CHAPTER VII

MANAGEMENT OF R.B.I. BALANCE

As mentioned earlier, all Commercial Banks are required, under Section 42(1) of the Reserve Bank of India Act 1935, to maintain with the Reserve Bank of India, a particular portion of their total Demand and Time Liabilities, as at the close of business every day, as Cash Reserves. This is known, in banking parlance, as the Cash Reserve Ratio (CRR). The Ratio to be maintained by banks would vary from time to time in accordance with the changes/revisions effected by the Reserve Bank of India from time to time in its monetary and credit policies. The imposition on banks of the statutory requirement to maintain CRR serves three major purposes:

1. First of all, CRR is used as instrument for ensuring liquidity in banks. Banks, more often than not, are prone to over trade and hence suffer from illiquidity. Cash Reserves maintained by banks are designed to come to their rescue on such occasions. However, in order to ensure that banks manage funds judiciously so that they would not often suffer from illiquidity, the Reserve Bank of India has made maintenance of CRR compulsory on their part and also their non-maintenance of it at the required level punishable under law by imposing penal interest at rates upto 15% for the extent of their default/shortfall. It may be pointed out in this context that the Reserve Bank of India does not pay any interest on the first 3% of the total of 9% of DTL they maintain as Cash Reserves with the Reserve Bank of India. In other words, the first 3% of the CRR (known as the basic Reserves) maintained by banks with the Reserve Bank of India carry no interest at all.

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Moreover, if a bank defaults, for any week, in maintaining CRR at the required level, then the Chief Executive of that bank is liable for criminal action to be initiated against him by the Reserve Bank of India. Further, banks would not be paid any interest for the balance (over the 3% basic CRR) maintained by it for the relevant week. Thus, the Reserve Bank of India compels banks, by these stern measures, to maintain the CRR at the required level. This helps banks to ensure liquidity which is the basic objective of the maxim of Cash Reserve Ratio.

2. Secondly, CRR is used as a tool to contain expansion in credit and thus, is treated as a vital instrument of monetary policy. In other words, the basic 3% Reserves are intended to ensure liquidity and the additional CRR (over and above the basic 3%) is intended to contain expansion in bank credit in quantitative terms. Through CRR, the Reserve Bank of India impounds a portion of the DTL and with every hike in the CRR additional funds to the corresponding extent are immobilised which results in a corresponding cut in expansion in bank credit.

3. Thirdly, through CRR, the Reserve Bank of India gets funds for its operations. In other words, these funds are available with the Reserve Bank of India for being used by the Government to meet its requirements.

Presently, (as of end July 1985), banks are required to maintain CRR at 9%. Besides, 10% of the incremental DTL with effect from 14.1.1977 and 31.10.1980 were impounded by the Reserve Bank of India as additional CRR. Further, 10% of the incremental DTL since
November 12, 1983 are being impounded by the Reserve Bank of India as additional CRR. However, the Reserve Bank of India released, during September 1983, in two equated instalments, one-fifth of the 10% of the DTL additionally impounded between 14.1.1977 and 31.10.1980. The day to day operations of banks are made and their claims on one another for funds through cheques are settled through the Reserve Bank of India. Hence, emergence of illiquidity in any bank would be visible first only in its balance with the Reserve Bank of India. Whenever there is acute shortage of funds in banks, they borrow from the market immediately - say in a few hours and make good the balance. The rate of interest in the Inter-Bank Call Money Market is decided by the quantum of (excess) money available with banks or otherwise. In other words, the basic theory of supply and demand operates and determines the rate of interest in the Call Money Market which is subject to the maximum of 10% fixed by the Indian Banks' Association, as mentioned earlier.

The instance of the Case Bank in 1980 is a standing example of how a bank would lose heavily if there is a poor management of funds resulting in non-maintenance of CRR at the required level. Life Insurance Corporation maintained huge short term funds with the Case Bank and went on renewing them, on an ongoing basis and thus maintained a stable balance. However, during the months of February to March every year, the LIC withdrew the funds, in bulk, to meet its seasonal requirements and replenished them in every succeeding May. Consequently, the Bank ran into difficulty/illiquidity during these periods and hence could not maintain the requisite balance with the Reserve Bank of India towards the CRR. The Bank did not realise that though the funds maintai-
ned by the Life Insurance Corporation were fairly stable, yet they could be withdrawn at any period of time, as they were only short dated deposits. Hence, they had deployed these funds in the form of credit and when the LIC withdrew, all of a sudden and on a large scale, its funds, during these periods, the Bank developed liquidity constraints. Consequently, the Bank recorded, for five weeks, a huge shortfall in the CRR, resulting in payment of penal interest to the Reserve Bank of India, in addition to non-receipt of interest from the Reserve Bank of India for whatever balances maintained with it. The loss on account of penal interest and non-receipt of interest for balances maintained with the Reserve Bank of India for default in CRR for the said weeks was a substantial sum and constituted as much as 20% of the gross profit of the Bank for that year. However, had the Bank deployed the funds received from the LIC only for short periods, then it would not have lost so much as it could have then got back its funds and paid back the same to the LIC when it withdrew its funds on a large scale.

This clearly indicates the need for banks to maintain their assets portfolio in conformity with the longevity of their deposits. In other words, mismanagement of funds by banks would affect their maintenance of adequate cash balance with the Reserve Bank of India and would consequently demoralise them.

The Reserve Bank of India pays banks, with effect from November 1983, interest at the rate of 10% p.a. on the balances maintained by them with it. Earlier, the rate of interest was very low. However, even now this rate is just sufficient to only compensate
banks the cost of their acquisition of these funds as shown below:

Cost of deposits Rs.7.95 per hundred
(inclusive of Servicing Cost) dired per annum.

If, for illustration, the CRR to be maintained by a Bank is Rs.100 creres and the balance maintained by banks under the basic CRR is Rs.20 creres, then interest bearing CRR would be only Rs.80 creres. Interest is paid on this amount at the rate of 10% p.a. Then the average return on funds maintained by the Case Bank with the RBI would be only Rs.5 per hundred per annum.

Thus, while the cost of deposits is Rs.7.95 per hundred p.a., the return on these funds is only Rs.5 per hundred and a net marginal profit of only Rs.0.05 per hundred is realised by the Bank.

A prudent management of the CRR portfolio by banks would call for strict adherence to the following principles:

Banks are under statutory obligation to maintain CRR at the required level and if there is any shortfall, banks should pay penal interest to the Reserve Bank of India for the shortfall (to the extent of the shortfall) and further the Reserve Bank of India would not also pay interest even for the actual (lessor) balance of Reserves maintained by them on account of the shortfall (even if the shortfall is quite negligible or marginal) recorded by them. Hence, if there is likely to be any shortfall in the CRR on account of shortage in funds and if on such occasion...
sions funds are available in the Inter-Bank Call Money Market even at the ceiling rate of interest of 10% p.a., then it would be advisable for banks to borrow from the market and maintain CRR at the required level, as otherwise they would lose heavily, as pointed out earlier, and as also shown in the following illustration:

Suppose, the total CRR required to be maintained by a given bank for a particular week is Rs.100 crores. Whereas, it is able to maintain only Rs.90 crores, thereby recording a shortfall of Rs.10 crores.

Of this sum of Rs.90 crores, basic CRR may be assumed at Rs.20 crores. Then Interest bearing Reserves under the CRR would be Rs.70 crores.

Loss of Interest for Rs.70 crores for one week @ 10% p.a. Rs.13.46 lakhs due to the shortfall

Penal Interest payable for the shortfall of Rs.10 crores @ 15% p.a. Rs.2.66 lakhs

Total Loss Rs.16.12 lakhs

If, on the other hand, funds are available in the Market and hence Rs.10 crores are borrowed for one week, even at the ceiling rate of 10% p.a., and the CRR is maintained at the required level, the interest payable (for that one week) for that sum of Rs.10 crores would be only Rs.1.92 lakhs. This would mean that the Bank would neither lose nor gain as the rate of interest paid by the Bank in the Call Money Market and the rate payable by the Reserve Bank of India for the balances maintained by the Bank with it are same at 10%.

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Short term funds should be used only for short term operations and hence, banks should necessarily keep a proper correlation between the two and thereby avoid emergence of illiquidity.

Excess cash balances maintained by banks with the Reserve Bank of India are not entitled for any interest (from the Reserve Bank of India) and hence banks should not maintain any excess balance under the CRR and it would erode their profit. At the same time, banks should maintain a close watch on the daily operations of their major branches selected on the basis of ABC analysis and advise them to transfer their excess funds to the concerned offices of the Reserve Bank of India or the nearby Currency Chests or the State Bank of India without any delay.

Depending upon market conditions and subject to necessity, market borrowings may be resorted to on days other than Fridays, particularly when interest rates are low.

If banks conform strictly to these basic principles, the return from their operations in regard to maintenance of CRR would be at the maximum level.