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   OBJECTIVES

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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

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   RECOMMENDATIONS/SUGGESTIONS

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RESERVE REQUIREMENTS IN THE BANKING SECTOR: A CRITICAL ASSESSMENT

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ABSTRACT

Banking institutions are legally empowered to invite public deposits and this exercise is circumspect by an element of risk. As a result of this risk, the banks venture into risk management. One of the important risk management tools is the reserve requirements in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). The CRR is the amount of reserves that a commercial bank has to maintain with the central banking authority at all times thereby acting like a cushion deposit with the central bank. The SLR, on the other hand, is the amount of reserves that a commercial bank has to maintain with itself at all times in order to maintain liquidity and enable itself to honour the depositors' demand as and when they arise. In India, as per the Banking Regulations Act, 1949 and the Reserve Bank of India Act, 1934 the maintenance of SLR is mandatory while the CRR is an operative requirement as prescribed by RBI from time-to-time. This maintenance of statutory reserves has an unfavorable bearing on the financial health of banks as it limits their credit creating capacity. While commercially deployable or loanable resources are reduced, the banks have to pay interest on total deposits mobilized from their customers. The present paper seeks to examine the justification of such reserves and the rationality behind the continuation of the reserve requirements, deriving no interest income from such reserves.

JEL CODE
E58

KEYWORDS
risk , reserve, interest, monetary policy, central banks.

INTRODUCTION

Banking institutions are institutions for creating credit and imbibing depositors' faith. Banking institutions are legally empowered to invite public deposits, accept it and use it for deriving margin or spread over the deposits accepted. A part of this spread is shared by several stakeholders; one part is shared with the depositors by way of interest payments, the other part is appropriated to the equity stock holders and investors by way of dividend and the remaining part is shared with the public revenue authorities as tax.

The entire exercise of a bank is circumspect by an element of risk; it assumes a risk on accepting deposits and thereby making itself liable to the depositors, while on the other when it formulates credit policy for deployment of deposits to the applicant borrowers, the bank again embraces credit assessment risk, credit delivery risk and credit recovery risk. Thus, risk management becomes a key function of a banking institution. Obviously when it handles public money, it is in the tight rope of regulating agencies and in the process it has to distribute the credit risk among a large number of selected potential borrowers so that the default risk of one segment of borrowers can be spread among large number of assured borrowers. This kind of lending function is also looked upon by the governmental authorities of a nation as a boosting input for attaining a desired level of economic growth coupled with employment generation, maximum deployment of credit resources for public good and at the same time, fulfilling the election manifesto of the political parties coming into ruling position in the legislative body. As a result of this risk, the banks venture into an area called reserve requirement to provide a cushion against the in-built risk in the institution. Hence, keeping monetary resource in reserve of both the central banking authorities as well as a banking institution is imperative in order to counter such risk. In this article, the authors examine the kind of reserve requirements imposed on a bank for the purpose of risk management as discussed hereunder.

One of the important risk management tools is the reserve requirements in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) which have been deliberated hereunder. The CRR is the amount of funds that all Scheduled Commercial Banks (SCB) excluding Regional Rural Banks (RRB) are required to maintain, without any floor or ceiling rate, with the Reserve Bank of India (RBI) with reference to their total Net Demand and Time Liabilities (NDTL) to ensure their liquidity and solvency (Section 42(1) of RBI Act, 1934). Default in maintenance of CRR requirements on a daily basis (presently 70% of the total requirement) by SCBs attracts penal interest for that day at 3% above the Bank Rate on the shortfall. And, in case, the shortfall continues the next succeeding day/s, penal interest at the rate of 5% p.a. above the Bank Rate is applicable.

Apart from CRR, every bank operating in India is required to maintain, at the close of business every day, a minimum proportion of their NDTL as liquid assets in the form of cash, gold and un-encumbered approved securities known as the SLR. In the event of SCBs SLR holdings falling below the statutory requirement, they can avail the Marginal Standing Facility (MSF) upto 2% of their NDTL outstanding at the end of the second proceeding fortnight and they do not have the obligation to seek specific waiver of the default in SLR compliance arising out of use of this facility (w.e.f. 17.04.12).

Currently, the CRR and SLR in India stand at 4% (w.e.f 09/02/2013) and 23% (w.e.f. 11/08/2012) respectively. The total deposits in all SCBs as on June, 2013 stands at Rs.7,06,01,822[1]. Therefore, the total deposits in the form of CRR @4% to be maintained with the RBI would amount to around Rs. 28,24,072. As the RBI does not pay any interest on the CRR, this acts as a tax on the banking system and places banks at a competitive disadvantageous position. Besides the CRR, every SCB has to maintain a minimum proportion of their NDTL as liquid assets with itself at all times in the form of SLR which again tells upon the financial health of the bank. The central banking authority has the prerogative to increase or decrease these ratios. An increase in these ratios restricts the bank's leverage position to pump more money into the economy and limit its credit creation ability.

It is believed that the requirement to maintain these reserves has put banks in a prejudicial position as compared to other financial institutions who can charge interest on every rupee they lend. Commercial banks also finance several government schemes at lower interest rates and invest a lion's share of their time and demand deposits in government securities to meet the reserve mandate for which they are not being offered any interest, which is putting a toll on its financial feasibility and profitability. The commercial banks, while creating the CRR, are again losing an alternative income earning opportunity by not being authorized to lend at a commercial rate because the money is already parked with the central bank. To add to these, the priority sector lending requirements further exerts pressure on the bank's profitability. The moment the central bank raises the CRR and SLR the banks are deprived of the resources otherwise available for lending purposes and other alternative profitable avenues. The present study makes an attempt to justify the imposition of CRR and SLR by the central banking authorities.

OBJECTIVES OF THE PRESENT STUDY

After considering the aforesaid matters, we now lay down the objectives of the present study:

1. To make a brief review of historical perspective of the requirement of CRR and SLR;
2. To examine the justification for making CRR and SLR deposits;
3. To examine the rationality behind the continuation of the reserve requirements deriving no interest income from such reserves.

[1] Quarterly Statistics on Deposits and Credit of Scheduled Commercial Banks, June, 2013

HISTORICAL PERSPECTIVE OF RESERVE REQUIREMENTS

The CRR is the amount of reserves that a commercial bank has to maintain with the central banking authority at all times. It is a kind of hedge whereby the possibility of faltering in repayment of depositors' money is made remote. Thus, the CRR acts like a cushion deposit with the central bank. The Statutory Liquidity Ratio (SLR), on the other hand, is the amount of reserves that a commercial bank has to maintain with itself at all times in order to maintain liquidity and enable itself to honour the depositors' demand as and when they arise.

The arrangement of CRR emerged in England in as early as 1826 following the establishment of private joint stock commercial banks. The banks were required to park their surplus cash with the Bank of England which was the issuer of notes circulated in the country and thereby commanded public confidence as the banker of the government.

With the establishment of the US Federal Reserve Bank in 1940, cash reserves began to be treated as a financial stability provision. Cash reserves with central banks worked as a great source of strength to commercial banks and thus generated depositors' faith and trust with the banking system. The centralized cash reserves offered a more elastic credit structure.

Initially, the cash reserves with central banks performed the following functions:

- Safety to deposits with commercial banks.
- Facilitation of inter-bank settlement, transaction clearance.
- Fund transfers to needy banks.
- Liquidity to the financial sector.

Control the volume of primary deposits with a potential to generate secondary deposits. This function is required in order to regulate the money supply, inflation, credit flow and stability in the money market.

Formerly, the central banks desired separate cash reserves to be maintained with them against time and demand deposits. For instance, the US Federal Reserve Bank specified 3% reserves against the time deposits and 7-13% against demand deposits, while the New Zealand Central Bank kept the ratios at 5 % and 20% respectively.

This arrangement in the 19th century was converted into mandatory ratio under the legal authority of central banks that empowered them to prevent injurious growth and to enhance supply of credit. In India, as per the Banking Regulations Act, 1949 and the Reserve Bank of India Act, 1934 the maintenance of SLR is mandatory while the CRR is an operative requirement as prescribed by RBI from time-to-time. By virtue of its operation, CRR has, also in reality, assumed the character of a mandatory statutory requirement, failing which banks are subjected to levying penalty by the RBI.

CHANGING ROLE OF CRR AND SLR

Central banks have been using CRR for the following purposes:

- To control the volume of primary deposits and potential to generate secondary deposits in order to regulate the money supply and inflation.
- To prevent excess credit expansion or contraction, to regulate money supply, to assist growth and to control inflation.
- It has been effectively used as an instrument to regulate money supply, its velocity and liquidity in the financial system.
- To induce the banking system to address and adjust its deposit liabilities to its actual reserves more rapidly within each reserve maintenance period.

The CRR is partly a prudential requirement for banks to maintain a minimum amount of cash reserves to meet their payments obligations in a fractional reserve system. The Reserve Bank of India Act, 1934 implicitly prescribed the CRR originally at a minimum of 3 percent of any bank's NDTL. That restriction was removed by an amendment in the year 2006. While the RBI is now free to prescribe this rate, any CRR above 3 per cent can still be viewed as a monetary tool to contain expansion of money supply by influencing the money multiplier.

Historically, the CRR had a much wider role to play. It was mainly used to neutralise the inflationary impact of deficit financing of the government during the 1970s, 1980s and 1990s. During the period of financial repression before 1990s, CRR was the most preferred monetary policy tool. This period witnessed a substantial influx of foreign funds through NRI deposits which prompted the central banking authorities to prescribe a differential CRR on such deposits to restrict their inflows. This role of CRR as being used as an instrument of regulating NRI deposit flows reduced once the relative attraction of such deposits vis-a-vis rupee deposits was removed. With the introduction of multiple indicator approach, the use of CRR as an instrument of monetary control was sought to be de-emphasised and liquidity management in the system was increasingly undertaken through indirect instruments such as open market operations (OMO), both outright and repos.

After 2004, when there was a huge influx of foreign capital through varied forms of debt and non-debt flows, and the RBI ended up accumulating large foreign exchange reserves, the CRR became an optional instrument to sterilise the rupee resources released from dollar purchases. This was particularly enabled by not paying any interest on CRR balances maintained by banks with the RBI. Since 2004, the use of CRR as an instrument of sterilisation and monetary tool has gained ground.

The CRR was gradually raised from its statutory minimum of 3 per cent in September 1962 to 15 per cent by July 1989. However, the Narasimham Committee of 1991 recommended the gradual reduction in CRR and increased the use of indirect market-based instruments. This was broadly accepted and the CRR was reduced from more than 15 per cent to 4.5 per cent by 2003. Presently, the CRR stands at 4% and is a direct monetary instrument used by the RBI for monetary policy intervention.

The Reserve Bank of India Act, 1934, was amended in June 2006 with a view to enhancing the RBI's operational flexibility and providing it with greater maneuverability in monetary management. The Act gives discretion to the RBI to decide the percentage of scheduled banks' NDTL to be maintained as CRR without any floor of 3 per cent and ceiling of 20 per cent. The payment of interest on CRR balances attenuates the effectiveness of the CRR as an instrument of monetary policy. From the fortnight beginning June 24, 2006, it was decided, with the concurrence of the Government of India, that no interest shall be payable on CRR balances.

The SLR is not a monetary tool and is only a prudential requirement to serve as a cushion to meet contingencies against potential liquidity threats to banking operations. The SLR can be seen more as a way of finding a captive market for government securities. For the SLR too, the Narasimham Committee's view was to bring it down to 25 per cent and resort to auctioning government securities at market related rates and accordingly it was reduced to 25 per cent by 1997. Just like CRR, RBI has the freedom to determine the level of SLR.

In the current period, central banks undertake monetary management by the instruments such as discount rate, repo, reverse repo and open market operations along with CRR and SLR. The CRR instrument is used to prevent excess credit expansion or contraction; to regulate money supply; to assist growth; and to control inflation. It is also useful to regulate money supply. It induces the banking system to address and adjust its deposit liabilities to its actual reserves more rapidly within each reserve maintenance period. The method of variable CRR is comparatively a new method of credit control used by the central banks. This method was first adopted by the Federal Reserve System of the USA in 1935 in order to prevent injurious credit expansion or contraction.

DEBATE OVER PAYMENT OF INTEREST

Banks maintain the CRR with the central banking authority which is currently 4% of their aggregate deposits without earning any interest on it. Besides, they are also mandated to maintain 23% of their NDTL as liquid assets with itself at all times. This maintenance of statutory reserves has an unfavorable bearing on the financial health of banks as it limits their credit creating capacity. While commercially deployable or loanable resources are reduced by 27%, the banks have to pay interest on total deposits mobilized from their customers. The interest earned by lending the remaining 73% of the deposits (other than NPAs) is not enough to meet the interest paid to depositors and operating expenses. It, thus, creates stress on spread or Net Interest Income (NII).

This matter can be further elucidated from the following data: On 4th November, 2012 RBI lowered the CRR by 25 basis points to 4.25%. This reduction injected around Rs. 17,500 crores into the banking system. Again on 29th January, 2013 RBI continued with policy rate reduction and reduced the CRR by 25 basis points to 4%, thereby again releasing Rs.18,000 crores into the liquidity and banking system. We now realize that the release of additional liquidity by a reserve cut empowers the banking institution to undertake more of credit delivery activity and in turn meeting the urgent credit requirements of the business units in the economy. If the SLR is reduced and CRR is done away with, possibly the banks could invest surplus funds in more remunerative commercial ventures and earn better returns and even pay better rate of interest to their depositors.

A cut in the CRR also prompts banks to trim their base rates. The base rate, which is the benchmark rate for most loans, is the minimum rate below which banks cannot provide loans. Therefore, a CRR cut would make a vast amount of cash available to banks and thereby reduce their need for deposits, thus paving the way for a lending rate cut.

All major central banks in the world either do not mandate a reserve ratio or pay an interest on the mandatory reserves they ask banks to set aside and park with central banks. In this context, we could cite the examples of some countries. In the UK, Canada, Sweden, Australia and New Zealand the CRR system does not exist in any form and any maintenance of reserves is completely voluntary. In USA, there is graded system, i.e. 'small banks' don't need to maintain any CRR with their central bank, while 'big banks' need to maintain CRR according to their size and the USA FED pays interest on such CRR deposits. In these countries, generally liquidity is regulated through open market operations (OMO).

These countries are able to use OMO successfully to carry out monetary policy because of their developed financial markets. In India due to constraints arising from lack of autonomy, the RBI has to use the OMO to groom the market for the floatation of government securities through buybacks, thus monetizing fiscal deficits retroactively. Until this situation improves, it has to rely on CRR for having some control on money supply.

The following arguments are generally put forward against the maintenance of CRR:

1. CRR is an inflexible instrument of monetary policy that drains liquidity across the board for all banks without distinguishing between banks having idle cash balances and those that are deficient.
2. In case CRR is not remunerated, it has the distortionary impact of a 'tax' on the banking system.
3. CRR is also discriminatory as it has an in-built bias in favour of financial intermediaries that are not required to maintain balances with the RBI. It does not apply to regional rural banks, non banking financial companies, mutual funds or insurance companies.

Earlier, RBI had to pay interest rates on CRR deposits. But in 2007, government amended the RBI Act and according to the new rules the RBI does not have to pay any interest on the CRR deposits. As the RBI does not pay any interest on CRR, this acts as a tax on the banking system and places banks at a competitive disadvantage vis-à-vis NBFCs and mutual funds, which do not maintain CRR. Moreover, debt mutual funds and insurance companies are attracting a sizeable chunk of public deposit.

However, some policymakers have suggested that SCBs should be paid atleast 7% interest on the CRR balance kept by them with the RBI. The then SBI Chairman, P. Choudhuri, at a FICCI event in Kolkata on 23rd August, 2012 urged that RBI should phase out CRR as banks cumulatively lose nearly Rs. 3 lakh crores of lendable resources in a capital starved country like India. If the CRR is phased out, this would allow banks to lower lending rates, helping commerce and industry.

Another school of thought argues that if CRR cannot be phased out completely, then initiate steps to amend the RBI Act paving the way for compensating the banks by paying them interest on the CRR maintained by them with the central banking authority. The CRR as one of the last remaining systematic inefficiencies has added to the cost base and resulted in a tax on banks, and in turn, a tax on borrowers. SLR securities are adequate as a solvency and liquidity reserve and additional pre-emption towards CRR is largely superfluous. There is a debate whether the RBI should continue to impose CRR on banks at all as a statutory pre-emption, especially when they have to park 23% of its deposits in government bonds. In course of our present research enquiry, we have come across a kind of similar debate among the bankers. We lay down here under the subject matter of the debating issues:

- While the government contends that interest payment on CRR will bring down interest rates in the economy, actually the earnings of the government from the RBI will drastically fall if such a course of action is exercised.
- RBI's contention is different. It says that the payment of interest will interfere with the conduct of monetary policy. The RBI would run into losses if asked to pay interest on mandatory percentage of deposits that banks have to park with the RBI called CRR. The RBI has stopped paying interest on such mandatory reserves since 2007.
- Another argument is put forward by M.Y. Khan (2012) that if cash reserves have to be abolished, then commercial banks should have to achieve the status of zero NPAs along with a satisfactory level of investment risk reserves in order to protect the depositors in case of a financial breakdown.

How a central bank utilizes the money mobilized in the form of CRR is not publicly disclosed. The RBI had indicated that it has to pay commission to banks handling government transactions, security printing charges, etc. which is a considerable expenditure. Payment of interest on CRR would proportionately reduce RBI's money transfer to the government and paying interest on CRR will dilute the effectiveness of the tool in terms of monetary policy changes. But the fact remains that interest on reserves takes a toll on the Treasury and hence, the RBI is not keen on interest payment to SCBs.

While there is a counter argument prevailing against this proposition, we know that CRR is one of the instruments of credit control and monetary policy implementation employed by the RBI to regulate and influence money supply, keeping in view the inflationary pressures and rising prices. CRR has a different vision altogether as a controlling instrument over risk management in banking operations. When a bank encounters financial risk owing to ir-recoverability of loans and advances and lands in teething problems, RBI then comes to the rescue of such banks. CRR accumulated over the years gives a cushion, both to the banker and also to its customers.

CONCLUSION

The present researchers in this article do not contest the principle of maintaining CRR by the central banking authorities. This is necessary in order to protect the security of the banking system, to exercise monetary control over credit flow, to control and ration the credit delivery system in the economy; what is debatable is the refusal of paying interest on the CRR deposits maintained by the commercial banks with the central bank. In a hypothetical case, we believe that a central bank's balance sheet is window-dressed and at the same time the balance sheet of the highly regulated commercial banks is under-dressed. Out of the total CRR amount mobilized by the RBI from which the central bank generates income whereas the commercial banks in turn do not accumulate any income out of this amount. We strongly believe payment of interest on CRR may not be unjust; atleast it will allow the banks to get an alternative source of income which otherwise they have been deprived of.

Our research analysis, on the same ground over the arrangement in the UK, USA, France, Italy, China where they pay a nominal interest on the CRR deposits, advocates the payment of interest by the RBI to the SCBs. We further strongly believe that the rate of interest may be nominal but when it is paid on the incremental amount accumulated over the periods the amount runs into billion dollars. In case, we totally deny payment of interest on CRR, it leads to under-reporting of liability by the central banks in its financial statements and it suffers from the limitation of fair value accounting and reporting. By denying of interest on CRR, the central bank is deriving a gain out of the endeavour of the commercial banks to mobilize demand and time deposit from the customers. If that situation continues, the commercial banks would attract a dis-incentive in mobilizing public deposits in the fold of the banking system. Once that dis-incentive sets in, there is a possibility that potential deposit in banking sector might be diverted to other institutional alternatives and the target of attaining growth rate of the country may suffer in the long run.

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