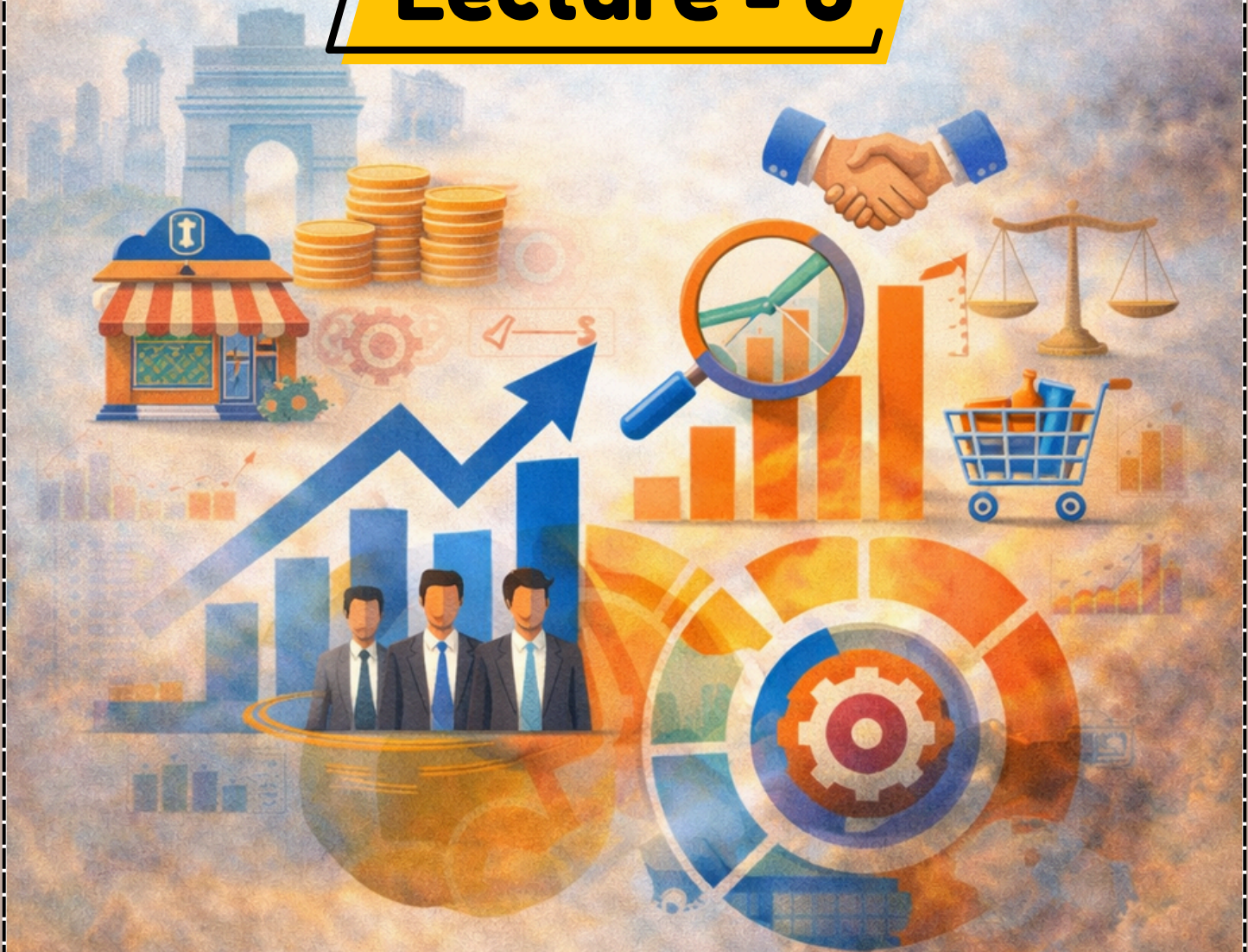
PARMAR SSC

BANKING SYSTEM

(PART - 2)

Lecture - 8



BY PARMAR SIR

LIQUIDITY

- **Definition:** Liquidity refers to how easily an asset can be converted into cash without losing its value. It measures the speed and ease of exchange.

Concept & Examples:

- **Money (Cash):** Money has the highest liquidity because it can be used immediately for transactions. It is already in the form of cash, so no conversion is needed.

Comparison (Gold vs. Bike)

- If you have Gold and a Bike, gold is considered more liquid.
- **Reason:** Gold has high acceptability. You can go to a jeweler and immediately get cash for it. A bike, however, is harder to sell quickly without a significant loss of value (distress sale). Finding a buyer for a bike takes time, and you might not get the desired price immediately.

Liquidity order



Cash > Gold > Cheque > Bond

Demand Deposit (e.g., Savings/Current Account) is more liquid than Term Deposit (e.g., Fixed Deposits)

EVOLUTION OF MONEY

The Barter System of Exchange

Historical Context:

- During the Harappan Civilization, there was no standardized form of currency (coins or notes). The economy functioned on the Barter System of Exchange.

Definition:

- The Barter System involves exchanging goods for goods. If you have a commodity I need, and I have a commodity you need, we exchange them directly.

Limitations of the Barter System:

- While simple in theory, the Barter System had significant restrictions/flaws:

Limitation	Explanation	Example
Double Coincidence of Wants	For a transaction to occur, both parties must want exactly what the other possesses at the same time.	If Person A has Fish and Person B has Meat, but Person B does not want fish, the transaction fails
Lack of Divisibility	Certain goods cannot be divided without destroying their value, making exchange difficult if values don't match	If Person A has a pair of expensive Shoes (₹200) and Person B has a T-shirt (₹100), Person A cannot give just "one shoe" for the shirt. He must give both or nothing
Lack of Store of Value	Wealth could not be stored for the future because many commodities are perishable	You cannot store Fish for future generations or security because they will rot. Thus, wealth transfer to children or saving for emergencies was impossible.

Discovery of Money

Significance:

- The invention of money solved the limitations of the Barter System by acting as a common medium of exchange.
- It eliminated the need for a double coincidence of wants.
- It allowed people to specialize in professions other than agriculture (e.g., teaching, gaming, business) because they could earn money to buy food, rather than needing to grow it themselves.

TYPES OF MONEY

1. Fiat Money

- **Definition:** It is a currency that the government declares as legal tender. It is authorized by the government to be used as a medium of exchange.
- **Key Features:**
  - It is issued by a Central Bank (RBI in India).
  - It is not backed by a physical commodity like gold or silver.
  - **Crucial Concept (Intrinsic vs. Face Value):** For Fiat Money to function, its Face Value (the value written on the note/coin) must be greater than its Intrinsic Value (the metal/paper cost).
  - **Example:** The government discontinued the old, thick ₹5 coins because they were being smuggled to Bangladesh and melted down to make razor blades. The metal (intrinsic value) was worth more than ₹5, leading to its disappearance from the market.

2. Fiduciary Money

- **Definition:** Money accepted as a medium of exchange solely based on the trust (fiduciary relationship) between the payer and the payee.
- **Example:** Cheques, Tokens, or Bitcoins.

Note: Unlike Fiat money, acceptance is not mandatory by law; if trust is broken (e.g., a cheque bounces), acceptance declines.

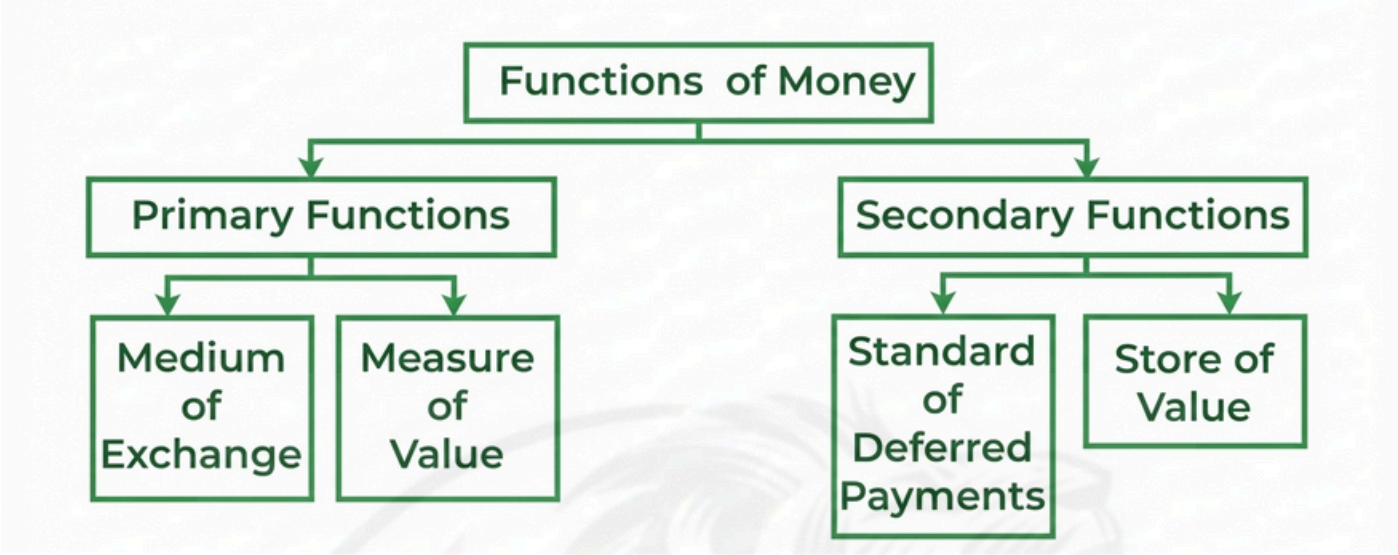
3. Plastic Money

- **Definition:** Also known as electronic money, it refers to payment methods using electronic fund transfers instead of cash.
- **Types:**
  - **Debit Cards:** You can spend only what is in your account.
  - **Credit Cards:** Follows the "Spend Now, Pay Later" concept (borrowed money).
  - **Prepaid Cards.**

4. Hot Money

- **Definition:** Funds that investors quickly move between countries or financial markets to take advantage of short-term opportunities (like high interest rates or stock market gains).
- **Nature:** It is highly volatile. Investors pull this money out rapidly if market conditions worsen.
- **Example:** Foreign Portfolio Investment (FPI).

FUNCTIONS OF & DEMAND FOR MONEY



Functions of Money

- Money was invented to solve the issues of the Barter System. Its functions are broadly classified into two categories: Primary and Secondary.

1. Primary Functions

A. Medium of Exchange:

- Money acts as an intermediary in the exchange process, allowing goods and services to be bought and sold easily.

B. Measure of Value (Unit of Account):

- It allows us to determine and quote the specific value of a product (e.g., "This meat costs ₹100" or "This book costs ₹200"). This solves the valuation problem of the barter system.

2. Secondary Functions

A. Standard of Deferred Payment:

- This function facilitates future payments. It allows people to purchase goods now and pay later (e.g., EMI options, loans).

Note: In modern economies, this is crucial for lending and credit systems.

B. Store of Value:

- Money allows wealth to be stored and transferred to future generations or kept for security.
- Unlike perishable goods (fish/meat), money does not rot, making it an efficient store of wealth.

Additional Characteristics of Money:

- **Highly Portable:** Easy to carry around.
- **Durable:** Does not degrade easily over time.

Why People Hold Money? (The Demand for Money)

- According to John Maynard Keynes, people hold money (liquidity) for three specific motives:

Motive	Description	Example
1. Transaction Motive	Money held for day-to-day transactions and current needs.	Keeping cash for groceries, vegetables, bills, or transportation.
2. Precautionary Motive	Money held for unforeseen emergencies or unexpected expenses.	Saving cash/jewelry for sudden illness, accidents, or disasters.
3. Speculative Motive	Money held to take advantage of future investment opportunities or to avoid potential losses in financial assets.	Waiting for gold/stock prices or interest rates to become favorable before investing.

- **John Maynard Keynes's theory of money demand includes a speculative motive, which is the desire to hold money for investment opportunities.**

Speculative Demand For Money & Interest Rates

- The speculative demand for money is the desire to hold cash for investment purposes rather than daily needs. It is closely linked to Interest Rates in the economy.

The Inverse Relationship:

- There is an inverse relationship between the market interest rate (r) and the speculative demand for money (M_s^d).

$$\text{Speculative demand for Money} \propto \frac{1}{\text{Rate of Interest}}$$

Scenario A: High Interest Rates

- **Behavior:** People prefer to invest in bonds/financial assets to earn high returns.
- **Result:** Speculative demand for money (holding cash) falls.

Scenario B: Low Interest Rates (e.g., during a Recession)

- **Behavior:** Returns on investments are low. People fear rates might fall further or bond prices might crash. Thus, they prefer to hold cash.
- **Result:** Speculative demand for money rises.

Interest rates are an opportunity 'cost or price' of holding money balance in an economy

Formula:

- The relationship is mathematically represented as:

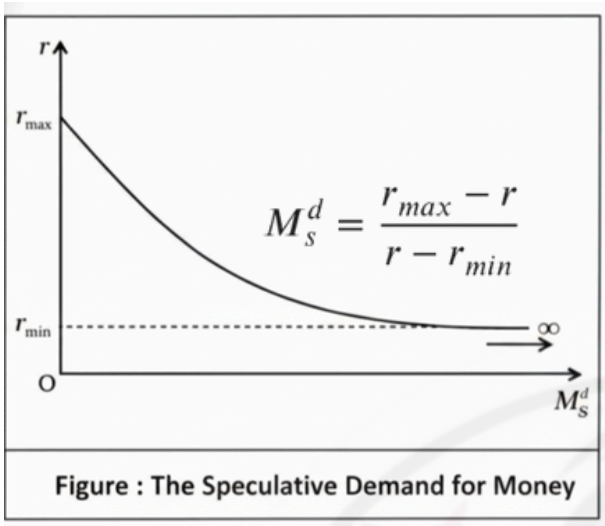


Figure : The Speculative Demand for Money

r_{max} = maximum interest rate

r_{min} = minimum interest rate

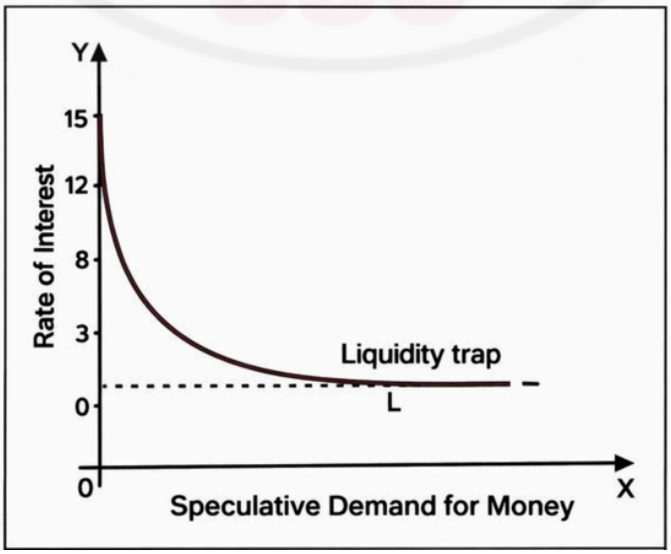
M_s = Speculative Demand for money

The Liquidity Trap

- **Definition:** A Liquidity Trap is an economic situation where interest rates are extremely low, and consumers prefer to hold cash rather than invest or spend it, which can lead any Monetary Policy ineffective.

Characteristics:

- **Infinite Elasticity:** In this zone, the demand for money becomes perfectly elastic (infinitely elastic).
- **Graph:** The Liquidity Preference Curve becomes horizontal.
- **Policy Failure:** In a liquidity trap, Monetary Policy becomes ineffective. Even if the central bank (RBI) increases the money supply to encourage spending, people simply hold onto the extra cash expecting better rates in the future.



TYPES OF MONEY IN THE ECONOMY

- To measure Money Supply, we first understand where money is located in the system.

1. Currency in Circulation

- **Currency with Public:** Money held by ordinary people for spending.
- **Currency with Banks (Vault Cash):** Money held by banks to meet daily operations and cash demands.

Note: Vault cash is not considered part of the money supply in terms of credit creation because it is not being lent out; it is idle cash for operations.

Concept: Currency Deposit Ratio (CDR)

- **Definition:** The ratio of money held by the public in currency to that held in bank deposits.

$$CDR = \frac{\text{Money held by public in currency}}{\text{Money held by public in deposits}}$$

- **Seasonal Trend:** During festive seasons, the CDR increases because people withdraw more cash for spending rather than keeping it in deposits.

2. Deposits with Banks

- **Demand Deposits (DD):** Money withdrawable anytime (e.g., Savings & Current Accounts). These are highly liquid.
- **Term Deposits (TD):** Fixed deposits for a set period (e.g., FD, RD). These are less liquid.

3. Deposits with RBI

- **Banker's Deposits:** CRR (Cash Reserve Ratio) balances that banks must keep with the RBI.
- **Other Deposits:** Deposits from foreign central banks, international financial organizations (IMF, World Bank), and government institutions.

4. Postal Deposits

- Similar to bank deposits but managed by the Post Office Savings Bank (POSB).
- Includes both demand and term deposit types within the postal system.

MEASURES OF MONEY SUPPLY (MONETARY AGGREGATES)

- The Reserve Bank of India (RBI) uses specific metrics called Monetary Aggregates to measure the total amount of money circulating in the economy at a given point in time. Understanding these aggregates (M1, M2, M3, M4) helps the RBI formulate Monetary Policy.

1. High-Powered Money (M0)

- Also known as Reserve Money, Monetary Base, or Base Money.
- **Definition:** It represents the total currency produced/printed by the RBI and the Government of India. It shows the total liability of the monetary authority.
- **Components:**

M0 = Currency in Circulation + Banker's deposit with RBI + Other Deposits with RBI

  - **Currency in Circulation:** Includes both currency held by the public and Vault Cash held by banks (cash kept for daily operations).
  - **Bankers' Deposits with RBI:** The money banks keep with RBI (e.g., CRR).
  - **Other Deposits with RBI:** Deposits from foreign central banks, financial institutions, etc..

Note: M0 is called "**High-Powered**" because it acts as the base for credit creation. However, the vault cash and CRR components are not directly used for transactions by the public.

The Four Money Aggregates (M1, M2, M3, M4)

M1 (Narrow Money)

- **Definition:** This is the most liquid measure of money supply. It represents money that is immediately available for transactions.
- **Components:**

M1 = Currency with public + Other Deposits with RBI + Demand Deposits

  - **Currency with Public:** (Total Currency – Cash held by Banks). We exclude Bank Vault Cash here because that money is not in active circulation for transactions.
  - **Demand Deposits:** Balances in Savings and Current accounts that can be withdrawn anytime.
  - **Other Deposits:** Deposits held by RBI from foreign banks/institutions.

M2

- **Definition:** A broader measure than M1, incorporating post office savings.
- **Components:**

M2 = M1 + Saving Deposits with Post Office Savings Bank

  - This adds savings held in post offices, which are safe but slightly less liquid than bank demand deposits.

M3 (Broad Money / Aggregate Monetary Resource)

- **Definition:** This is the most widely used measure for monetary policy analysis. It is referred to as Broad Money.
- **Components:**

M3 = M1 + Net Time Deposits (Term Deposits) with commercial banks

  - It includes Fixed Deposits (FDs) and Recurring Deposits (RDs).
  - **Why Broad?** It captures the bulk of the banking system's resources (Time Deposits) which are used for lending and credit creation.

M4

- **Definition:** The most comprehensive but least liquid measure.
- **Components:**

M4 = M3 + Total Deposits with Post Office

  - Includes all types of deposits with post offices (excluding National Savings Certificates)."

Liquidity Hierarchy

- Liquidity decreases as we move from M1 to M4.
- M1 = Most Liquid (Cash/Demand Deposits are instant).
- M4 = Least Liquid (Includes locked-in time deposits and post office deposits).

Aggregate	Name	Formula / Components	Liquidity Status
M0	High Powered Money	Currency in Circulation + Bankers' Deposits with RBI + Other Deposits with RBI	N/A (Base Money)
M1	Narrow Money	Currency with Public + Demand Deposits + Other Deposits with RBI	Highest Liquidity
M2	--	M1 + Post Office Savings Deposits	Moderate
M3	Broad Money	M1 + Time Deposits (TD) with Banks	Moderate
M4	--	M3 + Total Post Office Deposits	Lowest Liquidity

Interbank Offer Rates

- Banks lend to each other to meet short-term needs (like maintaining CRR). The interest rate charged for these transactions is decided by market forces and benchmarked against standard "Offer Rates" .

LIBOR (London Interbank Offer Rate)

- **Role:** It served as the global benchmark/base rate for loans, mortgages, and financial products worldwide .
- **Status:** It was discontinued and no longer published after 31st December 2021 due to manipulation scandals/issues .
- **Replacement:** It was officially replaced by SOFR (Secured Overnight Financing Rate) for US Dollar transactions .

MIBOR (Mumbai Interbank Offer Rate)

- **Role:** This was the Indian version of LIBOR, used for domestic interbank lending .
- **Current Status:** MIBOR was replaced by the FBIL-Overnight MIBOR (Financial Benchmark India Private Ltd) in 2015 .

MONEY MARKET INSTRUMENTS & RATES

- The financial market is broadly categorized based on the duration of lending and borrowing.
- **Money Market vs. Capital Market:**

Feature	Money Market	Capital Market
Duration	Short-Term (Less than 1 year)	Long-Term (More than 1 year)
Purpose	To meet short-term fund requirements.	To raise long-term capital for investment.
Instruments	Call Money, Notice Money, T-Bills.	Stocks, Bonds, Debentures.

Money Market Instruments

- These are used for short-term lending and borrowing among banks and financial institutions.

1. Call Money

- **Definition:** Loans that must be repaid within 1 day (Less than 24 hours) .
- **Usage:** Used for overnight requirements.

2. Notice Money

- **Definition:** Loans that must be repaid within 2 to 14 days .
- **Usage:** For slightly longer short-term needs than call money.

Treasury Bills (T-Bills)

- **Definition:** Treasury Bills are short-term debt instruments issued by the Government of India (GOI) but managed and issued by the Reserve Bank of India (RBI) .
- **Key Features:**
  - **Tenors:** They are issued in three specific maturity periods: 91 Days, 182 Days, 364 Days .
  - **Money Market Classification:** Since their maturity is less than one year, they are categorized as money market instruments .
  - **Zero-Coupon Securities:**
    - T-Bills do not pay regular interest.
    - They are issued at a discount to their face value and redeemed at face value .
    - **Example:** If a ₹100 T-Bill is issued at ₹95, the ₹5 difference is the profit (interest) for the investor upon maturity.

BANKING ASSETS & NON-PERFORMING ASSETS (NPAs)

- To a bank, a Loan is an Asset because it generates income (interest). Conversely, for the person taking the loan, it is a Liability.
- These assets are classified based on their performance (repayment status).

Classification of Assets

1. Regular Assets

- **Definition:** These are financial assets that generate consistent returns over the long term.
- **Status:** The borrower is paying both the Interest and the Principal on time. Everything is functioning smoothly.

2. Stressed Assets

- **Definition:** Loans that are not performing or are in danger of defaulting.
- **Timeline:** The principal or interest is overdue for less than 90 days.
- **Significance:** This is the warning stage where stress starts building up because payments have stopped coming in, but it hasn't crossed the critical 90-day threshold yet.

3. Non-Performing Assets (NPAs)

- **Definition:** A loan or advance becomes an NPA when the interest or principal payment remains overdue for a period of more than 90 days.
- **Impact:** The asset stops generating income for the bank.

Categories of NPAs

- Once an asset becomes an NPA (crosses 90 days), it is further classified based on how long it remains unpaid:

1. **Substandard Assets** — An asset that has remained an NPA for a period less than or equal to 12 months. (i.e., Overdue between 90 days to 1 year).
2. **Doubtful Assets** — An asset that has remained in the Substandard category for a period of more than 12 months. (i.e., Overdue > 1 year).
3. **Loss Assets** — Loans that are considered uncollectible and have no chance of recovery.

Willful Defaulters

- **Definition:** Borrowers who have the capacity to repay the loan but deliberately choose not to.
- **Example:** Vijay Mallya is cited as a classic example of a willful defaulter.

Resolution Mechanisms & International Regulations

- When loans turn into NPAs, banks need mechanisms to recover their money. The government and international bodies have established specific frameworks for this.

1. Bad Banks

- **Concept:** A Bad Bank is a financial entity set up specifically to buy Non-Performing Assets (NPAs) or "bad loans" from commercial banks.
- **Purpose:** By buying these bad loans, the Bad Bank clears the balance sheet of the commercial bank, allowing the commercial bank to focus on lending again. The Bad Bank then focuses solely on recovering the money from these bad assets.
- **Structure in India (2021 Budget):** Two major entities were announced to function as a Bad Bank structure:
  1. **NARCL (National Asset Reconstruction Company Limited):** It acquires the bad loans from banks.
  2. **IDRCL (India Debt Resolution Company Limited):** It manages the assets and tries to sell them to recover value.

2. Legal Frameworks for Recovery

A. SARFAESI Act, 2002

- **Full Form:** Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act.
- **Purpose:** It empowers banks and financial institutions to seize the collateral (property) of borrowers who fail to repay loans, without needing to go to court first.
- **Significance:** It was a major tool to tackle Willful Defaulters and recover secured loans efficiently .

B. Insolvency and Bankruptcy Code (IBC), 2016

- **Key Difference (Insolvency vs. Bankruptcy):**
  - **Insolvency:** A financial state where an entity cannot pay its debts .
  - **Bankruptcy:** A legal declaration of that insolvency .
- ***Objective:*** To resolve the "Twin Balance Sheet Problem" (where both banks are stressed with bad loans and corporates are stressed with debt).
- **The Process (CIRP):**
  - It initiates the Corporate Insolvency Resolution Process (CIRP) .
  - **Time Limit:** The code mandates a time-bound resolution. The standard period is 180 days, extendable by another 90 days (Total 270 days) to decide whether to revive the company or liquidate it.
- **Adjudicating Bodies:**
  - ***NCLT:*** National Company Law Tribunal (For initial cases) .
  - ***NCLAT:*** National Company Law Appellate Tribunal (For appeals) .

International Banking Regulations: Basel Norms

- Banking systems are interconnected globally. If a major banking system fails (like in the 2008 Lehman Brothers crisis), it affects the whole world . To prevent this, international standards called Basel Norms were introduced.

Basel Norms

- The Basel Norms, also known as the Basel Accords, are a set of International banking regulations that aim to strengthen the banking system and manage risk.
- **Background:**
  - **Established by:** The Bank for International Settlements (BIS), headquartered in Basel, Switzerland.
  - **Body:** The Basel Committee on Banking Supervision (BCBS), formed by central bank governors of G10 countries in 1974.
  - **Goal:** To strengthen the banking system and manage Risk by ensuring banks act as "Shock Absorbers" (having enough capital cushion).

The Three Accords:

Norm	Year Introduced	Focus & Key Features
Basel I	1988	Focused almost entirely on Credit Risk. Introduced the Capital Adequacy Ratio (CAR) minimum of 8% of Risk-Weighted Assets (RWA). India adopted guidelines in 1999.
Basel II	2004	Expanded risk coverage (Credit, Market, Operational). Refined the definition of Risk-Weighted Assets (RWA).
Basel III	2010	Introduced post-2008 crisis. Increased the capital requirements. Mandates a CAR of 12.9%, with specific requirements for Tier 1 (10.5%) and Tier 2 (2%) capital.

- Capital Adequacy Ratio (CAR) Also known as CRAR (Capital to Risk (Weighted) Assets Ratio). It is the ratio of a bank's capital to its risk.

$$CAR = \frac{\text{Tier 1 Capital (Core)} + \text{Tier 2 Capital (Supplementary)}}{\text{Risk Weighted Assets (RWA)}} \times 100$$

- **Risk Weighted Assets (RWA):** Different loans have different risks (e.g., a loan to the Govt is 0% risk, while a loan to a volatile business might be 100% risk). Banks must calculate capital based on this weighted risk.
- **Tier 1 Capital:** Core capital (Equity, disclosed reserves) – highly liquid and permanent.
- **Tier 2 Capital:** Supplementary capital (Subordinated debt, undisclosed reserves) – less liquid.



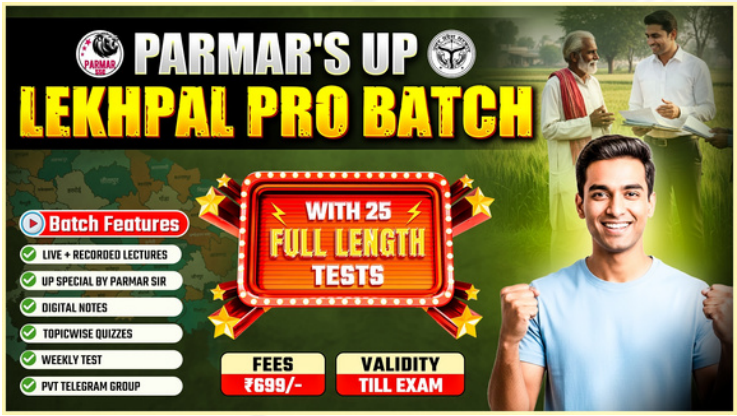


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