Functions of RBI

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Reserve Bank of India (RBI) is India's central bank. Central bank of a country execute multiple functions such as overseeing monetary policy, issuing currency, managing foreign exchange, working as a bank of government and as banker of scheduled commercial banks, etc. It also works for overall economic growth of the country. The Reserve Bank of India was established in 1935 with the provision of Reserve Bank of India Act, 1934. Though privately owned initially, in 1949 it was nationalized and since then fully owned by Government of India (GoI).

Preamble

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...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."

Functions of Reserve bank of India

Main Functions:

Monetary Authority

Monetary authority or monetary policy refers to the use of instruments under RBI control to regulate availability, cost and use of money and credit and providing the citizens the appropriate available monetary facilities. Central bank does this to maintain pricing stability, low & stable inflation as well as promoting economic growth of country.

Issuer of Currency

Reserve bank of India is the sole body who is authorized to issue currency in India. While coins are minted by GoI, the RBI works as an agent of GoI for distributing and handling of coins. RBI also works to prevent counterfeiting of currency by regularly upgrading security features of currency. For printing currency, RBI has four facilities at Dewas, Nasik, Mysore and Hyderabad. The RBI is authorized to issue notes up to value of Rupees ten thousand.

Banker and Debt Manager to Government

Just like individuals need a bank to carry out their financial transactions effectively & efficiently, Governments also need a bank to carry out their financial transactions. RBI serves this purpose for the Government of India (GoI). As a banker to the GoI, RBI maintains its accounts, receive payments into & make payments out of these accounts. RBI also helps GoI to raise money from public via issuing bonds and government approved securities.

Banker's bank and supervisor

RBI also works as banker to all the scheduled commercial banks. All the banks in India maintain accounts with RBI which helps them in clearing & settling inter- bank transactions and customer transactions smoothly & swiftly. Maintaining accounts with RBI help banks to maintain statutory reserve requirements. RBI also acts as lender of last resort for all the banks.

Regulator of the Banking System

RBI has the responsibility of regulating the nation's financial system. As a regulator and supervisor of the Indian banking system it ensures financial stability & public confidence in the banking system. RBI uses methods like On-site inspections, off-site surveillance, scrutiny & periodic meetings to supervise new bank licenses, setting capital requirements and regulating interest rates in specific areas. RBI is currently focused on implementing Basel III norms.

Manager of Foreign Exchange

With increasing integration of the Indian economy with the global economy arising from greater trade and capital flows, the foreign exchange market has evolved as a key segment of the Indian financial market and RBI has an important role to play in regulating & managing this segment. RBI manages forex and gold reserves of the nation.

On a given day, the foreign exchange rate reflects the demand for and supply of foreign exchange arising from trade and capital transactions. The RBI’s Financial Markets Department (FMD) participates in the foreign exchange market by undertaking sales / purchases of foreign currency to ease volatility in periods of excess demand for/supply of foreign currency.

Regulator and Supervisor of the Payment and Settlement Systems

Payment and settlement systems play an important role in improving overall economic efficiency. The Payment and Settlement Systems Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country. In this role, the RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms. Two payment systems National Electronic Fund Transfer (NEFT) and Real Time Gross Settlement (RTGS) allow individuals, companies and firms to transfer funds from one bank to another. These facilities can only be used for transferring money within the country.

NEFT operates on a deferred net settlement (DNS) basis and settles transactions in batches. The settlement takes place for all transactions received till a particular cut-off time. It operates in hourly batches — there are 12 settlements from 8 am to 7 pm on weekdays and SIX between 8 am and 1 pm on Saturdays. Any transaction initiated after the designated time would have to wait till the next settlement time. In RTGS, transactions are processed continuously, all through the business hours. RBI’s settlement time is 9 am to 4:30 pm on weekdays and 9 am to 2:00 pm on Saturdays.

Developmental Role

This is one of the most critical role RBI plays in building the country's financial structure. Key tools in this effort include Priority Sector Lending such as agriculture, micro and small enterprises (MSE), housing and education. RBI work towards strengthening and supporting small local banks and encourage banks to open branches in rural areas to include large section of society in banking net.

Monetary Policy

Monetary Policy refers to the process employed by Central bank of the country to control availability & cost of currency and thus keeping Inflation & Deflation low and stable. The central bank does so by using various tools. Broadly these tools can be categorized in two parts as Quantitative & Qualitative tools.

Quantitative Tools

Quantitative tools refer to reserve ratios.

Reserve Ratios

Reserve ratios are the share of net demand & time liabilities (NDTL) which banks have to keep aside to ensure that they have sufficient cash to cover customer withdrawals. There are two types of reserve ratios.

Statutory Liquidity Ratio (SLR)

The share of net demand and time liabilities that banks must maintain in safe and liquid assets, such as government securities, cash and gold. The RBI has cut the SLR by 50 basis point to 21.25% on 3 February 2015.

Cash Reserve Ratio (CRR)

The share of net demand and time liabilities that banks must maintain as cash with RBI. The RBI has set CRR at 4%. So if a bank has 200 Crore of NDTL then it has to keep Rs. 8 Crore in cash with RBI. RBI pays no interest on CRR.

Let's assume economy is showing inflationary trends & RBI wants to control this situation by adjusting SLR & CRR. If RBI increases SLR to 50% and CRR to 20% then bank will be left only with Rs. 60 crore for operations. Now it will be very difficult for bank to maintain profitability with such small capital. Bank will be left with no choice but to raise interest rate which will make borrowing costly. This will in turn reduce the overall demand & hence price will come down eventually.

Open Market Operation (OMO)

Open market operation is the activity of buying and selling of government securities in open market to control the supply of money in banking system. When there is excess supply of money, central bank sells government securities thereby sucking out excess liquidity. Similarly, when liquidity is tight, RBI will buy government securities and thereby inject money supply into the economy.

Policy Rates

Policy rates are various interest rate which RBI uses to control money supply in India. Repo Rate is often called as key policy rate in India as all the other rates can be derived from repo rate.

Bank Rate

When banks want to borrow long term funds from RBI, it is the interest rate which RBI charges to them. It is currently set to 7.75%(Fourth Bi-monthly Monetary Policy Statement, 2015–16). The bank rate is not used to control money supply these days. Although penal rates are linked to bank rate. If a bank fails to keep SLR or CRR then RBI will impose penalty & it will be 300 basis points above bank rate.

Liquidity Adjustment Facility (LAF)

Liquidity Adjustment facility was introduced in 2000. LAF is a facility provided by the Reserve Bank of India to scheduled commercial banks to avail of liquidity in case of need or to park excess funds with the RBI on an overnight basis against the collateral of Government securities. RBI accept application for a minimum amount of Rs.5 crore and in multiples of Rs. 5 crore thereafter. LAF enables liquidity management on a day-to-day basis. The operations of LAF are conducted by way of repurchase agreements called Repos & Reverse Repos.

Repo Rate

If banks want to borrow money (for short term, usually overnight) from RBI then banks have to pay this interest rate. currently, Repo rate is set to 6.75% - Fourth Bi-monthly Monetary Policy Statement, 2015-16. Banks have to pledge government securities as collateral. This kind of deal happens through a repurchase agreement. If a bank wants to borrow Rs. 100 crores, it has to provide government securities at least worth Rs. 100 crore (could be more because of margin requirement which is 5%-10% of loan amount) and agree to repurchase them at Rs. 106.75 crore at the end of borrowing period. So the bank has paid Rs. 6.75 crore as interest. This is the reason it is called repo rate. The government securities which are provided by banks as collateral can not come from SLR quota (otherwise the SLR will go below 21.5% of NDTL and attract penalty). Banks have to provide these securities additionally.

To curb inflation, RBI increases Repo rate which will make borrowing costly for banks. Banks will pass this increased cost to their customers which make borrowing costly in whole economy. Fewer people will apply for loan and aggregate demand will get reduced. This will result in inflation coming down. RBI does the opposite to fight deflation. Although when RBI reduce Repo rate, banks are not legally required to reduce their base rate.

Reverse Repo Rate

As the name suggest, reverse repo rate is just the opposite of repo rate. If a bank has surplus money, they can park this excess liquidity with RBI and central bank will pay interest on this. This interest rate is called reverse repo rate & it is set to 100 basis point below repo rate. So if Repo rate is set to 8% reverse repo rate will be 7%.At present, reverse repo rate is 5.75%. Fourth Bi-monthly Monetary Policy Statement, 2015–16

Marginal Standing Facility (MSF)

This scheme was introduced in May, 2011 and all the scheduled commercial bank can participate in this scheme. Banks can borrow up to 2.5percent of their respective Net Demand and Time Liabilities. RBI receive application under this facility for a minimum amount of Rs. One crore and in multiples of Rs. One crore thereafter. The important difference with repo rate is that bank can pledge government securities from SLR quota (up to one percent). So even if SLR goes below 21.5%(RBI/2014-15/445 DBR.Ret.BC.70/12.02.001/2014-15, dt. 03.02.2015) by pledging SLR quota securities under MSF, bank will not have to pay any penalty. The MSF rate is set to 100 basis point above repo rate and currently is at 7.75%.

Qualitative Tools

Margin Requirements or LTV

Loan to Value is the ratio of loan amount to the actual value of asset purchased. RBI regulates this ratio so as to control the amount bank can lend to its customers. For example, if an individual wants to buy a car from borrowed money and the car value is Rs. 10 Lac, he can only avail a loan amount of Rs. 7 Lac if the LTV is set to 70%. RBI can decrease or increase to curb inflation or deflation respectively.

Selective credit control

Under this measure, RBI can specifically instruct banks not to give loans to traders of certain commodities e.g. sugar, edible oil etc. This prevents speculations/ hoarding of commodities using money borrowed from banks.

Moral Suasion

Under this measure RBI try to persuade bank through meetings, conferences, media statements to do specific things under certain economic trends. For example, when RBI reduces repo rate, it asks banks to reduce their base rate as well. Another example of this measure is to ask banks to reduce their Non-performing assets (NPAs).

Limitations of Monetary Policy

In developing countries like India, Monetary Policy fails to show immediate or no results because of below factors:

1. People do not employ alternative investment options. A large section of society still depends on saving accounts, fixed deposits, Public Provident Fund for investment. Commercial banks have large deposits. RBI is not the main or even prominent money supplier for these banks. So whatever monetary action central bank takes has little or late impact on the economy.
2. Many people in rural areas are out of banking net and whatever RBI does has no impact on their financial activities.
3. Monsoon uncertainty adversely affects food production and thereby causes food inflation. Monetary Policy has no impact on food inflation.

4. Till now RBI has multi-indicator approach where it focuses on factors like Wholesale Price Index (WPI), growth and employment. The Urjit Patel committee has recommended RBI to only control Consumer Price Index (CPI).

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