in generating, executing ideas in optimum commercial way. Cooperative is member driven formal organization for socio-economic purpose, while SHG is informal one. NGO have more of social color while that of PRI is political one. Does the legal status of an institute influences effectiveness of the program? How & to what an extent? Cooperative type of organization is better (Financial efficiency & effectiveness) in functioning (agriculture & rural sector) compared to NGO, SHG & PRIs.[12]

Recently in 2007-08, NABARD has started a new direct lending facility under 'Umbrella Programme for Natural Resource Management' (UPNRM). Under this facility financial support for natural resource management activities can be provided as a loan at reasonable rate of interest. Already 35 projects have been sanctioned involving loan amount of about Rs 1000 crore. The sanctioned projects include honey collection by tribal's in Maharashtra, tussar value chain by a women producer company ('MASUTA'), eco-tourism in Karnataka etc.

Microfinance and NABARD

Thus the Reserve Bank of INDIA and NABARD has laid out certain guidelines in 06-07 for the commercial banks, Regional Rural Banks and Cooperative Banks to provide the data to RBI and es data regarding loans given by banks to the microfinance institutions.

NABARD a 100 % CSR company

NABARD has been instrumental in grounding rural, social innovations and social enterprises in the rural hinterlands. This Endeavour is perhaps unparalleled in the country, it has in the process partnered with about 4000 partner organizations in grounding many of the interventions be it, SHG-Bank Linkage programme, tree-based tribal communities' livelihoods initiative, watershed approach in soil and water conservation, increasing crop productivity initiatives through lead crop initiative or dissemination of information flow to agrarian communities through Farmer clubs. Despite all this, it pays huge taxes too, to the exchequer – figuring in the top 50 tax payers consistently. NABARD virtually ploughs back all the profits for development spending, in their unending search for solutions and answers. Thus the organization had developed a huge amount of trust capital in its 3 decades of work with rural communities

Small Industries Development Bank of India is an independent financial institution aimed to aid the growth and development of micro, small and medium-scale enterprises (MSME) in India. Set up on April 2, 1990 through an act of parliament, it was incorporated initially as a wholly owned subsidiary of Industrial Development Bank of India. Currently the ownership is held by 33 Government of India owned / controlled institutions.[1] Beginning as a refinancing agency to banks and state level financial institutions for their credit to small industries, it has expanded its activities, including direct credit to the SME through 100 branches in all major industrial clusters in India.[*citation needed*] Besides, it has been playing the development role in several ways such as support to micro-finance institutions for capacity building and on lending. Recently it has opened seven branches christened as Micro Finance branches, aimed especially at dispensing loans up to ₹5 lakh.[*citation needed*]

It is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities.[2]

SIDBI has also floated several other entities for related activities. **Credit Guarantee Fund Trust for Micro and Small Enterprises** ([2]) provides guarantees to banks for collateral-free loans extended to SME. **SIDBI Venture Capital Ltd.**([3]) is a venture capital company focused at SME. SME Rating Agency of India Ltd. (**SMERA** - [4]) provides composite ratings to SME. Another entity founded by SIDBI is **ISARC** - India SME Asset Reconstruction Company in 2009, as specialized entities for NPA resolution for SME.

C)SIDBI

The purpose is to provide refinance facilities and short term lending to industries. Its **headquarters is in Lucknow**.[3] Former Deputy Managing Director is Shri N.K. Maini. Dr. Kshatrapati Shivaji is the new Chairman and Managing Director of the organization.

History

Small Industries Development Bank of India (SIDBI), set up on April 2, 1990 under small industries

development bank of India act, is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities. The Charter establishing it, The Small Industries Development Bank of India Act, 1989 envisaged SIDBI to be "the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto.

Achievements

SIDBI retained its position in the top 30 Development Banks of the World in the latest ranking of The Banker, London. As per the May 2001 issue of The Banker, London, SIDBI ranked 25th both in terms of Capital and Assets.[updation needed]

Credit Guarantee Fund Trust for Micro and Small Enterprises popularly known as CGTMSE is widely being used by many PSU Banks and Private sector banks to fund MSME sector. During the year 2002-03 the aggregate sanction and disbursements of SIDBI amounted to ₹10,904 crore and ₹6,789 crore respectively. SIDBI has been permitted to raise finances up to ₹2,730 crore the year 2013 onward by the Reserve Bank of India.[4]

Business Domain of SIDBI

The business domain of SIDBI consists of Micro, Small and Medium Enterprises (MSMEs), which contribute significantly to the national economy in terms of production, employment and exports. MSME sector is an important pillar of Indian economy as it contributes greatly to the growth of Indian economy with a vast network of around 3 crore units, creating employment of about 7 crore, manufacturing more than 6,000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. In addition, SIDBI's assistance also flows to the service sector including transport, health care, tourism sectors etc.

SIDBI Among Top 30 Development Banks of the World

SIDBI retained its position in the top 30 Development Banks of the World in the ranking of The Banker, London. As per the May 2001 issue of The Banker, London, SIDBI ranked 25th both in terms of Capital and Assets.

In its Endeavour towards holistic development of the MSME sector, SIDBI adopts a 'Credit Plus' approach wherein, besides credit, the Bank also provides grant support for the Promotion and Development (P&D) of the sector to make it strong, vibrant and competitive. The P&D activities of the bank include Micro Enterprise Promotion, Entrepreneurship Development, Cluster Development, Capacity Building of the MSME Sector, promoting Responsible Finance among Micro Finance Institutions, Sustainable Finance to MSMEs including Energy Efficiency, Environment Protection, etc.

Cumulative disbursements as at end March 2014 have crossed ` 3260 trillion (€ 40.75 trillion) benefiting more than 32 million persons in the MSME sector. The total outstanding portfolio as at end March 2014 aggregated ` 612.71 billion (€7.66 billion).

SIDBI also functions as a Nodal/ Implementing Agency to various ministries of Government of India viz., Ministry of MSME, Ministry of Textiles, Ministry of Commerce and Industry, Ministry of Food Processing and Industry, etc.

SIDBI has taken the initiative to promote several institutions viz., Credit Guarantee Fund Trust for Micro and Small Enterprises, SIDBI Venture Capital, SME Rating Agency of India Ltd and India SME Technology Services Ltd., for the benefit of the MSME sector.

Micro Units Development & Refinance Agency (MUDRA) Bank, an initiative by Government of India to support non
corporate small business, is proposed to initiate it as a unit of SIDBI to benefit from SIDBI's initiatives and expertise.

National Housing Bank (NHB), a wholly owned subsidiary of Reserve Bank of India (RBI), was set up on 9 July 1988 under the National Housing Bank Act, 1987. NHB is an apex financial institution for housing. NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.

NHB registers, regulates and supervises Housing Finance Company (HFCs), keeps surveillance through On-site & Off-site Mechanisms and co-ordinates with other Regulators.

The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) identified the non-availability of long-term finance to individual households on any significant scale as a major lacuna impeding progress of

the housing sector and recommended the setting up of a national level institution.

The Committee of Secretaries considered' the recommendation and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI to examine the proposal and recommended the setting up of National Housing Bank as an autonomous housing finance institution. The recommendations of the High Level Group were accepted by the Government of India.

The Hon'ble Prime Minister of India, while presenting the Union Budget for 1987-88 on 28 February 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. Following that, the National Housing Bank Bill (91 of 1987) providing the legislative framework for the establishment of NHB was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on 23 December 1987, became an Act of Parliament.

The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing.

In pursuance of the above, NHB was set up on 9 July 1988 under the National Housing Bank Act, 1987. NHB is wholly owned by Reserve Bank of India, which contributed the entire paid-up capital. The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors.The Head Office of NHB is at New Delhi.

Objectives

NHB has been established to achieve, inter-Alia, the following objectives –

1. To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
2. To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
3. To augment resources for the sector and channelize them for housing.
4. To make housing credit more affordable.
5. To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
6. To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
7. To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

Board of Directors

- Shri Sriram Kalyanaraman, Managing Director & Chief Executive Officer
- Dr. Urjit R. Patel Deputy Governor, Reserve Bank of India (under Section 6(1) (d) of the National Housing Bank Act, 1987)
- Shri G.M. Rao Director, Central Board of Directors, Reserve Bank of India (under Section 6(1) (d) of the National Housing Bank Act, 1987)
- ShriAlokTandon, IAS, Joint Secretary to the Government of India, Ministry of Finance (under Section 6(1) (e) of the National Housing Bank Act, 1987)
- Smt. VijayaSrivastava, IAS, Joint Secretary to the Government of India,Ministry of Rural Development (under Section 6(1) (e) of the National Housing Bank Act, 1987))
- ShriSanjeev Kumar, IAS, Joint Secretary (RAY) to Government of India & Mission Director (JNNURM), Ministry of Housing and Urban Poverty Alleviation (under Section 6(1) (e) of the National Housing Bank Act, 1987)

RISKS AND RISK MANAGEMENT IN THE BANKING SECTOR

The Banking sector has a pivotal role in the development of an economy. It is the key driver of economic growth of the country and has a dynamic role to play in converting the idle capital resources for their optimum utilization so as to attain maximum productivity (Sharma, 2003). In fact, the foundation of a sound economy depends on how sound the Banking sector is and vice versa.

In India, the banking sector is considerably strong at present but at the same time, banking is considered to be a very risky business. Financial institutions must take risk, but they must do so consciously (Carey, 2001). However, it should be borne in mind that banks are very fragile institutions which are built on customers' trust, brand reputation and above all dangerous leverage. In case something goes wrong, banks can collapse and failure of one bank is sufficient to send shock waves right through the economy (Rajadhyaksha, 2004). Therefore, bank management must take utmost care in identifying the type as well as the degree of its risk exposure and tackle those effectively. Moreover, bankers must see risk management as an ongoing and valued activity with the board setting the example.

As risk is directly proportionate to return, the more risk a bank takes, it can expect to make more money. However, greater risk also increases the danger that the bank may incur huge losses and be forced out of business. In fact, today, a bank must run its operations with two goals in mind - to generate profit and to stay in business (Marrison, 2005). Banks, therefore, try to ensure that their risk taking is informed and prudent.

Thus, maintaining a trade-off between risk and return is the business of risk management. Moreover, risk management in the banking sector is a key issue linked to financial system stability. Unsound risk management practices governing bank lending often plays a central role in financial turmoil, most notably seen during the Asian financial crisis of 1997.

Definition of Risk

A risk can be defined as an unplanned event with financial consequences resulting in loss or reduced earnings (Vasavada, Kumar, Rao &Pai, 2005). An activity which may give profits or result in loss may be called a risky proposition due to uncertainty or unpredictability of the activity of trade in future. In other words, it can be defined as the uncertainty of the outcome.

Risk refers to 'a condition where there is a possibility of undesirable occurrence of a particular result which is known or best quantifiable and therefore insurable' (Periasamy, 2008). Risk may mean that there is a possibility of loss or damage which, may or may not happen.

Risks may be defined as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations (Kumar, Chatterjee, Chandrasekhar & Patwardhan 2005).

In the simplest words, risk may be defined as possibility of loss. It may be financial loss or loss to the reputation/ image (Sharma, 2003).

Although the terms risk and uncertainty are often used synonymously, there is difference between the two (Sharan, 2009). Uncertainty is the case when the decision-maker knows all the possible outcomes of a particular act, but does not have an idea of the probabilities of the outcomes. On the contrary, risk is related to a situation in which the decision-maker knows the probabilities of the various outcomes. In short, risk is a quantifiable uncertainty.

Risk in Banking Business

In the post LPG period, the banking sector has witnessed tremendous competition not only from the domestic banks but from foreign banks alike. In fact, competition in the banking sector has emerged due to disintermediation and deregulation. The liberalized economic scenario of the country has opened various new avenues for increasing revenues of banks. In order to grab this opportunity, Indian commercial banks have launched several new and innovated products, introduced facilities like ATMs, Credit Cards, Mobile banking, Internet banking etc. Apart from the traditional banking products, it is seen that Mutual Funds, Insurance etc. are being designed/ upgraded and served to attract more customers to their fold.

In the backdrop of all these developments i.e., deregulation in the Indian economy and product/ technological innovation, risk exposure of banks has also increased considerably. Thus, this has forced banks to focus their attention to risk management (Sharma, 2003). In fact, the importance of risk management of banks has been elevated by technological developments, the emergence of new financial instruments, deregulation and heightened capital market volatility (Mishra, 1997).

In short, the two most important developments that have made it imperative for Indian commercial banks to give emphasize on risk management are discussed below -

(a) Deregulation: The era of financial sector reforms which started in early
1990s has culminated in deregulation in a phased manner. Deregulation has given banks more autonomy in areas like lending, investment, interest rate structure etc. As a result of these developments, banks are required to manage their own business themselves and at the same time maintain liquidity and profitability. This has made it imperative for banks to pay more attention to risk management.

(b) Technological innovation: Technological innovations have provided a platform to the banks for creating an environment for efficient customer services as also for designing new products. In fact, it is technological innovation that has helped banks to manage the assets and liabilities in a better way, providing various delivery channels, reducing processing time of transactions, reducing manual intervention in back office functions etc. However, all these developments have also increased the diversity and complexity of risks, which need to be managed professionally so that the opportunities provided by the technology are not negated.

Type of Risks

Risk may be defined as 'possibility of loss', which may be financial loss or loss to the image or reputation. Banks like any other commercial organization also intend to take risk, which is inherent in any business. Higher the risk taken, higher the gain would be. But higher risks may also result into higher losses. However, banks are prudent enough to identify, measure and price risk, and maintain appropriate capital to take care of any eventuality. The major risks in banking business or 'banking risks', as commonly referred, are listed below -

- Liquidity Risk
- Interest Rate Risk
- Market Risk
- Credit or Default Risk
- Operational Risk

Type of Risks

Type of 'Banking Risks'

Liquidity Risk

The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk (Kumar et al., 2005). It can be also defined as the possibility that an institution may be unable to meet its maturing commitments or may do so only by borrowing funds at prohibitive costs or by disposing assets at rock bottom prices. The liquidity risk in banks manifest in different dimensions –

(a) ***Funding Risk***: Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is crucial. This arises from the need to replace net outflows due to unanticipated withdrawal/ non-renewal of deposits (wholesale and retail).

(b) ***Time Risk***: Time risk arises from the need to compensate for non- receipt of expected inflows of funds i.e., performing assets turning into non-performing assets.

(c) ***Call Risk***: Call risk arises due to crystallization of contingent liabilities. It may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

Interest Rate Risk

Interest Rate Risk arises when the Net Interest Margin or the Market Value of Equity (MVE) of an institution is affected due to changes in the interest rates. In other words, the risk of an adverse impact on Net Interest Income (NII) due to variations of interest rate may be called Interest Rate Risk (Sharma, 2003). It is the exposure of a Bank's financial condition to adverse movements in interest rates.

IRR can be viewed in two ways - its impact is on the earnings of the bank or its impact on the economic value of the bank's assets, liabilities and Off-Balance Sheet (OBS) positions. Interest rate Risk can take different forms. The following are the types of Interest Rate Risk -

(a) ***Gap or Mismatch Risk***: A gap or mismatch risk arises from holding assets and liabilities and Off-Balance Sheet items with different principal amounts, maturity dates or re-pricing dates, thereby creating exposure to unexpected changes in the level of market interest rates.

(b) ***Yield Curve Risk***: Banks, in a floating interest scenario, may price
their assets and liabilities based on different benchmarks, i.e., treasury bills' yields, fixed deposit rates, call market rates, MIBOR etc. In case the banks use two different instruments maturing at different time horizon for pricing their assets and liabilities then any non-parallel movements in the yield curves, which is rather frequent, would affect the NII. Thus, banks should evaluate the movement in yield curves and the impact of that on the portfolio values and income.

An example would be when a liability raised at a rate linked to
say 91 days T Bill is used to fund an asset linked to 364 days T Bills. In a raising rate scenario both, 91 days and 364 days T Bills may increase but not identically due to non-parallel movement of yield
curve creating a variation in net interest earned (Kumar et al., 2005).

(c) ***Basis Risk***: Basis Risk is the risk that arises when the interest rate of
different assets, liabilities and off-balance sheet items may change in different magnitude. For example, in a rising interest rate scenario, asset interest rate may rise in different magnitude than the interest rate on corresponding liability, thereby creating variation in net interest income.

The degree of basis risk is fairly high in respect of banks that
create composite assets out of composite liabilities. The loan book in India is funded out of a composite liability portfolio and is exposed to a considerable degree of basis risk. The basis risk is quite visible in volatile interest rate scenarios (Kumar et al., 2005). When the variation in market interest rate causes the NII to expand, the banks have experienced favorable basis shifts and if the interest rate movement causes the NII to contract, the basis has moved against the banks.

(d) ***Embedded Option Risk***: Significant changes in market interest rates
create the source of risk to banks' profitability by encouraging prepayment of cash credit/demand loans, term loans and exercise of call/put options on bonds/ debentures and/ or premature withdrawal of term deposits before their stated maturities. The embedded option risk is experienced in volatile situations and is becoming a reality in India. The faster and higher the magnitude of changes in interest rate, the greater will be the embedded option risk to the banks' Net Interest Income. The result is the reduction of projected cash flow and the income for the bank.

(e) ***Reinvested Risk***: Reinvestment risk is the risk arising out of

uncertainty with regard to interest rate at which the future cash flows could be reinvested. Any mismatches in cash flows i.e., inflow and outflow would expose the banks to variation in Net Interest Income. This is because market interest received on loan and to be paid on deposits move in different directions.

(f) ***Net Interest Position Risk***: Net Interest Position Risk arises when the
market interest rates adjust downwards and where banks have more earning assets than paying liabilities. Such banks will experience a reduction in NII as the market interest rate declines and the NII increases when interest rate rises. Its impact is on the earnings of the bank or its impact is on the economic value of the banks' assets, liabilities and OBS positions.

Market Risk

The risk of adverse deviations of the mark-to-market value of the trading
portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market Risk (Kumar et al., 2005). This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk.
Price risk occurs when assets are sold before their stated maturities.
In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.

The term Market risk applies to (i) that part of IRR which affects the price of interest rate instruments, (ii) Pricing risk for all other assets/ portfolio that are held in the trading book of the bank and (iii) Foreign Currency Risk.

(a)*Forex Risk*: Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position either spot or forward, or a combination of the two, in an individual foreign currency.

(b) ***Market Liquidity Risk***: Market liquidity risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price.

Default or Credit Risk

Credit risk is more simply defined as the potential of a bank borrower or counterparty to fail to meet its obligations in accordance with the agreed terms. In other words, credit risk can be defined as the risk that the interest or principal or both will not be paid as promised and is estimated by observing the proportion of assets that are below standard. Credit risk is borne by all lenders and will lead to serious problems, if excessive. For most banks, loans are the largest and most obvious source of credit risk. It is the most significant risk, more so in the Indian scenario where the NPA level of the banking system is significantly high (Sharma, 2003). The Asian Financial crisis, which emerged due to rise in NPAs to over 30% of the total assets of the financial system of Indonesia, Malaysia, South Korea and Thailand, highlights the importance of management of credit risk.

There are two variants of credit risk which are discussed below -

(a) ***Counterparty Risk***: This is a variant of Credit risk and is related to non-performance of the trading partners due to counterparty's refusal and or inability to perform. The counterparty risk is generally viewed as a transient financial risk associated with trading rather than standard credit risk.

(b) ***Country Risk***: This is also a type of credit risk where non- performance of a borrower or counterparty arises due to constraints or restrictions imposed by a country. Here, the reason of non-performance is external factors on which the borrower or the counterparty has no control.

Credit Risk depends on both external and internal factors. The internal factors include -

1. Deficiency in credit policy and administration of loan portfolio.
2. Deficiency in appraising borrower's financial position

prior to lending.
3. Excessive dependence on collaterals.
4. Bank's failure in post-sanction follow-up, etc.

The major external factors -
1. The state of economy
2. Swings in commodity price, foreign exchange rates and
Interest rates, etc.

Credit Risk can't be avoided but has to be managed by applying
Various risk mitigating processes -
1. Banks should assess the credit worthiness of the borrower
Before sanctioning loan i.e., credit rating of the borrower should be done beforehand. Credit rating is main tool of measuring credit risk and it also facilitates pricing the loan.

By applying a regular evaluation and rating system of all Investment opportunities, banks can reduce its credit risk as it can get vital information of the inherent weaknesses of the account.

2. Banks should fix prudential limits on various aspects of credit - benchmarking Current Ratio, Debt Equity Ratio, Debt Service Coverage Ratio, Profitability Ratio etc.

3. There should be maximum limit exposure for single/ groupBorrower.

4. There should be provision for flexibility to allow variations For very special circumstances.

5. Alertness on the part of operating staff at all stages of credit
Dispensation - appraisal, disbursement, review/ renewal, post- sanction follow-up can also be useful for avoiding credit risk.

Operational Risk

Basel Committee for Banking Supervision has defined operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'. Thus, operational loss has mainly three exposure classes namely people, processes and systems.

Managing operational risk has become important for banks due to the following reasons -
1. Higher level of automation in rendering banking and financial services
2. Increase in global financial inter-linkages

Scope of operational risk is very wide because of the above Mentioned reasons. Two of the most common operational risks are Discussed below -

a) ***Transaction Risk***: Transaction risk is the risk arising from fraud, Both internal and external, failed business processes and the inability to maintain business continuity and manage information.

(b) ***Compliance Risk***: Compliance risk is the risk of legal or regulatory Sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank's reputation is closely linked to its adherence to principles of integrity and fair dealing.

Other Risks

Apart from the above mentioned risks, following are the other risks Confronted by Banks in course of their business operations (Kumar et al., 2005) -

(a) ***Strategic Risk***: Strategic Risk is the risk arising from adverse Business decisions, improper implementation of decisions or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals and the quality of implementation.

(b) ***Reputation Risk***: Reputation Risk is the risk arising from negative Public opinion. This risk may expose the institution to litigation, financial loss or decline in customer base.

Risk Management Practices in India

Risk Management, according to the knowledge theorists, is actually a Combination of management of uncertainty, risk, equivocality and error (Mohan, 2003). Uncertainty - where outcome cannot be estimated even randomly, arises due to lack of information and this uncertainty gets transformed into risk (where estimation of outcome is possible) as information gathering progresses. As information about markets and knowledge about possible outcomes increases,

Risk management provides solution for controlling risk. Equivocality arises due
to conflicting interpretations and the resultant lack of judgment. This happens despite adequate knowledge of the situation. That is why; banking as well as other

institutions develop control systems to reduce errors, information systems to reduce uncertainty, incentive system to manage agency problems in risk- reward framework and cultural systems to deal with equivocality.

Initially, the Indian banks have used risk control systems that kept pace with
legal environment and Indian accounting standards. But with the growing pace of deregulation and associated changes in the customer's behavior, banks are exposed to mark-to-market accounting (Mishra, 1997). Therefore, the challenge of Indian banks is to establish a coherent framework for measuring and managing risk consistent with corporate goals and responsive to the developments in the market. As the market is dynamic, banks should maintain vigil on the convergence of regulatory frameworks in the country, changes in the international accounting standards and finally and most importantly changes in the clients' business practices. Therefore, the need of the hour is to follow certain risk management norms suggested by the RBI and BIS.

Role of RBI in Risk Management in Banks

The Reserve Bank of India has been using CAMELS rating to evaluate the financial soundness of the Banks. The CAMELS Model consists of six components namely Capital Adequacy, Asset Quality, Management, Earnings Quality, Liquidity and Sensitivity to Market risk

In 1988, The Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) has recommended using capital adequacy, assets quality, management quality, earnings and liquidity (CAMEL) as criteria for assessing a Financial Institution. The sixth component, sensitivity to market risk (S) was added to CAMEL in 1997 (Gilbert, Meyer & Vaughan, 2000). However, most of the developing countries are using CAMEL instead of CAMELS in the performance evaluation of the FIs. The Central Banks in some of the countries like Nepal, Kenya use CAEL instead of CAMELS (Baral, 2005). CAMELS framework is a common method for evaluating the soundness of Financial Institutions.

In India, the focus of the statutory regulation of commercial banks by RBI until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements (Kannan, 2004). In these circumstances, the supervision had to focus essentially on solvency issues. After the evolution of the BIS prudential norms in 1988, the RBI took a series of measures to realign its supervisory and regulatory standards and bring it at par with international best practices. At the same time, it also took care to keep in view the socio-economic conditions of the country, the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy, and ensured that the prudential norms were applied over the period and across different segments of the financial sector in a phased manner.

Finally, it was in the year 1999 that RBI recognized the need of an appropriate risk management and issued guidelines to banks regarding assets liability management, management of credit, market and operational risks. The entire supervisory mechanism has been realigned since 1994 under the directions of a newly constituted Board for Financial Supervision (BFS), which functions under the aegis of the RBI, to suit the demanding needs of a strong and stable financial system. The supervisory jurisdiction of the BFS now extends to the entire financial system barring the capital market institutions and the insurance sector. The periodical on-site inspections, and also the targeted appraisals by the Reserve Bank, are now supplemented by off-site surveillance which particularly focuses on the risk profile of the supervised institution. A process of rating of banks on the basis of CAMELS in respect of Indian banks and CACS (Capital, Asset Quality, Compliance and Systems & Control) in respect of foreign banks has been put in place from 1999.

Since then, the RBI has moved towards more stringent capital adequacy norms and adopted the CAMEL (Capital adequacy, Asset quality, Management,

Earnings, Liquidity) based rating system for evaluating the soundness of Indian
banks. The Reserve Bank's regulatory and supervisory responsibility has been widened to include financial institutions and non-banking financial companies. As a result, considering the changes in the Banking industry, the thrust lies upon Risk - Based Supervision (RBS). The main supervisory issues addressed by Board for Financial Supervision (BFS) relate to on-site and off-site supervision of banks.

The on-site supervision system for banks is on an annual cycle and is based
on the 'CAMEL' model. It focuses on core assessments in accordance with the statutory mandate, i.e., solvency, liquidity, operational soundness and management prudence. Thus, banks are rated on this basis. Moreover, in view of the recent trends towards financial integration, competition, globalization, it has become necessary for the BFS to supplement on-site supervision with off-site surveillance so as to capture 'early warning signals' from off-site monitoring that would be helpful to avert the likes of East Asian financial crisis

(Sireesha, 2008). The off-site monitoring system consists of capital adequacy, asset quality, large credit and concentration, connected lending, earnings and risk exposures viz., currency, liquidity and interest rate risks. Apart from this, the fundamental and technical analysis of stock of banks in the secondary market will serve as a supplementary indicator of financial performance of banks.

Thus, on the basis of RBS, a risk profile of individual Bank will be prepared.
A high-risk sensitive bank will be subjected to more intensive supervision by shorter periodicity with greater use of supervisory tools aimed on structural meetings, additional off site surveillance, regular on site inspection etc. This will be undertaken in order to ensure the stability of the Indian Financial System.

The BASEL Committee on Banking Supervision
At the end of 1974, the Central Bank Governors of the Group of Ten countries formed a Committee of banking supervisory authorities. As this Committee usually meets at the Bank of International Settlement (BIS) in Basel, Switzerland, this Committee came to be known as the Basel Committee. The

Committee's members came from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdoms and the United States. Countries are represented by their central banks and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.

The Basel Committee does not possess any formal supra-national supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends the statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems (NEDfi Databank Quarterly, 2004). In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

The Committee reports to the central bank Governors of the Group of Ten countries and seeks the Governors' endorsement for its major initiatives. In addition, however, since the Committee contains representatives from institutions, which are not central banks, the decision involves the commitment of many national authorities outside the central banking fraternity. These decisions cover a very wide range of financial issues.

One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles - that no foreign banking establishment should escape supervision and the supervision should be adequate. To achieve this, the Committee has issued a long series of documents since 1975.

BASEL I

In 1988, the BASEL Committee decided to introduce a capital measurement system (BASEL I) commonly referred to as the ***Basel Capital Accord***. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with active international banks.
Towards the end of 1992, this system provided for the implementation of a credit risk measurement framework with minimum capital standard of 8%.

The basic achievement of Basel I has been to define bank capital and the so- called bank capital ratio. Basel I is a ratio of capital to risk-weighted assets. The numerator, Capital, is divided into Tier 1 (equity capital plus disclosed reserves minus goodwill) and Tier 2 (asset revaluation reserves, undisclosed reserves, general loan loss reserves, hybrid capital instrument and subordinated term debt). Tier 1 capital ought to constitute at least 50 per cent of the total capital base. Subordinated debt (with a minimum fixed term to maturity of five years, available in the event of liquidation, but not available to participate in the losses of a bank which is still continuing its activities) is limited to a maximum of 50 per cent of Tier 1.

The denominator of the Basel I formula is the sum of risk-adjusted assets plus off-balance sheet items adjusted to risk. There are five credit risk weights: 0 per cent, 10 per cent, 20 per cent, 50 per cent and 100 per cent and equivalent credit conversion factors for off-

balance sheet items. Some of the risk weights are rather 'arbitrary' (for example, 0 % for government or central bank claims, 20 % for Organization for Economic Cooperation and Development (OECD) inter-bank claims, 50 % for residential mortgages, 100 % for all commercial and consumer loans). The weights represent a compromise between differing views, and are not 'stated truths' about the risk profile of the asset portfolio, but rather the result of bargaining on the basis of historical data available at that time on loan performance and judgments about the level of risk of certain parts of counterpart, guarantor or collateral (Lastra, 2004). The risk weights have created opportunities for regulatory arbitrage.

Interestingly, there is no strong theory for the 'target' ratio 8 per cent of capital (tier 1 plus tier 2) to risk-adjusted assets plus off-balance sheet items. The 8% figure has been derived based on the median value in existing good practice at the time (US/UK 1986 Accord): the UK and the USA bank around 7.5 per cent, Switzerland 10 per cent and France and Japan 3 per cent etc. Basel I was a simple ratio, despite the rather 'arbitrary' nature of the definition of Tier 2 capital, the risk weights and the 8 % target ratio. It is a standard broadly accepted by the industry and by the authorities in both developed and developing countries.

BASEL II (Revised International Capital Framework)

Central bank Governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries endorsed the publication of '*International Convergence of Capital Measurement and Capital Standards: a Revised Framework*', the new capital adequacy framework commonly known as **Basel II**. The Committee intends that the revised framework would be implemented by the end of year 2006.

In principle, the new approach (Basel II) is not intended to raise or lower the overall level of regulatory capital currently held by banks, but to make it more risk sensitive. The spirit of the new Accord is to encourage the use of internal systems for measuring risks and allocating capital. The new Accord also wishes to align regulatory capital more closely with economic capital. The proposed capital framework consists of three pillars-

Pillar 1	-	Minimum capital requirements
Pillar 2	-	Supervisory review process
Pillar 3	-	Market discipline

Pillar 1: Minimum Capital Requirements

Pillar 1 of the new capital framework revises the 1988 Accord's guidelines by aligning the minimum capital requirements more closely to each bank's actual risk of economic loss. The minimum capital adequacy ratio would continue to be 8% of the risk-weighted assets (as per RBI, it is 9%), which will cover capital requirements for credit, market and operational risks.

Estimating Capital required for Credit Risks

For estimating the capital required for credit risks, a range of approaches such as Standardized, Foundation Internal Rating Based (IRB) and Advanced IRB are suggested.

Under the Standardized Approach, preferential weights ranging from 0% to 150% would be assigned to assets based on the external credit rating agencies, approved by the national supervisors in accordance with the criteria defined by the Committee.

Under Internal Rating Based (IRB) Approach, banks would be allowed to estimate their own Probability of Default (PD) instead of standard percentages such as 20%, 50%, 100% etc. For this purpose, two approaches namely Foundation IRB and Advanced IRB are suggested. In case of Foundation IRB approach, RBI is required to set rules for estimating the value of Loss Given Default (LGD) and Exposure at Default (EAD), while under Advanced IRB approach, banks would be allowed to use their own estimates of LGD and EAD.

Estimating Capital required for Market Risks

The Narasimham Committee II on Banking Sector Reforms had recommended that in order to capture market risk in the investment portfolio, a risk-weight of 5% should be applied for Government[2] and other approved securities for the purpose of capital adequacy. The Reserve Bank of India has prescribed 2.5% risk-weight for capital adequacy for market risk on SLR and non-SLR securities with effect from March 2000 and 2001 respectively, in addition to appropriate risk-weights for credit risk. Further the banks in India are required to apply the 2.5% risk-weight for capital charges for market risk for the whole investment portfolio and 100 % risk-weight on open gold and forex position limits.

Estimating Capital required for Operational Risks

For operational risk, three approaches namely Basic Indicator, Standardized and Internal measurement have been provided.
Under the Basic Indicator approach, banks have to hold capital for operational risk equal to the fixed percentage (Alpha) of average annual gross income over the previous three years.

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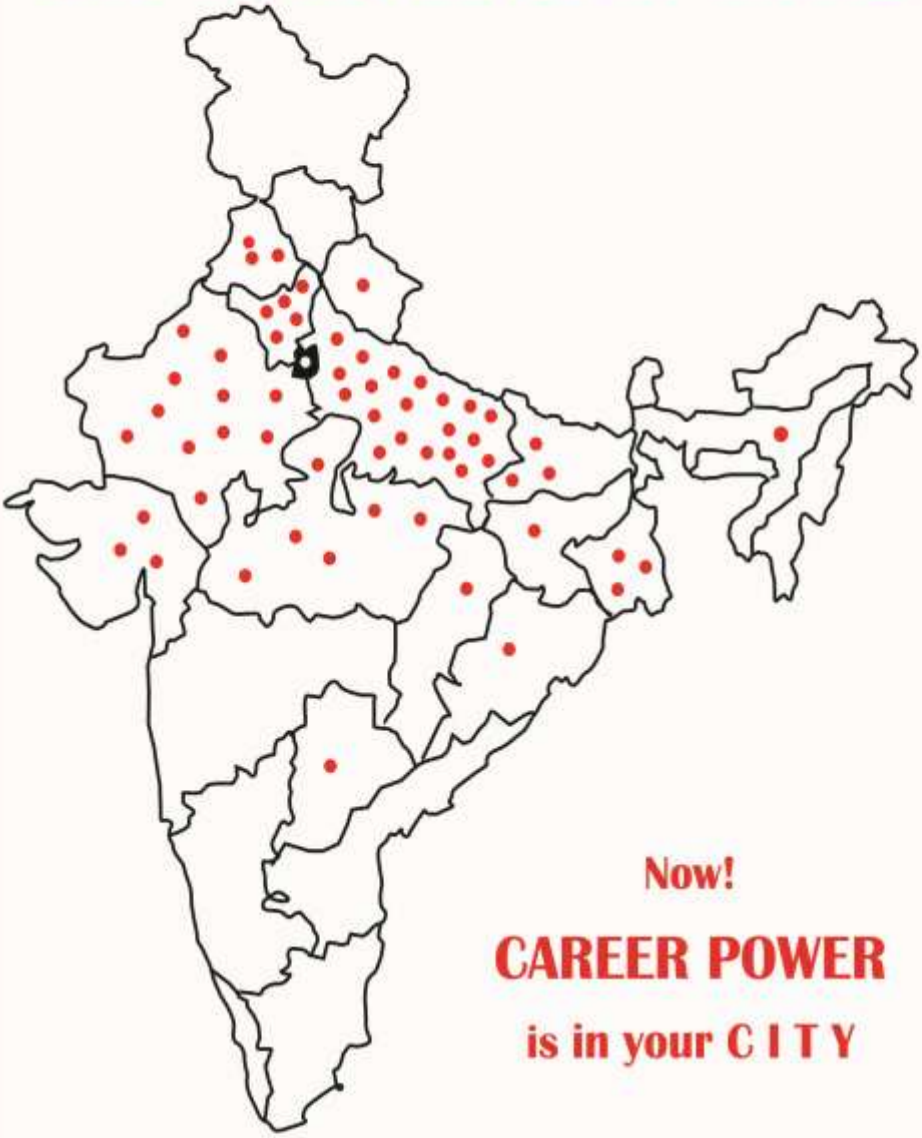

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The standardized approach builds on the basic indicator approach. It divides the bank's activities into 8 business lines - corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management and retail brokerage. The capital charge for operational risk is arrived at based on fixed percentage for each business line.

The Internal measurement approach allows individual banks to use their own data to determine capital required for operational risk

Thus, under BASEL II, the denominator of the minimum capital ratio will consist of three parts - the sum of all risk weighted assets for credit risk, plus 12.5 times (reciprocal of 8 % minimum risk based capital ratio) the sum of the capital charges for market risk and operational risk. The multiplicatory factor of 12.5 has been introduced in order to enable banks to create a numerical link between the calculation of capital requirement for credit risk and the capital requirement for operational and market risks. In case of capital requirement for credit risk, calculation of capital is based on the risk weighted assets. However, for calculating capital requirement for operational and market risk, the capital charge itself is calculated directly.

Regulatory Capital

--- = Desired Capital
Risk weight Asset Risks) for Credit Risk × 12.5 (Market + Operational Ratio (CAR)

Hence, the regulatory requirements cover three types of risks, credit risk,
market and operational risks.

Pillar 2: Supervisory Review Process

Pillar 2 of the new capital framework recognizes the necessity of exercising effective supervisory review of banks' internal assessments of their overall risks to ensure that bank management is exercising sound judgment and had set aside adequate capital for these risks. To be more specific -

- Supervisors will evaluate the activities and risk profiles of individual banks to determine whether those organizations should hold higher levels of capital than the minimum requirements in Pillar 1 would specify and to see whether there is any need for remedial actions.
- The committee expects that, when supervisors engage banks in a dialogue about their internal processes for measuring and managing their risks, they will help to create implicit incentives for organizations to develop sound control structures and to improve those processes.

Thus, the supervisory review process is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

There are three main areas that might be particularly suited to treatment under Pillar 2.

Risks considered under Pillar 1 that are not fully captured by the Pillar 1 process (e.g. the proposed Operational risk in Pillar 1 may not adequately cover all the specific risks of any given institution).

- Those factors not taken into account by the Pillar 1 process e.g. interest rate risk
- Factor external to the bank e.g. business cycle effects.

Pillar 3: Market Discipline

Pillar 3 leverages the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalization. The Committee believes that, when market place participants have a sufficient understanding of a bank's activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not (NEDfi Databank Quarterly, 2004).

Thus, adequate disclosure of information to public brings in market discipline and in the process promotes safety and soundness in the financial system. The Committee proposes two types of disclosures namely Core and Supplementary. Core disclosures are those which convey vital information for all institutions while Supplementary disclosures are those required for some. The Committee recommends that all sophisticated internationally active banks should make the full range of core and supplementary information publicly available. The Committee also has emphasized the importance of timeliness of information. For the purpose, it has recommended disclosure on semi-annual basis and for internationally active banks on a quarterly basis.

Global Financial Crisis and the Indian Banking Sector

The impact of the global crisis has been transmitted to the Indian economy through three distinct channels,

viz., the financial sector, exports and exchange rates. Fortunately, India, like most of the emerging economies, was lucky to avoid the first round of adverse affects because its banks were not overly exposed to subprime lending (Vashisht and Pathak, 2009). Only one of the larger private sector banks, the ICICI Bank, was partly exposed but it managed to counter the crisis through a strong balance sheet and timely government action. Excellent regulations by RBI and the decision not to allow investment banking on the US model were the two main reasons that helped to overcome the adverse situation. Further, RBI has also enforced the prudential and capital adequacy norms without fear or favor. RBI regulations are equally applicable to all the Indian Banks, both in the public and private sector. Indian commercial banks are professionally managed and proper risk management systems are put in place. In short, it can be said that strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their western counterparts (Kundu 2008). Contrary to the situation in India, in U.S., certain relaxations were permitted in the case of large banks which were considered 'too big to fail' and this relaxation ultimately triggered the crisis. Thus, eventually it was proved that it is not the size that matters, but prudence and proper risk management systems. Interestingly, while the developed world, including the U.S, the Euro Zone and Japan, have plunged into recession, the Indian Economy is being affected by the spill-over effects of the global financial crisis only (Chidambaram 2008). In fact, the financial sector has emerged without much damage and this was possible due to our strong regulatory framework and in part on account of state ownership of most of the banking sector (Kundu, 2008).

Although, Indian banks escaped the contagion because they were highly regulated at home and not too integrated with the global financial system in terms of sharing the risks inherent in the trillions of dollars of worthless financial products (Venu, 2010), but the global financial crisis and its aftermath forced banks to introspect about the kind of financial sector architecture India should have in the years ahead apart from quantification of risk and appropriate risk management models.

Interestingly, over the years, there were significant developments in the area of quantification of risk and presently, the focus has shifted to statistical aspects of risk management - especially to risk modeling and other computational techniques of risk measurement. Although academic research advocates the use of VaR for market risk assessment, in respect of credit risk, there is no single 'best practice' model for credit risk capital assessment (Gopinath, 2006). The Basel II 'Internal Rating Based' methodology provides a portfolio model for credit risk management but bank managements will have to focus on the determinants of credit risk factors, the dependency between risk factors, the integration of credit risk to market risk, data integrity issues like consistency of data over long periods, accuracy and so on. Likewise, models for assessing and managing other types of risk in the banking business need to be developed and simultaneously data availability and reliability issues with respect to the models need to be resolved.

Although researches are on to develop risk management models that can be used universally for assessing and managing risk, remarkable headway is yet to be seen. As far private sector banks are concerned, it was seen that irrational loan advances, and investments are prominent more than public sector banks. Therefore, private sector banks need strong and effective risk control systems. However, the in-built risk control systems that are being followed presently are equally strong for public and foreign sector banks (Subramanyam and Reddy, 2008).

Conclusion

Thus, as risk is indispensable for banking business, proper assessment of risk is an integral part of a bank's risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively. In the context of risk management practices, the introduction of Basel II norms and its subsequent adoption by RBI is a significant measure that promises to promote sound risk management practices. BASEL II seeks to enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide.

Moreover, the RBI has adopted a series of steps to ensure that individual banks tackle risks effectively by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector, so that systemic risk and financial turmoil can be averted in the country.

BASICS OF DERIVATIVES:

Derivatives: A derivative is an instrument whose value is derived from the value of one or more basic variables called bases (underlying asset, index, or reference rate) in a contractual manner. The underlying asset can be equity, commodity, forex or any other asset. The major financial derivative products are Forwards, Futures, Options and Swaps.

Definitions

A Swap contract is a contract in which parties agree to exchanging variable performance for a certain fixed market rate. In short, parties agree to exchanging cash flows on a future date. For Bitcoin this can either be fixed-floating commodity swaps or commodity-for-interest swaps

Futures Contracts or simply Futures are nothing more than an agreement between two parties to buy or sell a certain commodity (or financial instrument) at a pre-determined price in the future. Positions are settled on a daily basis.

Also Forwards come down to making an exchange at a future date. The agreements include delivering a certain amount of goods (or financial instruments) by the end of a certain period.

Futures and Forwards

The definitions should make clear why there can be confusion surrounding these derivatives. Every contract type involves an agreement to make an exchange at a certain pre-defined future date. Given the nearly identical description, Futures and Forwards are the most similar contracts. The key difference is in the fact that Futures are settled on a daily basis and Forwards are not.

Assume a farmer and a bread maker agree to exchange 5,000 bushels of wheat at $4 per bushel in June, equal to a total value of $20,000. The current price is also $4 per bushel. The farmer is the seller and thus has a short position, while the bread maker is the buyer and therefore has a long position. If the actual price of grain per bushel rises to $5 by the end of the contract, it would mean a loss of $5,000 to the farmer. On the other hand, the bread maker will have a profit of $5,000. This is the final outcome for **both** the Forward and Futures contract.

The big difference is in the daily adjustments in the Futures. If prices move to $5 per bushel the next day, then the gains and losses would be immediately credited or deducted. This is why margin requirements apply for Futures trading. For Forwards, nothing happens until maturity. Therefore, the intermediate gains and losses can never be greater than the final value.

If prices would move to $6 per bushel before the end of the Futures Contract, the farmer would see $10,000 deducted from his account while the bread maker would receive $10,000. Even if the price ends at $5 per bushel, the farmer will have to meet the margin requirements while the price is at $6 per bushel. This is why Futures Contracts mean increased liquidity risks compared to Forwards, where only the final value matters. If the farmer cannot meet the margin requirements, his positions could be force-closed and leave the farmer with a bigger realized loss then would otherwise be the case.

Because there is no daily settlement in Forwards, there is less such liquidity risk but increased counterparty risk instead. Margin requirements provide a guarantee that the counterparty will able to pay by the end of the contract, as accounts are adjusted every day. Forward contracts are typically negotiated directly between two parties as a result, while Futures are suitable to be quoted and traded on exchanges in standardized form.

Swaps and Forwards

A Swap contract compares best to a Forward contract, although a Forward has only a single payment at maturity while a Swap involves a series of payments in the futures. In fact, a single-period Swap is equivalent to one Forward contract. To prove this, consider a single period Swap maturing in June with a fixed price of $4 per bushel. The farmer in the previous example could take a long position in the Swap, meaning the fixed price would be receive while a floating (variable) performance has to be paid to the bread dealer. When the price per bushel increases to $5, the farmer will receive the fixed amount of $20,000. At the same time, the farmer would have to pay $25,000 to the bread dealer. Identical to the Forward, the farmer has lost $5,000 on the contract while the bread dealer has won $5,000.

Conclusion

Even though a farmer and bread maker were used for the example, all the same principles apply to similar Bitcoin derivatives (note that all contracts are typically cash settled). Bitcoin Futures can already be traded, and with the coming of crypto currency 2.0 other financial derivatives can also potentially be replicated, making them more accessible. Anyone hedging or speculating using these instruments should therefore be aware of the differences between them.

Financial inclusion :USE OF TECHNOLOGY

Ever since India's independence in 1947, the biggest priority for the nation has been its economic growth, education for all and financial inclusion for the vast population of the country. While India has made some noteworthy progress in the past six decades and more, but on the aspect of financial inclusion, progress has not been satisfactory.

Along with the regulation of the banking sector in the country, the Reserve Bank of India (RBI) has been also spearheading the movement for financial inclusion.

Accordingly the RBI "describes financial inclusion as the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players."

In a country where the vast majority of the population is still very poor, financial inclusion is of great significance to them. For the poor, access to finance and ensuring the optimum utilization of the resources they possess is a major challenge. Economic and societal uncertainties mean volatility in their income can have an adverse reaction on the financial stability. This exposes the poor to the dodgy moneylenders, which is turn can lead to debilitating debt trap.

Banks, both private and public, were supposed to play a pivotal role in financial inclusion, but beyond a point the impact has been minimal. In a speech last year the RBI, Deputy Governor, S S Mundra says, "according to census 2011, out of 24.67 crore households in the country, only about 14.48 crore or 58.70 % households had access to banking services. Further, of the 16.78 crore rural households, only about 9.14 crore or 54.46 % households were availing of banking services."

He adds that the statistics on the number of individuals or households that are credit-linked makes for an even more gloomy reading. "The World Bank Findex Survey (2012) points out that only about 35% of Indian adults had access to a formal bank account and a meager 8% borrowed formally in the last 12 months," says Mundra.

The question now is do we can either continue with our traditional ways of ensuring financial inclusion or look at new methods and opportunities that is available to us because of technology? India has made rapid strides in technology and it is important to now look at financial inclusion through the prism of the digital economy.

One of the biggest components of financial inclusion is financial literacy. No matter how many banks you open and how many boots you have on the ground, if a person does not know about the financial options that are open to him, policies, schemes and financial instruments will mean little. It is important for a person to firstly know what to look for and only then think of the benefits that he can obtain from it? The digital economy can be strongly leveraged to spread financial literacy.

Financial inclusion without financial literacy has no meaning as the stakeholders cannot grasp the benefits/ risks associated.

FINANCIAL LITERACY - THE DIGITAL WAY(FINANCIAL INCLUSION)

Financial literacy through the use of technology has to be based on three principles: to effectively use the power of mediums like a computer, mobile and Internet to enable people to have the skills, knowledge or information about financial instruments. Secondly, we must ensure people then have the ability to critically understand the content they have received through digital means and lastly apply it to the best of their knowledge and capacity.

While it may seem unimaginable to think that the poor would stand to benefit from technology due to their lack of technological skills, nothing can be further from the truth. It has been proven time and again that if it's simple and effective, technology is a big enabler for the poor. Banking correspondent services that are operating across far flung villages in the country has proved that technology can go a long way to bridge the divide.

Why it also helps is that if allows information to be democratized. In the financial world information is often the difference between getting a lemon of a deal or a favorable one. Technology has now enabled information to percolate to even the remotest of villages. It also allows interaction between people and the ability to question the best in the business. By enabling connections, technology has also bridged the geographical difference.

Mobile Course Delivery

As a country, India has seen rapid growth in mobile adoption and today more than 70 % of the population holds a mobile phone. Of that, according to Internet and Mobile Association of India (IAMAI) and IMRB International, the mobile Internet penetration in rural India is expected to grow from 45 million in December 2014 to 53 million by June 2015.

Banking footprint in Indian villages: the new mirror to urban India

More than 50% of the Indian population did not own bank accounts in 2009. Moreover, of approximately 87,000 bank branches in the country, only 36–37% is currently situated in rural areas.

RBI has asked banks to provide banking services to 73,000 villages with a population of more than 2,000 by March 2012.

In this regard, the RBI's vision of financial inclusion is aimed at providing the unbanked Indian population with access to financial products and services. Financial inclusion is significant from the perspective of sustainable economic development.

Where technology counts most

India is home to around 600,000 villages, and it is not viable for banks to reach all villages through a "brick-and-mortar" model to open bank branches at each village. This is where technology can play a pivotal role to make branchless banking a reality.

Most banks have started issuing smart cards to people in rural areas to initiate financial inclusion. These cards eliminate the need to visit bank branches to deposit and withdraw money, as banks appoint business correspondents to regularly visit assigned villages.
Cardholders are able to view their account balance and withdraw money from their accounts using a handheld device available with the bank's representatives.

Smart Cards: The use of smart cards to enable financial inclusion is expected to increase the Government of India's speed and efficiency of providing payments under several pension and social security schemes such as SandhyaSuraksha, as well as National Rural Employment Guarantee Act (NREGA) payments to the rural population.
Branch-on-wheels: This is another important technology-related initiative that banks in India have implemented to serve people in rural and semi-urban areas. Mobile vans serve as bank branches to cater to the banking needs of 50,000 people. These vans are expected to provide all services that a normal bank branch does, along with an ATM facility.

Unique identification project: With the launch of the Unique Identification Authority of India (UIDAI) project aimed at providing a unique identification (UID) number to the entire Indian population, customers will be able to open bank accounts using their UID number. This will automate the entire authentication mechanism as the UID number will alone be sufficient to fulfill the know-your-customer (KYC) norms of banks, cutting short the lengthy verification process. This will especially be useful for rural areas where it is difficult for customers to open their accounts in the absence of identity proofs.
In the near future, mobile banking has the potential to become a primary channel for delivering financial services to the rural population

CORPORATE GOVERNANCE IN BANKING SECTOR:
Abstract: Corporate governance is an age old concept which provides for a set of transparent relationships between an institutions management, its board, shareholders and other stakeholders. Corporate governance is gaining centre stage in the recent times due to failure of corporate and wide dissatisfaction among the people with the way corporate works and hence became a widely discussed topic worldwide. Corporate Governance is now recognized as a paradigm for improving competitiveness and enhancing efficiency and thus improving investors' confidence and accessing capital. Now corporate governance has become a more dynamic concept and a not a mere static one.
Bank and Financial Institutions are the backbone of the economic sector of any country. The healthy economic condition of a nation is depicted through the sound functioning of its banks. Banks form a crucial link of a country's economic sector hence they are universally regulated industry and their well being is imperative for the economy. Working of banks is different from other corporate in many important respects, and that makes corporate governance of bank not only different but also critical. Hence corporate governance is conceptually different for banks. If a corporate fails, the fall outs can be restricted to the stakeholders, but if a bank fails, the impact can spread rapidly through other banks with potentially serious consequences for the entire financial system and the macro economy. Thus though various guidelines are provided for working of a bank, corporate governance cannot be overlooked or discarded. Regulations, guidelines and corporate governance are complementary to each other in banking industry.
The present paper is divided into different sections. In the first part it discusses about corporate governance, its history in India as well as world. Second part talks about applicability of corporate governance as an internal mechanism in banking sector. In third part it talks about the applicability of corporate governance in the banking sector and the mechanism to be adopted for its dynamic usage and in the last part about the various recent developments of corporate governance in banking sector.
Keywords: *corporate governance, banking sector, corporate governance mechanism in banks.*
Introduction: *Corporate governance has only recently emerged as a discipline in its own right, although the strands of political economy it embraces stretch back through centuries. – World Bank Group.*[1]
The above mentioned definition makes it clear that corporate governance is an age old concept. As corporations operate and compete in virtually all parts of the world, there has always been a need to develop some governing law and the purpose of that law has been to integrate the legislatively imposed standards with the realities of the market place, so that overall goals would be promoted. Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. It therefore needs to take into account a number of aspects such as, enhancement of shareholder value, protection of shareholders rights, composition and role of board of directors, integrity of accounting practices and disclosure norms and internal control system.
Corporate Governance was brought in limelight through series of corporate failures such as Enron and World Corn. These companies collapsed because of the corporate mis governance and unethical practices they indulged in. Satyam scandal in India is also the case of corporate mis-governance. Satyam case exposed the complete lack of accountability in the company and raised questions on corporate governance practices of the country.

In a service industry like banking, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the o through which the objectives of the institutions are set, the strategy for attaining them is determined and the performance of the institution is monitored.

Bank and Financial Institutions are the backbone of the economic sector of any country. The healthy economic condition of a nation is depicted through the sound functioning of its banks. Banks form a crucial link of a country's economic sector hence they are universally regulated industry and their well being is imperative for the economy. Working of banks is different from other corporate in many important respects, and that makes corporate governance of bank not only different but also critical. Hence corporate governance is conceptually different for banks. If a corporate fails, the fall outs can be restricted to the stakeholders, but if a bank fails, the impact can spread rapidly through other banks with potentially serious consequences for the entire financial system and the macro economy. Thus though various guidelines are provided for working of a bank, corporate governance cannot be overlooked or discarded. Regulations, guidelines and corporate governance are complementary to each other in banking industry.

Virtually every major industrialized country as well as the Organization for Economic Co-Operation and Development and the World Bank has made efforts in recent years to refine their views on how large industrial corporations should be organised and governed. Academics in both law and economics have also been intensely focused on corporate governance. Oddly enough, in spite the general focus on this topic, very little attention has been given to the corporate governance of bank.

Genesis of Corporate Governance: Before delving further in the concept of Corporate Governance it is important to understand the meaning of the word Corporate and Governance. The word Governance derived from Latin word 'Gubernare' meaning thereby to rule or steer. Governance is a word with a pedigree that dates back to Chaucer and in his day the word carried with it the connotation wise and responsible, which is appropriate. It means either the action or the method of governing and it is in that latter sense that it is used with reference to companies. As per Webster Dictionary 'Corporate' means a body having the nature of, or involving or associated with corporations.[2] A 'corporation' in turn means 'a legal entity that exists independently of the person or persons who have been granted the charter creating it and invested with many of the rights given to individuals. The corporate world comprises of institutions, like companies, firms, proprietorship, etc. Corporate governance is a philosophy by which companies are directed, monitored, managed and controlled[3]. Corporate Governance provides the fundamental framework for the culture of an organization, which ensures efficient functioning of enterprises on sound ethical values and principles. Broadly it is a system of structuring, operating and controlling a company with a view to achieve long-term strategic goals to satisfy shareholders, creditors, employers, customers and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.

From the above discussion it can be seen that it is difficult to define corporate governance with only one definition. Hence there are various definitions of corporate governance as given by various experts from time and again. Some of the important definitions to understand the perspective to corporate governance properly are enumerated here below.

The 1992 Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) describes Corporate Governance "*as the system by which companies are directed and controlled".*

1. Wolfensohn, President, World Bank, has said that "*Corporate Governance is about promoting corporate fairness, transparency and accountability*".

Even the Experts at Organization of Economic Co-Operation and Development (OECD)[4]have defined "*Corporate Governance as the system by which business corporations are directed and controlled",* it means according to them it is a structure which specifies the distribution of rights and responsibilities among different participants in the corporations.

But today the concept of corporate governance has taken a new dimension and it runs as follows. "*Corporate Governance is the application of the best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders".*

Corporate Governance as per Indian Scenario: In the Indian context, the need for corporate governance has been highlighted because of the frequently occurring scams since 1991 due to emergence of the concept of liberalization. The scams such as Harshad Mehta Scam, Ketan Parekh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In order to reduce the number the scams in the Indian corporate world, there is a need to induct global standards. From the beginning of 1980s, situation have changed in India. Wide range changes have taken place in both the law and regulations in the field of corporate law and the capital market. As a result of several scams in India a need has arisen to bring reforms, in response to that, reforms begun in India in 1991. The most important event in the field of investor protection in India was the establishment of Securities and Exchange Board of India (SEBI) in 1992. Corporate governance is a multi-faceted subject.

There have been several major corporate governance initiatives launched in India since the mid 1990s. The first was by the Confederation of Indian Industry (CII), India's largest industry and business association, which came up with the first voluntary code of corporate governance in 1998. The second was by the SEBI, now enshrined as Clause 49 of the listing agreement. The third was the Naresh Chandra Committee, which submitted its report in 2002. The fourth was again given by SEBI the Narayana Murthy Committee, which also submitted its report in 2002. Based on some of the recommendations of this committee, SEBI revised Clause 49 of the listing agreement in August 2003. Subsequently, SEBI withdrew the revised Clause 49 in December 2003, and currently, the original Clause 49 is in force.

One of the important theme of corporate governance deals with the issues of accountability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behavior and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare.

In India the concept of Corporate Governance is gaining importance because of two reasons:

- After liberalization, there has been institutionalization of financial markets, FIIs and FIs became dominant players in the stock markets. The market began to discriminate between wealth destroyers. Corporate Governance is a critical by product of market discipline.
- Another factor is the increased role being played by the private sector. Companies are realizing that investors love to stay with those corporate that create values for their investors. This is only possible by adopting fair, honest and transparent corporate practices.

Indian Banking System: Banks play a pivotal role in the financial and economic system of the nation. The health of the economy is closely related to the soundness of its banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services. Indian banking industry, the backbone of the country's economy has always played a key role in preventing the economic catastrophe from reaching terrible volume in the country. Hence the failure of banks due to unethical or incompetent policies and management action is detrimental to the shareholders, public depositors and the economy at large. Owing to this fact, a proper corporate governance system is crucial for banks and other financial institutions.

History and Evolution of Indian Banking System: Modern banking in India could be traced back to the establishment of Bank of Bengal in 1809, the first joint stock bank sponsored by Government of Bengal and governed by the royal charter of the British India Government. In 1921, Imperial Bank of India was established by merging of three presidency banks. It had multiple roles and responsibilities to be played and also functioned as a commercial bank, a banker to the government and a banker's bank. In 1935 by the establishment of Reserve Bank of India (RBI), the central banking responsibility that the Imperial Bank of India was carrying out came to an end, leading it to become more a commercial bank.

By an act of parliament passed in May 1955, State Bank of India was established in July, 1955. In 1959, State Bank of India took over the eight former state associated banks and its subsidiaries. The decade of 1960s also witnessed significant consolidation in the Indian Banking Industry with more than 500 banks functioning in the 1950s reduced to 89 by 1969. 19 July 1969, was a landmark day for the Indian banking industry as on that day nationalization of 14 major banks was announced. Eight more banks were nationalized in 1980. Regional rural banks came into being in 1976 which allowed the opening of specialized regional rural banks to exclusively cater to the credit requirements in the rural areas. The period following nationalization was characterized by rapid rise in banks business and helped in increasing national savings. There was leapfrogged increase in savings rate, deposits and bank credits. Branch network also expanded significantly which lead to increase in the coverage of banking facilities.

Indian banking, which experienced rapid growth following nationalization, began to face pressures on assets quality by 1980s. Simultaneously, the banking

world everywhere was gearing up towards new prudential norms and operational standards pertaining to capital adequacy, accounting and risk management, transparency and disclosure etc. In the early 1990s, India embarked on a ambitious economic reform programme in which the banking sector reforms formed a major part. The Committee on Financial System (1991) more popularly known as the Narasimham Committee prepared blue print of the reforms. A few major aspects of reform included:

- Moving towards international norms in income recognition and provisioning and other related aspects of accounting.
- Liberalization of entry and exit norms leading to the establishment of several New Private Sector Banks and entry of a number of new Foreign Banks
- Freeing of deposits and lending rates (except the saving deposits rate)
- Allowing Public Sector Banks access to public equity markets for raising capital and diluting the government stake
- Greater transparency and disclosure standards in financial reporting
- Suitable adoption of Basel Accord on capital adequacy
- Introduction of technology in banking operations etc.

This led to major changes in the approach of the banks towards aspects such as competition, profitability and productivity and the need and scope for harmonization of global operational standards and adoption of best practices. Significant changes in the strength and sustainability of Indian banking was seen in addition to significant growth in business, Indian banks experienced sharp growth in profitability, greater emphasis on prudential norms with higher provisioning levels, reduction in the non performing assets and surge in capital adequacy. As a part of the adherence to liberalization of the financial services industry, in the year 2009, Indian banking industry prepared for smooth transition towards more intense competition arising from liberalization.

Indian Banking System at Glance: Banking system forms a strategic building block of the economy. The challenge and complexity of implementing corporate governance can be well understood only if we can appreciate the size of the banking system. We need to appreciate that the Indian banking system has made commendable progress in extending its geographical spread and functional reach.

As per the RBI report the number of scheduled commercial banks functioning in India as on March 31st 2012 was 169, of which 82 were regional rural banks. There are 101261 banks offices spread across the country, of which 36% are located in rural areas, 26% in semi urban areas, 20% in urban areas and the rest 19% in the metropolitan areas. The major bank groups (as defined by RBI) functioning during the reference period of the report are State Bank of India and its associate banks, Nationalized Banks and the IDBI ltd., Old Private Sector Banks, New Private Sector Banks and Foreign Banks[5].

Evolution of Corporate Governance in Banking System: As prelude to institutionalize Corporate Governance in banks, an Advisory Group on Corporate Governance was formed under the chairmanship of Dr. R. H. Patil. Following its recommendations in March 2001 another Consultative group was constituted in November 2001 under the Chairmanship of Dr. A. S. Ganguly, with a view to strengthen the internal supervisory role of the Boards in banks in India[6]. This move was further reinforced by certain observations of the Advisory group on Banking Supervision under the Chairmanship of ShriM.S.Verma which submitted its report in January 2003. Keeping all these recommendations in view and the cross country experience, the Reserve Bank initiated several measures to strengthen the corporate governance in the Indian Banking Sector. The noteworthy minimum benchmarks noted by the Group relate to the following[7].

- Strategies and techniques basic to sound corporate governance
- Organizational structure to ensure oversight by board of directors and individuals not involved in day to day running of business
- Ensuring that the direct lines of supervision of different business areas are different
- Ensuring independent risk management and audit functions
- Ensuring an environment supportive of sound corporate governance
- Role of supervisors

The issue pertaining to corporate governance becomes more critical on case of the banks whose controlling power is linked with Government. Government ownership is one of the primary issue that can have a direct impact on the quality of corporate governance. In India almost 80% of the banking operations are under the control of the public sector banks consisting of the nationalized banks, the State Bank of India and its subsidiaries. In Public sector banks, the right of the private shareholders are considerably curtailed as their approval is not required for paying dividend or formalizing the annual accounts.

The importance of corporate governance issues in public sector banks is important due to two principal reasons:

- Firstly, they constitute a huge share of business in the banking industry in India
- Secondly, it is highly unlikely that they are going to be phased out in due course.

Though the general principle of corporate governance is valid for the public sector entities, but they simply cannot imitate the private sector banks in this respect. Things start getting worse, when uncertainties looms involving ownership issues, and the public ownership being treated as a transitional phenomenon. Further, expectation of change in ownership (dilution of Government Stake) can result in the change of institutional structure of significance difference. When Government is the owner, it is accountable to the political institutions, which in turn may not have pure economic motives in mind. A mixed ownership structure can bring the different objectives of shareholding on a common platform and help in reconciling them. Issues relating to the separation of ownership and management in both private and public sectors banks needs to be addressed, in contrast to the traditional Corporate Governance issues stemming from the outside financial, in developing countries and especially in India, things are a bit different. Here, the grueling question is not how the outside financiers (shareholders) exert management control, but also as to how they can (including minority shareholders) exercise control over the big inside shareholders

The most important development in the field of corporate governance and investor protection in India has been the establishment of the securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then. The Basel committee in the year 1999 had brought out certain important principles on corporate governance for banking organizations which more or less have been adopted in India. Today the banks are governed by the Banking Regulation Act, 1949; Reserve Bank of India Act, 1934; Foreign Exchange Management Act, 1999; Payment and Settlement Systems Act, 2007; other relevant Statutes and the Directives, Prudential regulations and other Guidelines/ Instructions issued by RBI and other regulators from time to time, including the regulations of SEBI regarding public issues and other guidelines applicable to listed banking though there is scope for enhancing effective implementation[8].

Need for Corporate Governance in Banking System: Banks are critical components of the economy while providing finance for commercial enterprises, basic financial services to a broad segment of the population and access to payment systems. Banks in India are facing increasing competition, within and outside India, both in terms of markets for its products and for sources of fund.

The importance of banks to national economies is underscored by the fact that banking is, almost universally, a regulated industry and that banks have access to government safety nets. In order to meet the statutory need of having sound Capital Adequacy requirements, banks are accessing the Capital Market at regular intervals. Hence the banks need to stimulate the interest of investors at all times. Investors believe that a bank with good governance will provide them a safe place for investment and also give netter returns. Good corporate governance is therefore an important factor in a competitive environment. Investors, customers, employees and vendors have all become more discerning and are demanding greater transparency and fairness in all dealings. To attract and retain the commitment of investors, customers, employees, Banks should ensure that they match the global benchmark in Corporate Governance Practices.

Banks are also important catalysts for economic reforms, including corporate governance practices. Because of the systemic function of banks, the incorporation of corporate governance practices in the assessment of credit risks pertaining to lending process will encourage the corporate sector in turn to improve their internal corporate governance practices, importance of implementing modern corporate governance standards is conditioned by the global tendency to consolidation in the banking sector and a need in further capitalization. It is of crucial importance therefore that have strong corporate governance practices.

Banks, just like any other organization are incorporated entities. As a result of which, the primary requirements of corporate governance apply to them as any other incorporated entity. Added to this certain features that are very specific to banks, adds on to the importance of Corporate Governance issues in banks.
Among other features, the most important one is the fact that banks form an integral part of the economy of the country, and any failure in a bank might have a direct bearing on the financial health of the country. Banks, help in channelizing the people's saving.

The capital structure of bank is unique in two ways. First, banks tend to have very little equity relative to other firms. Second, banks' liabilities are largely in the form of deposits, which are available to

creditors/depositors on demand, while their assets often take the form of loans that have longer maturities. Thus, the principle attribute that makes banks as financial intermediaries "special" is their liquidity production function. By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy. The liquidity production function may cause a collective-action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run.

The second important driver of a good corporate governance stems from their funding patterns. Banks, by their basic definition are highly leveraged financial institutions, with the equity capital of the shareholders being reduced to a miniscule proportion of loan capital in the form of borrowing and deposits of deposits from customers of the bank. As a result of this, the stakeholders in banks, (mainly the depositors and lenders) have a rightful claim of accountability from the banks and their boards[9].

The third important element in the Corporate Governance structure relates to the control function. It is imperative to discuss the same in brief. Control functions in banks deal with internal frauds as well as external frauds. The former relates to situations where the banks own personnel indulge in corrupt and unethical practices. The latter deals with situations where the customers of the bank try to seek for malpractices. The incidents of the external frauds are so devastating that special attention is being mandated both for their prevention as well as their post scenario analysis. In this connection it is important to remind of the COSO framework that was framed with this intention in mind.

Finally, failing to comply with stipulated norms can be one of the challenging issues of Corporate Governance framework. With Banks being under intense watch of the central bank as well as other regulatory bodies, it is a common observation, that most failures (crashes) in banks have occurred due to compliance failure situations. With a lot of reports and norms, being introduced (The Basel II norms being the latest of them), failure to adhere to the regulatory norms have never reduced.

BASEL II Recommendation: The Basel Committee on Banking Supervision is a committee, of banking supervisory authorities, established by the Central Bank Governors of the G10 developed countries in 1975. The Committee in 1988 introduced the Concept of Capital Adequacy framework, known as Basel Capital Accord, with a minimum capital adequacy of 8 percent[10]. It also issued a consultative document titled "The New Basel Capital Accord" in April 2003, to replace the 1988 Accord, which re-enforces the need for capital adequacy requirements under the current conventions. This accord is commonly known as Basel II and is currently under finalization. Basel II is based on three pillars:

- Pillar 1 – Minimum Capital Requirements
- Pillar 2 – Supervisory Review Process
- Pillar 3 – Market Discipline

Enhancing Corporate Governance in Banks

The Basel committee had issued, in August 1999, a guidance paper entitled "Enhancing Corporate Governance for Banking Organizations" to supervisory authorities worldwide to assist them in promoting the adoption of sound corporate governance practices by banks in their countries[11]

Importance of Corporate Governance for Banks

From a banking industry perspective, corporate governance involves the manner in which their boards of directors and senior management govern the business and affairs of individual banks, affecting how banks set their corporate objectives, run day-to-day operations, consider the interests of various stakeholders, align corporate activities with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations and protect the interests of depositors.

Sound Corporate Governance Practices for Banks

According to the paper some of the best corporate governance practices for banks include establishing strategic objectives and a set of corporate values communicated throughout the organization, strong risk management functions, special monitoring of risk exposures, setting and enforcing clear lines of responsibility, etc.

Role of RBI In Promoting Corporate Governance: The growing competitiveness and interdependence between banks and financial institutions in local and foreign markets have increased the importance of corporate governance and its application in the banking sector. Corporate governance in banks can be achieved through a set legal, accounting, financial and economic rules and regulations. To make sure that the competence and integrity in banking sector is maintained, the need for uniform standards of the concept of governance in private and public sector is emphasized. The regulatory framework implemented by the central bank can affect the overall well being of banking sector.

Best Practices of Banking System In Corporate Governance: Good governance can be built based on the business practices adopted by the

board of directors and management. Many bank failures in the past have been attributed to inadequate and insufficient management which enabled the banks to accept low quality assets and assume additional risks that extend beyond the level appropriate for the banks' capacity[12].

Important commandments for ensuring corporate governance in banks are:

- Banks shall realize that the times are changing
- Banks shall establish an Effective, Capable and Reliable Board of Directors
- Banks shall establish a Corporate Code of Ethics for themselves
- Banks shall consider establishing an office of the Chairman of the Board
- Banks shall have an effective and Operating Audit Committee, Compensation Committee and Nominating/
- Corporate Governance Committee
- Banks shall consider Effective Board Compensation
- Banks shall disclose the information
- Banks shall recognize that duty is to establish Corporate Governance Procedures that will serve to enhance shareholder value

Recent Scenario

Recent steps taken by Banks in India for Corporate Governance are:

- Introduction of non executive members on the Board
- Constitution of various Committees like Management Committee, Audit Committee, Investor's Grievances Committee, ALM Committee etc.
- Gradual implementation of prudential norms as prescribed by RBI
- Introduction of Citizens Charter in Banks
- Implementation of "Know Your customer" (KYC) concept.

Summing Up: Banks and financial sector being a highly service oriented sector, making corporate governance effective is a great challenge. More so, when the driving force of commercial banks is to grab the opportunity, trading profits with only focus on profitability. The levers of systemic control have to be not only progressively tightened but they are also to be scrutinized from the point of deliverables. Moreover the recent global financial crisis leading to the demise of several reputed global investment banks exposes the fissure in the effectiveness of corporate governance model.

Banking sector is the key for monetary conditions in a country. Due to the special nature of the activities carried on by the banks, they face a lot of problems as far as the area of corporate governance is concerned. In the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. The guidance paper issued by the Basel Committee is of paramount significance in enforcing corporate governance standards in various countries across the world.

Corporate Governance is now identified and acknowledged as a powerful tool to generate trust and confidence in an institution. The trend in the world of targeting governance practices in the banking sector to be at the cutting edge of prevailing practices worldwide is a significant step in the right direction and should continue to be so in the future as well.

India has one of the best Corporate Governance legal regimes but poor implementation. SEBI has carved out a certain more stringent provisions relating to listed companies as a condition of the Listing Agreement.

The special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in developing economies such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the cost of raising bank capital and the presence of distributional cartels. Due to special nature of the activities carried on by the banks, they face a lot of problems as far as the area of corporate governance is concerned. Also, in the Indian scenario, due to the peculiar nature of bank holdings there are a lot of embedded conflicts. There exists a doubt as to what standard should be applied while enforcing corporate governance in banks. Central banks play an important role in this regard. As far as best corporate governance practices for banks are concerned, they may include realization that the times are changing, establishing an effective, capable and reliable board of directors, establishing a corporate code of ethics by the banks for themselves, considering establishing an office of the chairman of the board, having an effective and operating audit committee, compensation committee and nominating/ corporate governance committee in place, considering effective board compensation, disclosing the information and recognizing their duty to establish corporate governance procedures that will serve to enhance shareholder value.

Finally this study concluded that, the corporate governance practices in the banking and financial sector in India should improve for best investment policies, appropriate internal control systems, better credit risk management, better customer service and

adequate automation in order to achieve excellence, transparency and maximization of stakeholder' value and wealth.

INTRODUCTION TO PUBLIC REVENUE ↓

Governments need to perform various functions in the field of political, social &economic activities to maximise social and economic welfare. In order toperform these duties and functions government require large amount ofresources. These resources are called public revenues.
Public revenue, consists of taxes, revenue from administrative activities likefines, fees, gifts & grants. Public revenue can be classified into two types.

Tax revenue ↓
Taxes are the first and foremost sources of public revenue. Taxes arecompulsory payments to government without expecting direct benefit or returnby the tax payer. Taxes collected by government are used to provide commonbenefits to all mostly in form of public welfare services. Taxes do notguarantee any direct benefit for person who pays the tax. It is not based ondirect quid pro quo principle.

The following are the characteristics of a tax :-
1. A tax is a compulsory payment made to the government. People onwhom a tax is imposed must pay the tax. Refusal to pay the tax is apunishable offence.
2. There is no quid pro quo between a taxpayer and public authorities. Thismeans that the tax payer cannot claim any specific benefit in return for thepayment of a tax.
3. Every tax involves some sacrifice on part of the tax payer.4. A tax is not levied as a fine or penalty for breaking law.
The government collect tax revenue by way of direct & indirect taxes. Directtaxes includes; corporate tax; personal income tax capital gain tax and wealthtax. Indirect taxes includes custom duty, central excise duty, vat and servicetax.
In 2006-07 (india related), the tax revenue contributed about 81% of the totalrevenue receipts of the central government, whereas non-tax revenue receiptscontributed the remaining 19%.

Non-tax revenue ↓
The revenue obtained by the government from sources other then tax is called non-tax revenue. The sources of non-tax revenue are :-
1. Fees
Fees are another important source of revenue for the government. A fee ischarged by public authorities for rendering a service to the citizens. Unlike tax,there is no compulsion involved in case of fees. The government providescertain services and charges certain fees for them. For example, fees arecharged for issuing of passports, driving licenses, etc.

2. Fines or penalties
Fines or penalties are imposed as a form of punishment for breach of law ornon fulfillment or certain conditions or for failure to observe some regulations.
Like taxes, fines are compulsory payments without quid pro quo. But whiletaxes are generally imposed to collect revenue. Fines are imposed as a formof punishment or to prevent people from breaking the law. They are notexpected to be a major source of revenue to the government.

3. Surplus from public enterprises
The government also gets revenue by way of surplus from public enterprises. In India, the government has set up several public sector enterprises toprovide public goods and services. Some of the public sector enterprises domake a good amount of profits. The profits or dividends which the governmentgets can be utilized for public expenditure. There is some sort of quid-pro-quoin the case of surplus from public enterprises. This is because, the public getsgoods and services, and the government gets prices, and consequently profitsfrom selling such goods and services.

4. Special assessment of betterment levy
It is a kind of special charge levied on certain members of the community whoare beneficiaries of certain government activities or public projects. Forexample, due to a public park in a locality or due to the construction of a road,people in that locality may experience an appreciation in the value of theirproperty or land. Thus, due to public expenditure, some people mayexperience 'unearned increments' in their asset holding. Betterment levy islike a tax because it is a compulsory payment, but unlike a tax, in case ofbetterment levy there is some element of quid pro quo.

6. Deficit financing
Deficit means an excess of public expenditure over public revenue.This excess may be met by borrowings from the market, borrowings fromabroad, by the central bank creating currency. In case of borrowing fromabroad, there cannot be compulsion for the lenders, but in case of internalborrowings there may be compulsion. The government may force variousindividuals, firms and institutions to lend to it at a much lower rate than themarket would have offered.

TAXES-

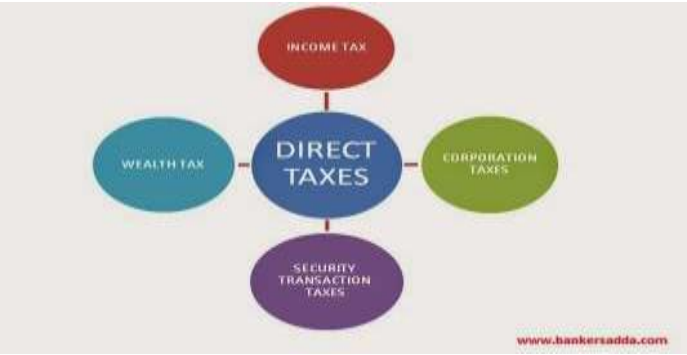
Taxes are the amount of money government impose on an individual or corporates directly or indirectly so as

to generate revenue or to keep in check any black money activities in India.

THERE ARE TWO CATEGORIES OF TAXES IN INDIA, THESE ARE –

DIRECT TAXES-

These taxes are levied directly on the persons.
These contributes major chunk of the total taxes collected in India.



Some of the direct taxes are-

INCOME TAX-

This is a type of tax levied on the individuals whose income falls under the taxable category (2.5 lakhs per annum). The Indian Income Tax Department is governed by CBDT and is part of the Department of Revenue under the Ministry of Finance, Govt. of India. Income tax is a key source of funds that the government uses to fund its activities and serve the public.

Corporate Income Tax –

This is the tax levied on the profits a corporate house earned in a year. In India, the Corporate Income tax rate is a tax collected from companies. Its amount is based on the net income companies obtain while exercising their business activity, normally during one business year.

Securities Transaction Tax-

Introduced in 2004, STT is levied on the sale and purchase of equities. more clearly, The income a individual generate through the securities market be it through reseling of shares or through debentures is taxed by the government of India and the same tax is called as Securities Transaction Tax.

Banking Cash Transaction Tax -

A bank transaction tax is a tax levied on debit (and/or credit) entries on bank accounts. It can be automatically collected by a central counterparty in the clearing or settlement process.

INDIRECT TAXES-

You go to a super market to buy goods or to a restaurant to have a mouthful there at the time of billing you often see yourself robbed by some more amount than what you enjoyed of , these extra amounts are indirect taxes, which are collected by the intermediaries and when govt tax the income of the intermediaries this extra amount goes in to government's kitty, hence as the name suggests these are levied indirectly on common people.
Some examples of Indirect Taxes are-

Value Added Tax-

When we pay an extra amount of price for the goods and services we consume or buy, that extra amount of money is called as VAT. This taxes is about to be replaced by Goods and Services Tax.

Current rate-

On agricultural goods-4%
On luxury items- 20%

Customs Duty –

Customs Duty is a type of indirect tax levied on goods imported into India as well as on goods exported from India. In India, the basic law for levy and collection of customs duty is Customs Act, 1962. It provides for levy and collection of duty on imports and exports.

Excise Duty –

An excise or excise tax is an inland tax on the sale, or production for sale, of specific goods or a tax on a good produced for sale, or sold, within a country or licenses for specific activities. Excises are distinguished from customs duties, which are taxes on import.

Service Tax-

Service Tax is a tax imposed by Government of India on services provided in India. The service provider collects the tax and pays the same to the government. It is charged on all services except the services in the negative list of services.

FINANCE COMMISSION:

The **Finance Commission of India** came into existence in 1951. It was established under *Article 280* of the Indian Constitution by the President of India. It was formed to define the financial relations between the centre and the state. The Finance Commission Act of 1951 states the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission.[1] As per the Constitution, the commission is appointed every five years and consists of a chairman and four other members. Since the institution of the first finance commission, stark changes have occurred in the Indian economy causing changes in the macroeconomic scenario. This has led to major changes in the Finance Commission's recommendations over the years. Till date, Fourteen Finance Commissions have submitted their reports.

The Indian State, like all other federations, is also ridden by the problems of Vertical and Horizontal Imbalances. Explaining vertical Imbalances result because states are assigned responsibilities and in the process of fulfilling those that they incur expenditures disproportionate to their sources of revenue. So the finance commission was set up so that the states are able to gauge the needs and concerns of their people more effectively, and hence, are more efficient in addressing them.

Function

Functions of the Finance Commission can be explicitly stated as:

1. Distribution of net proceeds of taxes between Centre and the States, to be divided as per their respective contributions to the taxes.
2. Determine factors governing Grants-in Aid to the states and the magnitude of the same.
3. To make recommendations to president as to the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.

PROPOSAL OF THE 14th FINANCE COMMISSION:

- As the states are subjected to more and more interstate migrant workers and illegal migrants from the neighboring countries, the finance commission shall give appropriate weight-age in distribution of the total taxes to the states based on these criteria. The states which are giving more employment to interstate workers are ahead in demographic transition. Demographic transition of a state is a real index & status of all round human and economical development.
- The states with coast line shall be given appropriate share from the royalty / taxes collected by the central government from the minerals produced (including oil & natural gas) from the area of territorial waters and exclusive economic zone similar to land based minerals production. Articles 1 & 3 of the constitution define India as union of two entities only which are either states or union territories. There is no third entity such as territorial waters or exclusive economic zone. These are parts of states / union territories under Indian union.
- Article 282 accords financial autonomy in spending the resources available with the states for public purpose. Finance commission should desist from specific expenditure related grant in aids to the states out of the Consolidated Fund of India.[4][5]
- Under article 360 of the constitution, President can proclaim financial emergency when the financial stability or credit of the nation or of any part of its territory is threatened. Finance commission should bring out the guidelines which may warrant the imposition of financial emergency in the entire country or a state or a union territory or a panchayat or a municipality or a corporation to take up precautions for improving their financial soundness.
- Finance commission should deliberate and recommend whether government advertisements other than educational advertisements are serving public purpose for deserving government expenditure under article 282 of the constitution.[6]
- The finance commissions shall deliberate and recommend on all issues related to government spending which are taken up by various law commissions earlier and of public topics with wide public attention.
- **Major Recommendations of 14th Finance Commission headed by Prof. Y V Reddy**

1.The share of states in the net proceeds of the shareable Central taxes should be 42%.This is 10% higher than the recommendation of 13th Finance Commission.

2.Revenue deficit to be progressively reduced and eliminated.

3.Fiscal deficit to be reduced to 3% of the GDP by 2017–18.

4.A target of 62% of GDP for the combined debt of centre and states.

5.The Medium Term Fiscal Plan(MTFP)should be reformed and made the statement of commitment rather than a statement of intent.

6.FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.

7.Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act(GST).
8.Initiatives to reduce the number of Central Sponsored Schemes(CSS)and to restore the predominance of formula based plan grants.
9.States need to address the problem of losses in the power sector in time bound manner.

- **Major Recommendations of 13th Finance Commission headed by shri Vijay Kelkar.**

1. The share of states in the net proceeds of the shareable Central taxes should be 32%.This is 1.5% higher than the recommendation of 12th Finance Commission.
2. Revenue deficit to be progressively reduced and eliminated, followed by revenue surplus by 2013–14.
3. Fiscal deficit to be reduced to 3% of the GDP by 2014–15.
4. A target of 68% of GDP for the combined debt of centre and states.
5. The Medium Term Fiscal Plan(MTFP)should be reformed and made the statement of commitment rather than a statement of intent.
6. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.
7. Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Act(GST).To incentivise the states, the commission recommended a sanction of the grant of Rs500 billion.
8. Initiatives to reduce the number of Central Sponsored Schemes(CSS)and to restore the predominance of formula based plan grants.
9. States need to address the problem of losses in the power sector in time bound manner.

FISCAL POLICY IN INDIA:
Meaning of Fiscal Policy ↓

The fiscal policy is concerned with the raising of government revenue and incurring of government expenditure. To generate revenue and to incur expenditure, the government frames a policy called budgetary policy or fiscal policy. So, the fiscal policy is concerned with government expenditure and government revenue.
Fiscal policy has to decide on the size and pattern of flow of expenditure from the government to the economy and from the economy back to the government. So, in broad term fiscal policy refers to "that segment of national economic policy which is primarily concerned with the receipts and expenditure of central government." In other words, fiscal policy refers to the policy of the government with regard to taxation, public expenditure and public borrowings.
The importance of fiscal policy is high in underdeveloped countries. The state has to play active and important role. In a democratic society direct methods are not approved. So, the government has to depend on indirect methods of regulations. In this way, fiscal policy is a powerful weapon in the hands of government by means of which it can achieve the objectives of development.

SquareMain Objectives of Fiscal Policy In India ↓

The fiscal policy is designed to achieve certain objectives as follows :-

1. Development by effective Mobilization of Resources

The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilization of Financial Resources.
The central and the state governments in India have used fiscal policy to mobilize resources.
The financial resources can be mobilized :-

Taxation : Through effective fiscal policies, the government aims to mobilize resources by way of direct taxes as well as indirect taxes because most important source of resource mobilization in India is taxation.

Public Savings : The resources can be mobilized through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

Private Savings : Through effective fiscal measures such as tax benefits, the government can raise

resources from private sector and households. Resources can be mobilized through government borrowings by ways of treasury bills, issue of government bonds, etc., loans from domestic and foreign parties and by deficit financing.
2. Efficient allocation of Financial Resources

The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc. While Non-development Activities includes expenditure on defense, interest payments, subsidies, etc.
But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

3. Reduction in inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

4. Price Stability and Control of Inflation

One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by Reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc.

5. Employment Generation

The government is making every possible effort to increase employment in the country through effective fiscal measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

6. Balanced Regional Development

Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax holidays, Finance at concessional interest rates, etc.

7. Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures like Exemption of income tax on export earnings, Exemption of central excise duties and customs, Exemption of sales tax and octroi, etc.
The foreign exchange is also conserved by Providing fiscal benefits to import substitute industries, Imposing customs duties on imports, etc.
The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export.

8. Capital Formation

The objective of fiscal policy in India is also to increase the rate of capital formation so as to accelerate the rate of economic growth. An underdeveloped country is trapped in vicious (danger) circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending.

9. Increasing National Income

The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country.

10. Development of Infrastructure

Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measure such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost.

11. Foreign Exchange Earnings

Fiscal policy attempts to encourage more exports by way of Fiscal Measures like, exemption of income tax

on export earnings, exemption of sales tax and octroi, etc. Foreign exchange provides fiscal benefits to import substitute industries. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem.

SquareConclusion On Fiscal Policy ↓

The objectives of fiscal policy such as economic development, price stability, social justice, etc. can be achieved only if the tools of policy like Public Expenditure, Taxation, Borrowing and deficit financing are effectively used.
Though there are gaps in India's fiscal policy, there is also an urgent need for making India's fiscal policy a rationalized and growth oriented one.
The success of fiscal policy depends upon taking timely measures and their effective administration during implementation.

INFLATION : AN OVERVIEW

Inflation is a sustained increase in the general price level of goods and services in an economy over a period of time. When the general price level rises, each unit of money buys fewer goods and services. Inflation reflects a reduction in the purchasing power per unit of money.

Inflation occurs due to an imbalance between demand and supply of money, changes in production and distribution cost or increase in taxes on products. When economy experiences inflation, i.e. when the price level of goods and services rises, the value of currency reduces. This means now each unit of currency buys fewer goods and services.

It has its worst impact on consumers. High prices of day-to-day goods make it difficult for consumers to afford even the basic commodities in life. This leaves them with no choice but to ask for higher incomes. Hence the government tries to keep inflation under control.
Contrary to its negative effects, a moderate level of inflation characterizes a good economy. An inflation rate of 2 or 3% is beneficial for an economy as it encourages people to buy more and borrow more, because during times of lower inflation, the level of interest rate also remains low. Hence the government as well as the central bank always strive to achieve a limited level of inflation.

Many developing countries use changes in the Consumer Price Index (CPI) as their central measure of inflation. India used WPI as the measure for inflation but now on basis of Urjit Patel recommendations, new CPI(combined) is declared as the new standard for measuring inflation (April 2014).

There are several variations in inflation:

Deflation: When the general level of prices is falling. This is the opposite of inflation.

Hyperinflation: Unusually rapid inflation. In extreme cases, this can lead to the breakdown of a nation's monetary system. One of the most notable examples of hyperinflation occurred in Germany in 1923, when prices rose 2,500% in one month.

Stagflation: It is the combination of high unemployment and economic stagnation with inflation. This happened in industrialized countries during the 1970s, when a bad economy was combined with OPEC raising oil prices. In recent years, most developed countries have attempted to sustain an inflation rate of 2-3%.

Recession: A period of general economic decline; typically defined as a decline in GDP for two or more consecutive quarters. A recession is typically accompanied by a drop in the stock market, an increase in unemployment, and a decline in the housing market. A recession is generally considered less severe than a depression, and if a recession continues long enough it is often then classified as a depression.

Depression : A depression is a severe economic catastrophe in which real gross domestic product (GDP) falls by at least 10%. A depression is much more severe than a recession and the effects of a depression can last for years. It is known to cause calamities in banking, trade and manufacturing, as well as falling prices, very tight credit, low investment, rising bankruptcies and high unemployment.

Causes of inflation
Inflation is the result of two sets of factors :

Cost-Push Inflation

Cost-push inflation basically means that prices have been "pushed up" or increased by increases in costs of any of the four factors of production (labor, capital, land or entrepreneurship).
(Aggregate supply is the total volume of goods and services produced by an economy at a given price level.)When there is a decrease in the aggregate supply of goods and services due to an increase in the cost of

production, we have cost-push inflation. As a result, the increased costs are passed on to consumers, causing a rise in the general price level (inflation).

Demand Pull inflation

A situation where the demand for goods and services rises faster than the supply of goods and services. This excess demand increases the prices of the goods and services hence creating inflation. Can be simply said as " Too much money chasing too few goods ".Some factors that cause this demand pull inflations are excessive foreign investment, expansionary fiscal policy e.g increase in government expenditure), expansionary monetary policy(eg. Increase in money supply),easy access to credit , deficit financing and others.

Some of the most important measures that must be followed to control inflation are:

1. Fiscal Policy: Reducing Fiscal Deficit
2. Monetary Policy: Tightening Credit
3. Supply Management through Imports
4. Incomes Policy: Freezing Wages.

1. Fiscal Policy: Reducing Fiscal Deficit:

Fiscal policy means how a Government raises its revenue and spends it. If the total revenue raised by the Government through taxation, fees, surpluses from public undertakings is less than the expenditure it incurs on buying goods and services to meet its requirements of defense, civil administration and various welfare and developmental activities, there emerges a fiscal deficit in its budget. To check inflation the Government should try to reduce fiscal deficit. It can reduce fiscal deficit by curtailing its wasteful and inessential expenditure. In India, it is often argued that there is a large scope for scaling down non-plan expenditure on defense, police and General Administration and on subsidies being provided on food, fertilizers and exports.

2. Monetary Policy: Tightening Credit:

Monetary policy refers to the adoption of suitable policy regarding interest rate and the availability of credit. Monetary policy is another important measure for reducing aggregate demand to control inflation. It affects the cost of credit through interest rate. The higher the rate of interest, the greater the cost of borrowing from the banks. Other tools of monetary policy like SLR, CRR, Repo rate ,Reverse Repo rate, open market operations are use to control inflation in the economy by draining the liquidity from the market.

3. Supply Management through Imports:

To check the rise in prices of food-grains, edible oils, sugar etc., the Government has often taken steps to increase imports of goods in short supply to enlarge their available supplies.When inflation is of the type of supply-side inflation, imports are increased. To increase imports of goods in short supply the Government reduces customs duties on them so that their imports become cheaper and help in containing inflation.

Another anti-inflationary measure is the avoidance of wage increases. When cost of living rises due to the initial rise in prices, workers demand higher wages to compensate for the rise in cost of living. By freezing wages of the employee can helpful in controlling inflation.