CHAPTER

1

RESERVE BANK OF INDIA ACT, 1934

Covering-

- Reserve Bank of India - Establishment
- Organisational Structure& Management
- Central Board of Directors
- Local Boards
- Offices and Branches
- Purpose/Functions of the Reserve Bank
- Reserve Bank as Banker Banks
- Payment and Settlement Systems
- Monetary Policy
- Instruments of monetary policy
- Constitution of monetary policy committee
- Advance Your Knowledge
- Self-Test Questions

EXPECTED MARKS COVERAGE (1 to 5)

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RESERVE BANK OF INDIA ACT, 1934

The **Reserve Bank of India Act, 1934** ***established the Reserve Bank*** and set in motion a series of actions culminating in the start of operations in 1935.

RESERVE BANK OF INDIA-ESTABLISHMENT & INCORPORATION

Section 3 of the RBI Act states that a bank to be called the Reserve Bank of India shall be constituted for

the **purposes of taking over the management of the currency from the Central Government** and
of **carrying on the business of banking** in accordance with the provisions of the Act.

Sub section (2) of this section provides that the B**ank shall be a body corporate by the name of Reserve Bank of India,** having perpetual succession and a common seal, and shall by the said name sue and be sued.

Starting as a **private shareholders' bank, the Reserve Bank was nationalized in 1949**. It then assumed the **responsibility to meet the aspirations of a newly independent country and its people**

THE PREAMBLE TO THE RESERVE BANK OF INDIA ACT

<u>**The Preamble to the Reserve Bank of India Act, 1934**</u> (the Act), under which it was constituted, **specifies <u>its objective</u>** <u>as</u>

"to regulate the issue of Bank notes and
the 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".

The Reserve Bank designs and implements the regulatory policy framework for **banking and non-banking financial institutions** <u>*with the aim*</u> of

providing **people access to the banking system,**
protecting depositors' interest, and
maintaining overall health of the financial system.

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ORIGIN OF THE RESERVE BANK OF INDIA AT A GLANCE

1926: The Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.

1927: A bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.

1933: The White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.

1934: The Bill was passes and received the Governor General's assent

1935: The Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crore (rupees fifty million).

1942: The Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar)

1947: The Reserve Bank stopped acting as banker to the Government of Burma

1948: The reserve Bank stopped rendering central banking services to Pakistan

1949: The Government of India nationalised the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.

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ORGANISATIONAL STRUCTURE & MANAGEMENT

The organizational structure of RBI can be classified under the following designations:

- Central Board of Director
- Governor
- Deputy Governors
- Executive Directors
- Principal Chief General Manager
- Chief General Managers
- General Managers
- Deputy General Managers
- Assistant General Managers
- Managers
- Assistant Managers
- Support Staff

CENTRAL BOARD OF DIRECTORS

The Central Board of Directors is at the **top of the Reserve Bank's organisational structure**. ***Appointed by the Government*** under the provisions of Reserve Bank of India Act, 1934, the Central Board has the **primary authority and responsibility for the oversight of Reserve Bank**. It **delegates specific functions to the Local Boards and various committees.**

As per Section 8 of the Act, the **constitution of the Central Board** is as follows:

(a)	**a Governor** and **not more than four Deputy Governors** to be appointed by the Central Government;
(b)	**four Directors** to be nominated by the Central Government, one from each of the **four Local Boards** as constituted by section 9;
(c)	**ten Directors** to be nominated by the Central Government; and.
(d)	**two Government officials** to be nominated by the Central Government;

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THE GOVERNOR AND DEPUTY GOVERNOR

The **<u>Governor is the Reserve Bank's chief executive.</u>**
The Governor supervises and directs the affairs and business of RBI.
The management team also includes **Deputy Governors and Executive Directors**.
The **Governor and Deputy Governors** devote their whole time to the affairs of the Bank, and receive such salaries and allowances as may be determined by the Central Board, with the approval of the Central Government.
The **Deputy Governor and the Director** nominated under Section 8 **may attend any meeting** of the Central Board and take part in its deliberations but shall **not be entitled to vote.** However when the ***Governor is, for any reason, unable to attend any such meeting***, a **Deputy Governor authorized by him** in this behalf in writing **may vote for him** at that meeting.
The Governor and a Deputy Governor hold the office for such term **not exceeding five years** as the Central Government may fix when appointing them, and they are eligible for re-appointment.

LOCAL BOARDS

The Reserve Bank also has **four Local Boards**, constituted by the Central Government under the RBI Act, one each for the **Western, Eastern, Northern and Southern** areas of the country, which are located in Mumbai, Kolkata, New Delhi and Chennai. Each of these Boards has **five members** appointed byte Central Government for a term of **four years** and thereafter until his successor is appointed. They are **eligible for re-appointment**.

These Boards **represent territorial and economic interests** of their respective areas, and **advise the Central Board on matte**rs, such as, issues relating to local cooperative and indigenous banks. They also perform **other functions that the Central Board** may delegate to them.

OFFICES AND BRANCHES

The Reserve Bank has a **network of offices and branches** through which it discharges its responsibilities. The units operating in the **four metros** — Mumbai, Kolkata, Delhi and Chennai — are known as **offices,** while the units located at **other cities and towns are called branches**. Currently, the Reserve Bank has its offices, including branches, at **27 locations in India**.

PURPOSE /FUNCTIONS OF THE RESERVE BANK

The purposes for which the Reserve Bank of India established as India's central bank have been spelt out in the **preamble to the RBI Act**, <u>which states as follows:</u>

<u>(A)</u>

(i) "to regulate the issue of Bank notes and
(ii) the keeping of reserves with a view to securing monetary stability in India and
(iii) generally to operate the currency and credit system of the country to its advantage".

; and

(B) that it is essential to have a **modern monetary policy framework** to *meet the challenge of an increasingly complex economy*: the primary objective of the monetary policy **is to maintain price stability** while keeping in mind the **objective of growth** and the **monetary policy framework in India shall be operated by the Reserve Bank of India.**

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The functions of the Reserve Bank of India can be summarized as under:

(a)	Banking Functions
(b)	Issue bank notes
(c)	Monetary Policy Functions
(d)	Public Debt Functions
(e)	Foreign Exchange Management
(f)	Banking Regulation & Supervision
(g)	Regulation and Supervision of NBFCs
(h)	Regulation & Supervision of Co-operative banks
(i)	Regulation of Derivatives and Money Market Instruments
(j)	Payment and Settlement Functions
(k)	Consumer Protection Functions

Foreign Exchange Management

The powers and responsibilities with respect to **external trades and payments**, ***development and maintenance of foreign exchange market in India have been conferred on RBI*** under the provisions of **Foreign Exchange Management Act, 1999 ('FEMA').**

The Reserve Bank, as the **custodian of the country's foreign exchange reserves**, is vested with the responsibility of managing their investment

Right to Issue Bank Notes

Management of currency is one of the core **central banking functions of the Reserve Bank** for which it derives the necessary statutory powers from Section 22 of the RBI Act, 1934. **Along with the Government of India, the Reserve Bank is responsible** for the ***design, production and overall management*** of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes

Denominations of Notes

The Indian Currency is called the **Indian Rupee (*abbreviated as Re. in singular*** *and* ***Rs. in plural***), and its subdenomination the Paisa (plural Paise). At present, notes in India are issued in the denomination **of Rs.5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.200, Rs.500 and Rs.2,000.** The printing of Rs.1 and Rs.2 denominations has been discontinued.

Banker to the Central Government & State Governments

Reserve Bank acts as banker to the Central Government and all the State Governments in India. As a banker to the Government, the Res**erve Bank receives and pays money on behalf of the various Government departments.** The Reserve Bank also undertakes to float loans and manage them on behalf of the Governments.

The **banking functions** for the governments are carried out by the **Public Accounts Departments at the offices/ branches of the Reserve Bank**,
while management of p**ublic debt** including floatation of new loans is done at **Public Debt Office at offices/branches of** the Reserve Bank and by the **Internal Debt Management Department at the Central Office.**

RESERVE BANK AS 'BANKER TO BANKS'

The Reserve Bank to fulfill this function, **opens current accounts of banks with itself,** enabling these banks **to maintain cash reserves** as well as **to carry out inter-bank transactions through these accounts**.

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Inter-bank accounts can **also** be settled by transfer of money through **electronic fund transfer** system, such as, the Real Time Gross Settlement System (RTGS).In addition, the Reserve Bank has also introduced the **Centralised Funds Management System (CFMS)** to facilitate centralised funds enquiry and transfer of funds across Deposit Accounts Department (DADs). This helps banks in their fund management as they can access information on their balances maintained across different DADs from a single location.

As Banker to Banks, the **Reserve Bank provides short-term loans and advances to select banks**, when necessary, to facilitate lending to specific sectors and for specific purposes. These loans are provided against promissory notes and other collateral given by the banks.

The Reserve Bank also acts as the '**lender of last resort**'. It c**an come to the rescue of a bank that is solvent but faces temporary liquidity problems** by supplying it with much needed liquidity when no one else is willing to extend credit to that bank.

PAYMENT AND SETTLEMENT SYSTEMS

The regulation and supervision of **payment systems** is being increasingly recognised as a **core responsibility of central bank**s. Safe and efficient functioning of these systems is an important pre-requisite for **proper functioning of financial system** and the efficient transmission of monetary policy.

The Payment and Settlement Systems Act, 2007 provides for regulation and supervision of payment systems in India and **designates the Reserve Bank as the authority for the purpose**. As per the Act, ***only payment systems authorised by the Reserve Bank can be operated in the country***. The Act also provides for the settlement effected under the rules and p**rocedures of the system provider to be treated as final and irrevocab**le.

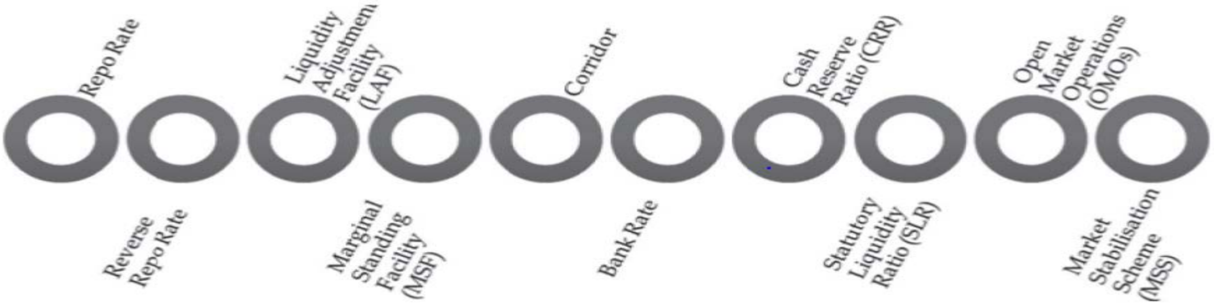
The Reserve Bank has put in place an institutional framework and structure for oversight of the payment systems. In 2005, it created a **Board for Regulation and Supervision of Payment and Settlement Systems** (BPSS) as a *Committee of the Central Board*. A **new department called the Department of Payment and Settlement Systems (DPSS**) was constituted to assist the BPSS in performing its functions.

MONETARY POLICY

Monetary policy refers to the ***policy of the central bank with regard to the use of monetary instruments*** under its control to achieve the goals specified in the Act. The **Reserve Bank of India (RBI) is vested with the responsibility of adopting and implementing monetary policy**. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934. The primary objective of monetary policy is to **maintain price stability** while keeping in mind the objective of growth. **Price stability is a necessary precondition to sustainable growth.**

INSTRUMENTS OF MONETARY POLICY

There are **several direct and indirect instruments** that are used for implementing monetary policy.



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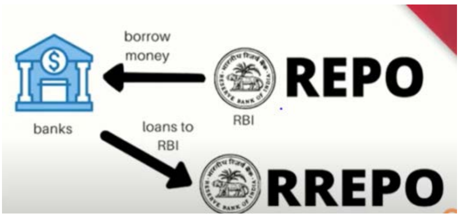
(a) ***<u>Repo Rate:</u>*** **<u>The (fixed) interest rate</u>** at which the Reserve Bank **provides overnight liquidity *to banks*** against the collateral of government and other approved securities under the Liquidity Adjustment Facility (LAF).

(b) ***<u>Reverse Repo Rate</u>:*** **The (fixed) interest rate** at which the Reserve Bank **absorbs liquidity,** on an overnight basis, ***from banks*** against the collateral of eligible government securities under the LAF.



(c) ***<u>Liquidity Adjustment Facility (LAF):</u>*** A liquidity adjustment facility (LAF) is a **tool used in monetary policy**, primarily by the Reserve Bank of India (RBI) that allows banks

to borrow money through repurchase agreements (repos) or
to make loans to the RBI through reverse repo agreements.

The RBI may **use the facility for adjusting liquidity** *to manage high levels of inflation*. It does this by **raising the repo rate**, which increases the <u>cost of debt</u> servicing. This, in turn, r**educes the supply of <u>investment</u>** and money within the <u>economy</u> of India.

(d) ***<u>Marginal Standing Facility (MSF):</u>***

A facility under which **scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank.**
Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in **an emergency situation when inter-bank liquidity dries up completely.**
Banks borrow from the central bank by pledging government securities **at a rate higher than the repo rate** under liquidity adjustment facility or LAF.
This provides a safety valve against unanticipated liquidity shocks to the banking system.

(e) ***<u>Corridor:</u>*** The Corridor in monetary policy of the RBI refers to **the area between the reverse repo rate and the MSF rate**. ***Reverse repo rate will be the lowest*** of the policy rates whereas ***Marginal Standing Facility is something like an upper ceiling*** with a higher rate than the repo rate.

(f) ***<u>Bank Rate:</u>*** It is the rate at which the **Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers**. The Bank Rate is published under Section 49 of the Reserve Bank of

(g) India Act, 1934. This **rate has been aligned to the MSF rate** and, therefore, **changes automatically as and when the MSF rate changes** alongside policy repo rate changes.

(h) ***<u>Cash Reserve Ratio (CRR):</u>*** The av**erage daily balance that a bank is required to maintain with the Reserve Bank.** Cash reserve ratio (CRR) is **the percentage of a bank's total deposits that it needs to maintain as liquid cash**. This is an RBI requirement, and the cash reserve is kept with the RBI. A bank does not earn interest on this liquid cash maintained with the RBI and neither can it use this for investing and lending purposes

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(i) ***Statutory Liquidity Ratio (SLR):*** Statutory Liquidity Ratio popularly called SLR is **the minimum percentage of deposits that the commercial bank maintains through gold, cash and other securities**. However, these deposits are maintained by the banks themselves and not with the RBI or Reserve Bank of India.

(j) ***Open Market Operations (OMOs):*** Open Market Operations is the **simultaneous sale and purchase of government securities and treasury bills by RBI**. The **objective of OMO is to regulate the money supply in the economy**. RBI carries out the OMO **through commercial banks** and does not directly deal with the public

(k) ***Market Stabilisation Scheme (MSS)***: Market Stabilization scheme (MSS) is **a monetary policy intervention by the RBI to withdraw excess liquidity (or money supply) by selling government securities in the economy**. MSS is **used when there is high liquidity in the system**

This instrument for monetary management was introduced in 2004. **Surplus liquidity** of a more enduring nature arising from large capital inflows **is absorbed** through sale of short-dated government securities and treasury bills. The **cash so mobilised is held in a separate government account** with the Reserve Bank.

CONSTITUTION OF MONETARY POLICY COMMITTEE

Section 45ZB of the Act states that:-

(1)	The **Central Government** may, by notification in the Official Gazette, constitute a Committee to be called the Monetary Policy Committee of the Bank.
(2)	The Monetary Policy Committee shall consist of the following Members, namely:—
	(a) the **Governor of the Bank**—Chairperson, ex officio;
	(b) **Deputy Governor of the Bank**, in charge of Monetary Policy—Member, ex officio;
	(c) **one officer of the Bank** to be nominated by the Central Board—Member, ex officio; and
	(d) **three persons to be appointed by the Central Government**—Members.
(3)	The Monetary Policy Committee **shall determine the Policy Rate** required to achieve the inflation target.
(4)	The decision of the Monetary Policy Committee **shall be binding on the Bank.**
(5)	The Bank shall organise **at least four meetings** of the Monetary Policy Committee in a year.
(6)	The **meeting schedule of the Monetary Policy Committee for a year** shall be published by the Bank at least **one week before the first meeting in that year**

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Answers to be analysed in Classroom

Q. 1.

Answer to Question No. 1:-

Q. 2.

Answer to Question No. 2:-