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Impact of Interest Rate on Nationalised Bank and Their Investors: A Study with Respect to Indian Banking System

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ABSTRACT

The objective of creating a large financial, especially banking, network was satisfied by the 1980s. Post-nationalisation, banking in India acquired a broad mass base and emerged as an important instrument of socio-economic change. By its worst in 1991 statutory stipulations came to account for as much as 63.5 per cent of the deposit mobilization by the banking system, further limiting the scope for portfolio optimization by the banking system. Furthermore, the imperative of maintaining low interest rates in order to contain the interest rate cost of public debt and to provide concessional credit to various sectors resulted in a degree of financial repression in the economy.

The Present Paper aims at offering a comprehensive perspective on central banking in India. To place the issue in context, it begins by tracing the evolution of central banking, against the backdrop of the debates in the much-contested field of monetary economics. Against this historical background, the Paper turns to three contemporary issues in central banking: formulation and conduct of monetary policy, strengthening financial stability and management of the changes in Interest rates of Reserve Bank of India.

KEYWORDS : Indian Banking, Reserve Bank of India, Monetary Policy, Credit Policy.

Introduction: -

Developing countries such as India have been late starters in central banking. The evolution of central banking in these countries has been influenced by both, the central banking practices elsewhere in the industrial world as also the imperatives of the domestic economy. Since the overriding accent of these economies has been on achieving rapid economic development, inevitably, central banks in these countries have had a distinct developmental orientation. Going beyond the conventional objectives of central banking, the First Five-Year Plan (1951) had noted that

"…central banking in a planned economy…would have to take on a direct and active role, firstly in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly, ensuring that the finances available flow in the directions intended…".

In line with its statutory mandate, the Reserve Bank has also promoted an appropriate structure of policies, procedures and institutions in rural financing, including the institution of the Agricultural Refinance and Development Corporation (1963).

Bank: - For a common man, a bank means a storehouse of money for a businessman it is an institution of finance and for a worker it may be a depository for his savings. It may be explained in brief as "Banking is what a bank does." But it is not clear enough to understand the subject in full. The Oxford Dictionary defines a bank as "an establishment for the custody of money which it pays out on a customer's order ".

EVOLUTION OF BANK

It is interesting to trace the origin of the word 'bank' in the modern sense, to the German word "Banck" which means, heap or mound or joint stock fund.

The Banking Regulation Act, 1949, under which banks are regulated by the Reserve Bank of India, defines a banking company and banking as under:

DEFINITION OF BANK

Section 5(b) defines bank as accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, and order or otherwise. Section 49A of the Act prohibits any institution other than a banking company to accept deposit money from public withdrawal by cheque.

Let us see the definitions of bank and banking, given by various authorities.

Crowther defines a bank as, "one that collects money from those who have it to spare or who are saving it out of their income and lends the money so collected to those who require it".

Dr. L. Hart says that the bankers are "one who in the ordinary course of business honors cheques drawn upon him by persons from and for whom he receives money on current accounts".

FEATURES OF BANKING:

From the views of above authorities, we can derive the following basic characteristics of Banking:

(i) **Dealing in money:** The banks accept deposits from the public and advancing them as loans to the needy people.
(ii) **Dealing with credit:** The banks are the institutions that can create i.e., creation of additional money for lending. Thus, "creation of credit" is the unique feature of banking.

Review of Literature:-

The maintenance of savings bank deposit accounts, however, entails transaction costs for banks. Although the exact cost structure of maintaining savings bank account is not readily available, some idea of this could be had from the fee structure imposed by banks for non-adherence to the stipulated conditions by the savings bank depositors. The charges for non-maintenance of minimum balance by select public sector banks vary between ` 20 and ` 225 for urban areas and ` 20 and ` 100 for rural areas per quarter. With regard to the number of free transactions for using other banks' ATM for cash withdrawal and balance enquiry up to a maximum of five per month, select banks charge ` 18 to ` 20, subject to the maximum of ` 20 per transaction as stipulated by the Reserve Bank.

Need of Study: -

Banks are the backbone of financial systems and play an important role in economic development. They act as intermediaries in channelizing funds from surplus units to deficit units. The Indian banking sector saw a major shift in the policy atmosphere after the introduction of financial sector reforms in 1991. So as per the said Reserve Bank of India has to Regulate its Monetary a well as Credit Policy to Control the Inflation & Liquidity in the market.

Statement of Problem:-

Is there is a need to study the Behavior of the Interest Rates of Reserve Bank of India?

Objectives: - The study was planned to perceive the following objectives

- To study the Interest Rates of Reserve Bank of India.
- To study the Relation between Interest Rates and Deposits of Banks.
- To identify the challenges faced by banking and financial sector.

Hypothesis:-

H1: There is Positive effect of Interest rates on the banks.

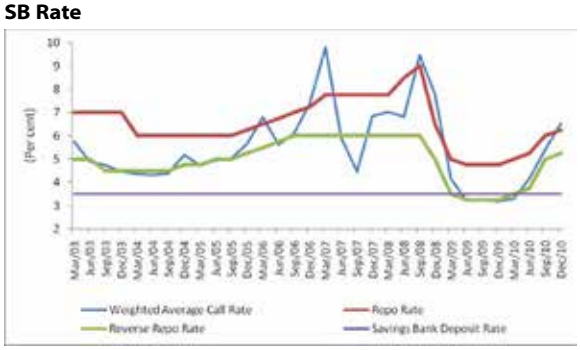
H2: The Credit policy is creates challenges for the banks but is a need of economy.

Research Methodology: -

The study is based on the Secondary data which is collected from the Articles, Published papers, Reserve Bank website, and news papers etc.

Regulation of interest rates imparts rigidity to the instrument/product as rates are either not changed in response to changing market conditions or changed slowly. This adversely affects the attractiveness of a product/instrument. In the case of savings bank deposits, its interest rate has remained unchanged at 3.5 per cent since March 1, 2003 even as the Reserve Bank's policy rates and call rates. (Chart 1)

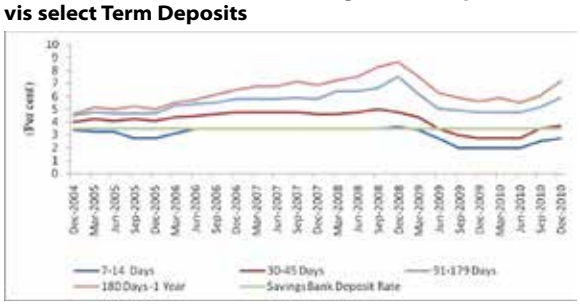
Chart 1: Movement of Policy Rates, Call Money Rate and SB Rate



As the administered savings deposit interest rate has not moved in sync with the changing market conditions, it has generally been unfavorable to savers. It is significant to note that about 90 per cent of savings deposits are held for savings purposes.

A comparison of interest rate on savings deposit and term deposit with maturity up to one year during December 2004 to December 2010 reveals some interesting patterns (Chart 2). First, during most of the period since December 2004, the interest rate on savings deposits has been equivalent to interest rate on term deposit of 7 - 14 days maturity, barring two brief periods (December 2004 - June 2006 and March 2009 – December 2010) when it was marginally higher. Second, interest rate on savings deposit were lower than those on term deposit of all other maturities up to one year, barring a brief period (June 2009 - September 2010) when the interest rate on savings deposits was higher than that of term deposit with maturity of 30-45 days.

Chart 2: Interest Rates for Savings Bank Deposit vis-à-vis select Term Deposits



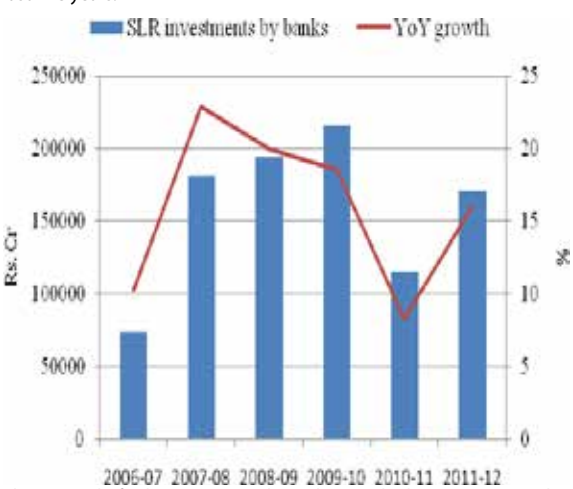
The graph shows the trend observed in the year on year growth for Deposit, Credit and Investments seen since April 2010. The credit growth picked up post June 2010 tracking the money lent to telecom companies for 3G and BWA auctions. The investments marked a sudden dip around December 2010 in wake of the SLR cut from 25% to 24% announced by the RBI.



A reversal of the trend was observed since Jan 2011 wherein the credit growth started stalling however investments continued to be robust despite the SLR cut. The slowdown in credit can be attributed to the successive rate hikes announced by RBI. Tracking a huge sell-off post the SLR reductions, the Year to Year growth rate declined substantially.

Banks SLR:

The graph shows the investments by banks in SLR securities over the last five years.



The rationale for having SLR is that it has worked as a macro prudential tool. SLR makes banks invest in government bonds which are risk-free assets and reduces the overall systemic risk in the banking sector. The SLR has been gradually brought down by the RBI over the years.

Suggestion:-

1) The rationale for having SLR is that it has worked as a macro prudential tool. SLR makes banks invest in government bonds which are risk-free assets and reduces the overall systemic risk in the banking sector.
2) As the administered savings deposit interest rate has not moved in sync with the changing market conditions, it has generally been unfavorable to savers.

Conclusion: - RBI exercises control on banks through its various tools like CRR and SLR. The Indian banking system has a very wide reach and deep presence. In terms of liquidity and profitability it has achieved new dimensions. NPAs, interest rates, and government control are some of the areas that duly affect the profitability of banks in India's, CRR, interest rate slabs, prudential norms, capital adequacy norms, are some of the areas where many reforms have been suggested and brought. So the hypothesis no.1 is proved i.e. The Interest Rates affects positively on the Nationalised Banks in India.

Scope of Further Study: - There is lot of scope for further research because the Indian banks face various problems in Financial Sector from several years. If we want to minimize them it requires systemic planning for overcoming these problems.

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