



“IMPLICATIONS OF FORMULATING AND CONTROLLING THE CRR AND SLR BY THE RESERVE BANK OF INDIA”

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ABSTRACT:

CRR and SLR have been strategic instruments of monetary policy of the RBI. However, the authorities have started questioning the use of these reserves in the current economic scenario in India. Also, many countries have already abolished these mandatory reserve requirements in consonance with the requirements of the commercial banks, mutual funds etc. Hence, it becomes pivotal to examine the rationale behind these reserve requirements and in the light of the same, examine the need to alter or completely erase these reserve requirements. The topic is relevant, more importantly after the series of changes in RBI's monetary policy starting with the announcements from the erstwhile Governor of RBI, Mr. Raghuram Rajan. The scope is to analyse the functions of RBI related with formulating and controlling of CRR and SLR in India. The author has however, made a brief comparative overview of other jurisdictions like U.S.A, South Africa, U.K and Canada. The article primarily evaluates whether, the Reserve Requirements and Liquidity Ratio Requirements need to be altered in view of current economic scenario in India.

Keywords: reserve requirements, monetary policy, RBI, monetary policy instruments, banking, reforms

INTRODUCTION

The most important task for any commercial bank is to meet its primary reserve needs. These reserves are required partly for legal reasons and partly as working balances of the bank. The important characteristic of these reserves is that they are cash assets, and they do not, therefore, earn any income for the bank. The primary reserves, where these are required by law, are stipulated as some definite percentage of the banks demand and time deposits. The primary reserves have two economic functions: the first is that they give the bank short-run liquidity which enables it to buy time until it can make fundamental adjustments in its assets and liabilities; the second function is that it is an important adjunct to the conduct of monetary policy.¹

The design of monetary policy has been a subject of debate in the specialized literature. Over the last three decades, this literature has moved from questioning the very existence of reserve requirements (RRs) to analyzing and discussing their role as a tool for monetary policy. The large variation in how central banks implement RRs around the world suggests that a consensus has yet to emerge on what constitutes an optimal reserve requirement strategy. I survey the main modelling strategies which incorporate RRs in the design of monetary policy. Furthermore, I discuss different modelling approaches in which RRs can affect the banking system, improve monetary policy decisions, and help achieve a central bank's macroeconomic objectives.²

One of the major operations in monetary policy is statutory liquidity Ratio (SLR). Statutory liquidity ratio refers amount that the commercial banks require to maintain in the form of gold or government approved securities before

¹ T. K. Velayudham, *Reserve Ratio of Commercial Banks*, 13(49), ECONOMIC AND POLITICAL WEEKLY, 2016, (Dec. 9, 1978).

² César Carrera, *The Evolving Role of Reserve Requirements in Monetary Policy*, Journal of Centrum Cathedra available at http://www.centrum.pucp.edu.pe/pdf/revistas/JCC6.179_The_Evolving_Role_of_Reserve_Requirements.pdf (Last visited on November 26, 2024).



providing credit to the customers. Here by approved securities, we mean, bond and shares of different companies. Statutory Liquidity Ratio is determined and maintained by the Reserve Bank of India in order to control the expansion of bank credit. It is determined as percentage of total demand and time liabilities. Time Liabilities refer to the liabilities, which the commercial banks are liable to pay to the customers after a certain period mutually agreed upon and demand liabilities are such deposits of the customers which are payable on demand. Example of time liability is a fixed deposits for 6 months, which is not payable on demand but after six months. Example of demand liability is deposit maintained in saving account or current account, which are payable on demand through a withdrawal form of a cheque. SLR is used by bankers and indicates the minimum percentage of deposits that the bank has to maintain in form of gold, cash or other approved securities. Thus, we can say that it is ratio of cash and some other approved liabilities (deposits). It regulates the credit growth in India.³

The research is doctrinal and analytical in its approach. The author has conducted a comparative and analytical study in various jurisdictions like the U.S.A, U.K., South Africa and India. A final step analysis is application of this analysis to the research problem and makes tentative conclusions and suggestions. The author has utilized primary and secondary sources in the research.

REVIEW OF LITERATURE:

The author has used books, articles, newspaper articles of various jurisdictions to carry out the research. However, the current development on the topic can be gathered by journals like the Business and Economics Law Journal, Economic and Political Weekly and Berkley law Review. These journals have captured some innovative approaches on alteration of reserve requirements. The emerging problem has been mentioned in these articles. However, the authors have not taken a step ahead in suggesting solutions to such approaches in Indian context.

The recent literature on reserve requirements highlights their role as a defence mechanism against crises or negative aggregate shocks, especially for developing countries. From a macro prudential perspective, reserve requirements can serve as a preventive measure against potential distortions in the financial system. In fact, reserve requirements can complement and strengthen the monetary policy schemes of central banks that use a short-term interest rate as the operating target. In this context, the objective of this paper is to review RR policies in the literature of the last 30 years.

I. CONCEPT OF CRR AND SLR

➤ *Cash Reserve Ratio (Reserve Requirements)*

Currently, setting reserve requirements seems to be a common practice among central banks around the world. Gray (2011) illustrated the current practices on reserve requirements by pointing out that out of 121 central banks, only nine do not use reserve requirements. Gray used the 2010 International Monetary Fund (IMF) survey and reported that central banks that do have a reserve requirements system have different operating practices. Reserve requirements are an amount of money and/or liquid assets that commercial banks must hold in cash or on deposit with the central bank (as part of its reserves). Usually, central banks require commercial banks to hold a specific percentage of deposits from the public. There is a large variation across countries as to how much to have as reserves (percentage of deposits), how much to remunerate, and the length and structure of the maintenance period.

³ Ravi Sharma, *Educate square*, <http://educatesquare.com/what-is-statutory-liquidity-ratioslr/>, (Last visited on November, 23 2013).



Like a tax, reserve requirements can increase fiscal revenues at the cost of reducing the rate of return on deposits. In fact, the literature during the 1970s and 1980s focused on the similarities between regulated and unregulated banking systems in terms of the tax effects of imposing reserve requirements.

More recent analysts Betancourt & Vargas, Di Giorgio, have argued that as the short-term interest rate becomes the standard operating target for monetary policy, reserve requirements lose ground as a monetary policy tool. On the other hand, Terrier et al. suggested that central banks use reserve requirements for monetary or financial stability.

The nature of the debate about reserve requirement policies has evolved over time. Therefore, it is possible to identify the main issues that have motivated the different types of work during different periods of time. In the late 1980s and 1990s, the literature focused on the use of reserve requirements as a monetary policy instrument to stabilize the money supply. This group of papers used overlapping generation models in which reserve requirements are a temporal mechanism that ensures liquidity between periods.

Moreover, the wave of literature that followed used partial equilibrium models in which a representative bank must decide the optimal quantity of reserves and when to enforce reserve requirements. In this process, banks have to decide the optimal amount of reserves to allocate for the next period and whether they should maintain excess reserves. The main conclusion is that the policy rate and reserve requirements can complement each other.

The most recent literature is characterized by dynamic stochastic general equilibrium (DSGE) models, which give an active role to reserve requirements. The potential effects of reserve requirements are associated with financial frictions and the financial accelerator of Bernanke, Gertler, and Gilchrist (1999).

1.1 **Legal Provision under the RBI Act, 1934**

The Present System Section 42 of the Reserve Bank of India Act, 1934, lays down in detail the manner in which the reserves are to be maintained by banks with the Reserve Bank, the proportion of deposits to be held as reserves, the items to be included or excluded from demand and time liabilities, the time-limit for purposes of reporting the data to the Reserve Bank, the exceptions and relaxations which could be made in favour of commercial banks. For purposes of this analysis, however, two important aspects of Section 42 are considered, as -these are directly relevant to the problem examined here. The first is Section 42(i) of the RBI Act, which requires banks to maintain with Reserve Bank, an average daily balance, the amount of which shall not be less than 6 per cent of the net liabilities. The average daily balance refers to average balances held at the close of business on each day of the week, from Saturday to the following Friday⁴ i.e., the banking week. Thus, the reserve ratio is calculated by averaging over a one-week period, daily figures of deposits and reserves and working out the latter as a proportion of the former. It needs to be pointed out that Section 42(i) does not expect banks to hold the exact amount of the required reserves every day; Instead they are required to hold only average reserves over a week. Thus, a bank may run a surplus or a shortfall in its balances on any particular day without attracting penalty, as long as it makes up the deficiency within the week for which the average balance is to be maintained. For instance, a bank may build up huge balances during the earlier part 'of the week so as to raise the figure of average daily balances over the week.⁵

Incidentally, the present system of maintaining reserves as an average daily balance is in force since 1956, when this basis was adopted as a result of the package of amendments to the RBI Act in that year. Originally, Section 42(i) of RBI Act required the banks to maintain with the Reserve Bank- minimum reserves at the close of business on any

⁴ The Reserve Bank of India, *Functions and Working*, (1970), (Last visited on November 26, 2024).

⁵ T. A. Vaswani, *INDIAN BANKING SYSTEM*, (2006).



day.⁶ The second aspect is the time limit laid down in Section 42 for purposes of reporting to the Reserve Bank the data on the average daily balances. In terms of Section 42, the return must relate to a Friday and must be sent not later than 5 days after the date to which it relates. In other words, the return which becomes available on a Friday of the week relates to the position as on the previous Friday. This lag of about a week seems to be the irreducible minimum that is available to the banks to compile the required data on their reserves.⁷

1.2 Definition of CRR

Cash Reserve Ratio (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 RBI with reference to their total net Demand and Time Liabilities (DTL) to ensure the liquidity and solvency of Banks (Section 42 (1) of RBI Act 1934). The current CRR is 4.75% and at present no incremental CRR is required to be maintained by the banks.

1.3 Rationale behind maintenance of CRR

The cash reserve ratio is conceived as an instrument of monetary regulation. It is deployed as a means of mopping up excess liquidity with the banking system for gaining better control over inflation.⁸ In the present liberalised monetary system of India, knowledge of optimal cash reserve ratio (CRR) is of crucial policy interest. CRR refers to that portion of deposits that a bank has to mandatorily keep with RBI without earning any interest as part of prudential measures. Along with CRR, banks are required to invest a portion of their deposits in government securities as part of their statutory liquidity ratio (SLR) requirements. Although CRR has come down from its peak level of 15% in 1994 to 4% at present, RBI had some years ago ceased to pay interest on CRR.

According to Gray, the purpose of reserve requirements is related to prudential management of deposits, monetary policy, and liquidity management. With respect to prudential management, banks hold reserves in order to meet demand for short-term liquidity. Regarding monetary policy, reserve requirements allow the central bank to control the money supply through the money multiplier and also to control the interest rate and the availability of credit. Finally, liquidity management refers to a situation in which banks have to satisfy RRs and have to decide the optimal amount of reserves to hold.⁹

According to one school of thought, it needs to be phased out as it does not earn any interest income and increases pressure to earn more from remaining resources." He added that this in turn translated into a cost increase which benefits none, unlike SLR which funds the government and contributes to the economy.

1.4 Computation of DTL

Demand Liabilities are liabilities which are payable on demand and Time Liabilities are those which are payable otherwise than on demand. The components for computation of DTL include Demand Liabilities, Time Liabilities and Other Demand & Time Liabilities (ODTL) as under:-

⁶ T. K. Velayudham, *Reserve Ratio of Commercial Banks*, 13(49), ECONOMIC AND POLITICAL WEEKLY, 2016, (Dec. 9, 1978).

⁷ *Id.*

⁸ Ganti Subrahmanyam, *Optimal Cash Reserve Ratio in India's Liberalised Monetary System*, 19(1), SAVINGS AND DEVELOPMENT, (1995).

⁹ S. Gray, *Central Banks' Balances and Reserves Requirements*, (IMF Working Paper/11/36, International Monetary Fund, 2011).



a) Demand Liabilities:-

Current Deposits, Savings bank deposits, Margins held against letters of credit/guarantees, Balances in overdue fixed deposits, Outstanding TTs, MTs, DDs, Unclaimed deposits, Credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand, & Money at Call and Short Notice from outside the Banking System (Liability to others).

b) Time Liabilities:-

Fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit, if not payable on demand, & deposits held as securities for advances which are not payable on demand and Gold deposits.

c) Other Demand and Time Liabilities (ODTL):-

Interest accrued on deposits, bills payable, unpaid dividends, suspense account balances representing amounts due to other banks or public, net credit balances in branch adjustment account, any amounts due to the banking system which are not in the nature of deposits or borrowing.

Participation Certificates issued to other banks, the balances outstanding in the blocked account pertaining to segregated outstanding credit entries for more than 5 years in inter-branch adjustment account, the margin money on bills purchased / discounted and gold borrowed by banks from abroad, Cash collaterals received under collateralized derivative transactions and Loans/borrowings from abroad.

Liabilities not included under DTL/ODTL

- a) Paid up capital, reserves, credit balance in the Profit & Loss Account, loan taken from the RBI, refinance taken from Exim Bank, NHB, NABARD, SIDBI;
- b) Net income tax provision;
- c) Amount received from DICGC towards claims pending adjustments thereof;
- d) Amount received from ECGC
- e) Amount received from insurance company on ad-hoc settlement of claims pending judgment of the Court;
- f) Amount received from the Court Receiver;
- g) The liabilities arising on account of utilization of limits under Bankers Acceptance Facility (BAF);
- h) District Rural Development Agency (DRDA) subsidy of Rs.10, 000/- kept in Subsidy Reserve Fund account in the name of Self Help Groups.
- i) Subsidy released by NABARD under Investment Subsidy Scheme for Construction/Renovation/Expansion of Rural Godowns;
- j) Net unrealized gain/loss arising from derivatives transaction under trading portfolio;
- k) Income flows received in advance such as annual fees and other charges which are not fundable.
- l) Bill rediscounted by a bank with eligible financial institutions as approved by RBI and,
- (m) Provision not being a specific liability arising from contracting additional liability and created from profit and loss account.

Exempted Categories

- a) Liabilities to the banking system in India
- b) Credit balances in ACU (US\$) Accounts;
- c) Demand and Time Liabilities in respect of their Offshore Banking Units (OBU)



- d) Inter-bank term deposits/term borrowing liabilities of original maturities of 15 days and above and up to one year, and
- e) Inter-bank assets of term deposits and term lending of original maturity of 15 days and above and up to one year.

Procedure/maintenance

As a measure of simplification, a lag of one fortnight in the maintenance of stipulated CRR by SCBs has been introduced. All SCBs are required to maintain minimum CRR balances up to 70 per cent of the average daily required reserves for reporting fortnight on all days of the fortnight (w.e.f. December 2002). RBI does not pay any interest on CRR maintained by SCBs.

Other provisions/penalty

- All SCBs are required to submit to RBI a provisional Return in Form 'A' within 7 days from the expiry of the relevant fortnight.
- Default in maintenance of CRR requirement on a daily basis (presently 70% of the total requirement) by SCBs attracts penal interest for that day at 3% above Bank Rate on the short fall.
- In case the shortfall continues on the next succeeding day/s, penal interest at the rate of 5% p.a. above the Bank Rate is applicable.

1.5 The Purpose of CRR

Cash Reserve Ratio (CRR) is ratio of reserves at which commercial banks must hold or deposit with the central Bank. In other words it is a central bank regulation that sets the minimum reserves that each commercial bank must hold physically in bank vaults or as deposits made with the central bank. This reserve can be maintained either in cash, gold or unencumbered government securities.

The reserve requirement, on one hand, helps the bankers to have enough cash to meet any crisis and on the other hand, they serve as tools for Central Bank to control the liquidity in the system in order to manage the Inflation. When CRR is altered then the interest rates will be changing as per availability of funds with the commercial banks.

➤ **What is SLR?**

SLR is the requirement imposed by the regulator on commercial banks that compels them to invest a percentage (currently 23.0%) of their Net Time and Demand Liabilities (NDTL) in approved government securities. Through this, today, 23% all the resources - deposits and borrowings - mobilized by commercial banks are invested in government securities. This has three important implications:

SLR reduces the resources available for commercial lending by banks. Every rupee deployed in SLR is a rupee not invested in a private enterprise that needs capital. There is no free lunch: when capital given to the government, it comes at the cost of capital available to the private sector. Any reduction in the SLR (as in the CRR) will yield more capital for the Indian private sector. It is hence important to critically analyse both.¹⁰

By creating a large captive source of deficit financing, SLR effectively subsidizes government at the cost of savers and commercial borrowers. When a government has to borrow at a competitive rate in the market, the market exerts a check on irresponsible fiscal behavior of the government. When there is a large captive source of borrowing, the government is shielded from the pressures of the bond market and is more likely to engage in fiscal imprudence. Such

¹⁰ Investment, *Interest and Monetary Policy in India*, University of Bombay, Bombay, (1974).



a large scale preemption of savings by the government through SLR fundamentally distorts the interest rate structure in the economy by artificially depressing the yield curve. This complicates the pricing of all assets in the economy.¹¹

1.6 Purposes of SLR

SLR is aimed at serving three purposes: (i) it is an instrument of credit control; (ii) it works as a cushion against the possibility of bank failures; and (iii) it is a conduit for financing government deficits. Out of these, SLR has been serving overwhelmingly the third purpose.

As a credit control instrument, it is relatively blunt and being used rather infrequently. Between October 25, 1997 and August 11, 2012 SLR has been changed only five times from 25 per cent to 23 per cent (Source: *Handbook of Statistics on Indian Economy, RBI, 2012*, Table 46). As far as its function as a cushion against bank failures is concerned, it is practically meaningless because weak commercial banks are not allowed to fail by the Government/RBI which is guided by the too-big-to-fail doctrine while resolving bank failures.¹²

Therefore, one may conclude that the biggest casualty of abolition of SLR would be government borrowing programmes which are of gigantic size every year. So the basic question is who will subscribe to such borrowings? The answer will determine the fate of the banking structure, post-SLR abolition.

If we want to "right-size" SLR we have to ask some important questions:

What is the rationale for imposing SLR?

What is the right level of SLR, that is consistent with this rationale and does not result in preemption of resources from the banking system?

Are there other conditions that need to be imposed on SLR so that it achieves the objectives?

1.7 Rationale for SLR

What is the conceptual foundation for the regulator to impose SLR? The answer is: prudence. Banks raise public deposits with a promise to redeem them at par or more. To reduce the risk of the portfolio of the bank, the regulator ensures through SLR that at least some part is deployed in the safest assets available. But if prudence is the reason, what is the right level of such reserves that will ensure adequate prudence? Could it be that imposing a requirement as high as 23% is beyond prudence, and is actually a means for the government to preempt savings in the economy? It is hence important to ask the next question: What SLR do we need?¹³

1.8 What is the right level of the SLR?

Banks are in the business of taking risk. These risks are taken by deploying public deposits. The most potent weapon that the regulators have used against excessive risk taking is "risk capital" which the equity capital committed by the banks owners. In fact, the entire edifice of modern day bank regulation is based on provision of risk capital as a buffer

¹¹ *Id.*

¹² Reserve Bank of India, *Handbook of Statistics on Indian Economy*, 2012, http://www.rbi.org.in/scripts/chro_bankrate.aspx, (Last visited on November 23, 2024).

¹³ Ajay Shah, *Rethinking the Statutory Liquidity Ratio (SLR) in Indian banking* <http://ajayshahblog.blogspot.in/2012/10/rethinking-statutory-liquidity-ratio.html>, Monday, October 29, 2012, (Last visited on November 24, 2024).



against risk taking by banks. If we believe, as do most regulators, in risk capital as the buffer against risks, then it makes eminent sense for banks to hold *this* capital safely. This would logically lead us to conclude that prudence should demand that the bank's risk capital be held in very safe assets. In India, the risk capital requirement is 9% of risk assets which translates roughly to 6.5% of NDTL (given that the risk assets are typically 70% of NDTL). Therefore, the policy prescription should be: *Banks must hold their entire risk capital in safe assets* which should include both CRR and SLR. Even if we assume the CRR is zero, this means that the theoretically right level of SLR would be around 6.5% of NDTL. If we scan the international landscape, this is the sort of number that we see in most countries. It is reasonable to argue that an SLR value above 6.5% of NDTL is motivated by pre-emption and not prudence. When the regulator prescribes a level of 23% for SLR, 6.5 percentage points are for prudence and the remaining 16.5 percentage points is really preemption by the government.¹⁴

1.9 *Composition of SLR*

The next important question about SLR is about its composition - what investments should qualify as SLR investments? Currently securities issued by the sovereign (Central and State Government bonds) are the only ones that are allowed as SLR investments. But if we accept *prudence* as the logic for SLR, then the regulation must make sure that these investments are as safe as they can be. This raises concerns about the rating threshold and of concentration risk. If Indian government securities are rated BBB and that of New Zealand government are AAA, it makes sense for banks to hold SLR in New Zealand Govt securities. Also, there should be limits on any individual issuer of securities, reflecting the standard risk management practice followed by any portfolio manager.¹⁵

Putting all the arguments above provides us an ideal construct of SLR as follows:

SLR is imposed for the purpose of prudence and hence the operative principle is that banks should hold all the regulatory required risk capital in SLR

The level of SLR should be consistent with the objective of prudence and anything over such a prudential level should be considered as preemption, which should be gradually eliminated.

SLR should be invested in top rated securities available globally; furthermore there should be concentration limits on single security and issuer.

1.10 *What is the difference between SLR and CRR?*

What SLR does is it restricts the bank's leverage in pumping more money into the economy. On the other hand, CRR, or cash reserve ratio, is the portion of deposits that the banks have to maintain with the RBI. Higher the ratio, the lower is the amount that banks will be able to use for lending and investment.

The other difference is that to meet SLR, banks can use cash, gold or approved securities where as with CRR it has to be only cash. CRR is maintained in cash form with RBI, where as SLR is maintained in liquid form with banks themselves.¹⁶

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Mansi Tiwari, *Statutory Liquidity Ratio*, THE ECONOMIC TIMES, http://articles.economictimes.indiatimes.com/2008-11-16/news/27702089_1_slr-cash-reserve-ratio-crr NOV 16 2008, (Last visited on November, 24 2024).



II. NEED FOR ALTERATION OF CRR AND SLR**➤ Should CRR be abolished?**

Reserve requirements are enshrined in introductory economics textbooks as one of the "tools," albeit a crude one, of monetary policy. Such regulations are understood to affect the banking system, and, ultimately, the economy by influencing the proportion of total assets that depositories hold as cash assets (either vault cash or balances with the Federal Reserve).¹⁷

In recent years, different trends have emerged across industrial economies. The Bank of Canada has abolished reserve requirements. The new System of European Central Banks, in contrast, has established a 2-percent reserve requirement on almost all liabilities. In December 1990 and January 1991, the Federal Reserve reduced reserve requirements on non-personal time deposits to zero. Then, in April 1992, marginal reserve requirements on transactions deposits for the largest class of depositories were reduced from 12 percent to 10 percent.¹⁸

In the absence of reserve requirements, depository institutions would continue to hold cash assets. Such assets are required to satisfy normal business operations, including settlement of interbank transactions (such as wire transfers and check clearing) and the exchange of retail deposits for currency on request. This represents a transactions demand for cash assets.¹⁹

The evidence from recent U.S. data strongly suggests that the amount of cash assets demanded by most depositories now is determined by institutions' transaction demands. Under the legal reserve requirement ratios that were established in December 1990 and April 1992, and the "home-brewed" ratios allowed via the implementation of retail deposit "sweep" programs since 1994, reserve requirement regulations no longer are binding constraints on the portfolios of most depository institutions.²⁰

The former SBI Chairman that "CRR does not help anybody. It is locked up in the vault and not ploughed back into the economy. It is unfairly applied on banks. If CRR is a liquidity mop-up tool, why not apply it to insurance companies, NBFCs and debt mutual funds, who as well mobilize deposits from the public?" he asked.²¹

After three days of SBI chairman commented the RBI Deputy Governor K.C. Chakrabarty commented that "the banks must work within the frame work of the regulatory norms". He also said that "If SBI is not protected, the risk may catch other banks leading to a systemic failure and SBI is too big to fail." He further went on to say that "If the SBI Chairman is not able to do business as per our regulatory environment, he has to find some other place".²²

Few years ago RBI had ceased to pay interest rate on CRR, which affects the commercial banks. This is one of the main reasons why SBI chairman wanted CRR to be abolished. SBI chairman had got some support for his view from Former RBI governor and present chairman of the Prime Minister's Economic Advisory Council (EAC) C Rangarajan; he said on that there is a need to bring down the cash reserve ratio as the instrument is no longer used in credit control and liquidity management. In his own words "We need to move towards a situation in which the level of CRR comes down and it is used as an instrument of credit control only in extraordinary circumstances," he also stated that "As

¹⁷ Robert H. Rasche, *Reserve Requirements and Monetary Policy*, FEDERAL RESERVE BANK OF ST. LOUIS, (1999), available at, <http://www.stlouisfed.org/publications/cb/articles/?id=1512>, (Last visited on November 26, 2024).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ BW Online Beureau, CRR Battle Far from Over, BUSINESS WORLD, (September 6, 2024).

²² *Id.*



OMO (open market operations) becomes increasingly a major instrument of credit control, the role of CRR as an instrument of credit control will come down,".²³

When one reads the debate then one may come to a quick conclusion that SBI governor is right and CRR should be abolished. If CRR is abolished then what are the other tools through which RBI can control credit and inflation? (Even though this is not the only tool to do this, but one of the major tool for RBI). No doubt as EAC chairmen said that OMO becomes increasingly a major instrument of credit control, but at the same time we cannot ignore or doubt the credibility of CRR. The Problem with commercial banks is few years back RBI had stopped paying interest rates on the cash reserves; this affects the business of the commercial banks, because without any incentive when the cash is kept then it is no use for anybody.²⁴

RBI need to find a amicable solution to stop this debate, either by paying some interest rates or through some other incentives. While the politics of abolishing reserve requirements are more complex than most people realize, the mechanics of doing so are quite straight-forward. While abolishing reserve requirements may seem to be a radical idea, Britain, Canada, Belgium, New Zealand, and Sweden function quite well without them. Also, most other industrialized nations have less onerous and costly reserve requirements than the United States. Indirectly, banks also will benefit from the abolition of reserve requirements because their customers will be able to reduce their cash management expenses.²⁵

Without doubt, CRR is not a new concept in the world. The US came up with the concept of cash reserve as early as 1863. Liquidity is also regulated by the central banks through open market operations in the European Union. So, across the globe, in demand driven economies, one of the quickest tools to reduce money supply in the economy (and consequently money available for consumers and businesses) has been CRR. While developing countries have tuned the ratio very frequently, US hardly makes changes in CRR. For example, China has changed CRR six times in an attempt to control the availability of credit and inflation in 2010. Similarly, India too has had to alter this ratio frequently. Yes, CRR does have a serious drawback in the form of lost interest. The debate is not completely irrelevant but considering the present economic scenario of India, the largest and most responsible banks should ponder over other crucial issues including how to bring in more investments, increase GDP growth rate and create a favourable environment for domestic entrepreneurs.²⁶

➤ *What does a reduction in SLR mean?*

A cut in SLR means that the home, car and commercial loan rates will go down. It also means that banks will now have the option of selling Rs 40,000 crore of government securities that until now formed part of their statutory investments.

The RBI is empowered to increase this ratio up to 40%. An increase in SLR also restricts the bank's leverage position to pump more money into the economy.²⁷

²³ *Id.*

²⁴ Economicsmate, *CRR Debate- Whether CRR will survive?*, (September 12, 2012), ECONOMICS DOODLE, available at <http://economicsdoodle.blogspot.in/2012/09/crr-debate-whether-crr-will-survive.html>, (Last visited on November 26, 2024).

²⁵ Reserve Bank of India, *Reserve Bank of India Post Policy Conference Call for Media* (2013), available at <http://rbidocs.rbi.org.in/rdocs/Content/PDFs/RBC29102013F.pdf> (Last visited on November 26, 2024).

²⁶ *Id.*

²⁷ Mrunal, *(economy) statutory liquidity ratio SLR meaning and implication*, <http://mrunal.org/2012/08/econ-slr.html>, (last visited on 26th November 2024).



2.1 *What happens if SLR is decreased?*

Earlier SLR was 24%, but on last day of July, RBI changed it to 23%. That means, if earlier SBI had total Rs.100 Deposited in all its 11,000+ branches, then SBI would have to park Rs.24 in G-sec but with new RBI rule, SBI will have to park only Rs.23.

Meaning SBI can take away Rs.1 from its G-sec investment and use it for giving as loan to regular customers. So, SBI will sell G-sec worth Rs.1 from its suitcase and use that 1 Rupee for lending as House, Car, Business loans to the customers.

SBI has one more rupee to lend to the customers; it'll reduce the interest rate (to seduce more customers). Thus Interest Rates go down when SLR is decreased. In real life, 1% decrease in SLR, means SBI alone will have additional Rs.10,000 crores for lending and all the banks (SBI, ICICI, Bank of Baroda etc combined), will have more than 68,000 crores for lending.

Now the reverse: If SLR is increased, then banks have less money to lend = they'll charge more interest rates on loans to keep the profit margin same.²⁸

2.2 *Value and Formulae:*

The quantum is specified as some percentage of the total demand and time liabilities (i.e. the liabilities of the bank which are payable on demand anytime, and those liabilities which are accruing in one month's time due to maturity) of a bank.

SLR rate = (liquid assets / (demand + time liabilities)) × 100%

This percentage is fixed by the central bank. The maximum and minimum limits for the SLR are 40% and 25% respectively in India. Following the amendment of the Banking regulation Act (1949) in January 2007, the floor rate of 25% for SLR was removed. Presently, the SLR is 23 %.²⁹

2.3 *Procedural Aspects, Notifications and Amendments in SLR Policy:*

1. **Maintenance of percentage of liquid assets:**

Section 24(2A) of the banking regulation act, 1949 as amended by the banking regulation (amendment) act, 2007 provides:

A scheduled bank, in addition to the average daily balance which it is required to maintain under sec 42 of RBI Act 1934, and every other banking company in addition to the cash reserve which it is required to maintain under section 18 of the banking regulation act 1949 shall maintain in India, assets, the value of which shall not be less than such percentage not exceeding 40% of the total of its demand and the time liabilities in India as on the last Friday of the second preceding fortnight as the RBI may, by notification in the official gazette, specify from time to time and such assets shall be maintained, in the specified form and manner.³⁰

The commercial banks/all Scheduled Commercial Banks (SCBs), in addition to the average daily balance which they are required to maintain under section 42 of RBI Act, 1934, in india a Statutory Liquidity Ratio(SLR) or certain

²⁸ *Id.*

²⁹Nidhi, Investment path, *Define Statutory Liquid Ratio (SLR)*, <http://www.investmentpaths.com/resources/3865-Define-Statutory-Liquid-Ratio-SLR-banking.aspx>, (Last visited on 24 November, 2024).

³⁰ M. L. Tannan, TANNANS BANKING LAW AND PRACTICE IN INDIA, 396, (2010).



percentage of specified liquid assets. Eg Cash, gold, unencumbered approved securities, etc, as specified by the **Reserve Bank of India** from time to time by notification. The value such specified assets shall not exceed 40% of the total of its demand and time liabilities in India as on the last Friday of the second fortnight.³¹

1. Maintenance of SLR

Consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the SLR for SCBs in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total DTL in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.³²

SCBs can participate in the Marginal Standing Facility (MSF) scheme introduced by Reserve Bank with effect from May 09, 2011. Under this facility, the eligible entities may borrow up to two per cent of their respective NDTL outstanding at the end of the second preceding fortnight from April 17, 2012. Additionally, the eligible entities may also continue to access overnight funds under this facility against their excess SLR holdings.³³

In the event, the banks' SLR holding falls below the statutory requirement up to two per cent of their NDTL, banks will not have the obligation to seek a specific waiver for default in SLR compliance arising out of use of this facility in terms of notification issued under sub section (2A) of section 24 of the Banking Regulation Act, 1949.³⁴

Reserve Bank has specified vide notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011 that every SCB shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 24 per cent on the total net demand and time liabilities as on the last Friday of the second preceding fortnight as prescribed vide notification DBOD.No.Ret.BC.66/12.02.001/2010-11 dated December 16, 2010 valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:³⁵ The liquid assets include cash or Gold valued at a price not exceeding the current market price or investment in 'Statutory Liquidity Ratio (SLR) securities' viz.

In cash, or

In gold valued at a price not exceeding the current market price, or

In encumbered investment in the following instruments which will be to as "statutory liquidity ratio(SLR) securities".

- a) Dated securities issued up to 06.05.2011 (Detailed in RBI notification of date).
- b) Treasury Bills of GOI
- c) Dated securities of the Government of India issued from time to time under the market borrowing programme* and the Market Stabilization Scheme
- d) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme; and

³¹ *Id.*

³² Reserve Bank of India, *RBI Master Circular*, <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/64MLR260613.pdf>, (Last visited on 28th November 2024).

³³ *Id.*

³⁴ *Id.*

³⁵ *Supra* 31.



e) Any other instrument as may be notified by the Reserve Bank of India.³⁶

Explanations:

- “Unencumbered investment” of a banking company shall include its investment in the aforesaid securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.
- Market borrowing programme refers to domestic rupee loans raised by GOI and State Governments from the public and managed by the RBI through issues of marketable securities Act, 2006 and the regulations framed hereunder, through an auction or any other method, as specified in this regards as per notification. Provided that the securities (including margin) are not acquired under RBI – Liquidity Adjustment Fund (LAF).
- In computing the amount for the above purpose, the following shall be deemed to be “cash maintained in India”
 1. The deposit required under sub-section (2) of section 11 of the banking regulation act 1949 to be made with Reserve Bank by a banking company incorporated outside India;
 2. Any balance maintained by a scheduled bank with reserve bank in excess of the balance required to be maintained by its under section 42 of RBI Act, 1934 and
 3. Net balance in current accounts with other scheduled commercial banks in india.³⁷
 - Encumbered SLR securities shall not be included for the purpose of computing the percentage specified above. Provided that for the purpose of computing the percentage of assets referred to hereinabove, the following shall be included, namely:
 - a. Securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.
 - b. Securities offered as collateral to the RBI for availing liquidity assistance from Marginal Standing Facility (MSF)
 - c. The deposit required under sub-section (2) of Section 11 of the Banking Regulation Act 1949 to be made with the Reserve Bank by a banking company incorporated outside India; 4
 - d. Any balances maintained by a scheduled bank with the RBI in excess of the balance required to be maintained by it under Section 42 of the Reserve Bank of India Act 1934 (2 of 1934); and
 - e. Net balances in current accounts with other scheduled commercial banks in India. Procedure for Computation of SLR/Penalty³⁸
 4. Procedure for computation of SLR

The procedure to compute total NDTL for the purpose of SLR under Section 24 (2) (B) of B.R. Act, 1949 is broadly similar to the procedure followed for CRR.

SCBs are required to include inter-bank term deposits / term borrowing liabilities of all maturities in ‘Liabilities to the Banking System’. Similarly, inter-bank assets of term deposits and term lending of all maturities in ‘Assets with the Banking System’ for computation of NDTL for SLR purpose.³⁹

³⁶ *Supra* 31.

³⁷ *Supra* 31.

³⁸ *Supra* 31.

³⁹ *Supra*30.

**Classification and Valuation of approved securities:**

As regards classification and valuation of approved securities, banks may be guided by the instructions contained in master circular (as updated from time to time) on prudential's norms for classification, valuation and operation of investment portfolio by banks.⁴⁰

Penalties:

- Default in maintenance of the required amount of SLR attracts penalty at the rate of 3% p.a. above the Bank Rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of 5% p.a. above the Bank Rate for the concerned days of default on the shortfall.⁴¹

Returns in form VIII to be submitted to RBI

SCBs are required to submit to RBI before 20th of every month a return (For VIII) showing the amount of SLR held on alternate Fridays during immediate preceding month with particulars of their DTL in India on such Fridays (Public holidays preceding working day).⁴²

Temporary/ad-hoc measures:

The special 14 day term repo facility for banks through relaxation in the maintenance of SLR up to 1.5% of their NDLT, to enable them to meet the liquidity requirement of mutual funds (MFs), non-banking financial companies (NBFCs) and housing finance companies (HFCs).⁴³

The forex liquidity to Indian public and private sector banks having foreign branches or subsidiaries and provided through forex swaps up to 3 months. Further for funding the swaps, banks can borrow under LAF for the corresponding tenor at prevailing repo rate. RBI will be prepared to consider any specific relaxation of SLR requirement for the purpose.⁴⁴

Correctness of computation of demand and time liabilities to be certified by statutory auditors:

The Statutory Auditors should verify and certify that all items of outside liabilities, as per bank's books had been duly complied by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI.

In the event of SCBs SLR holdings fall below the statutory requirement upto 2% of their DTL, they can avail the Marginal Standing Facility (MSF) upto 2% of their net DTL outstanding at the end of the second proceeding fortnight and they will 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).⁴⁵

2.4 ALCO Philosophy

One's contention is that whether a bank subscribes to government securities or not is intertwined with the philosophy its ALCO (Asset-Liability Committee) follows from time to time. If a bank's ALCO is a risk-lover it may try to minimize the bank's holdings of government securities and increase exposure to commercial lending and corporate

⁴⁰ Reserve Bank of India, *RBI Master Circular*, <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/64MLR260613.pdf>, (Last visited on 28th November 2024).

⁴¹ *Id.*

⁴² *Supra* 31.

⁴³ *Supra* 31.

⁴⁴ *Supra* 31.

⁴⁵ *Supra* 31.



bonds, the market for which would eventually receive a fillip. However, in an environment of subdued investor confidence and low credit absorption capacity like the present one, even the daring ALCOs would proceed cautiously.

With commercial lending occupying the centre-stage, such banks may be required to tone up their credit administration and risk management processes, practices and procedures lest large-scale incidence of NPAs become imminent, with its attendant problematic impact on safety and soundness parameters of these banks.⁴⁶

An ALCO which is risk-averse may try to hold as much as possible in government securities and move rather slowly on the commercial lending front. Thus, these banks may start practicing what is known as “narrow banking”, the cons of which outweigh the pros.⁴⁷

Thus, the banking sector may get divided into two classes — “narrow” banks and “broad” banks. However, this division would be highly volatile as the philosophies of bank ALCOs do not remain static over time. They change as and when a bank’s board and management changes, besides the operating environment.⁴⁸

2.5 The Banking Regulation (Amendment) Act, 2007

Section 24 of the banking regulation Act 1949 containing provisions for the maintenance of a percentage of assets has been amended by the Banking Regulation (Amendment) act 2007, it has been amended to ensure the reserve bank, as the regulator and the authority vested with the powers to conduct monetary policy, has the necessary flexibility regarding stipulation of the holding of the liquid instruments by banks. As such the existing floor of the 25% was removed keeping intact the ceiling of 40% as the guidance for Reserve Bank. It will give more operational flexibility to Reserve Bank of India in the conduct of the monetary policy.⁴⁹

The Banking Regulation (Amendment) Act, 2007, which came into force on January 23, 2007, removed the floor rate of 25% for SLR and empowered the Reserve Bank to determine SLR-eligible assets, among others. The reserve bank has maintained the pre-emption under SLR AT 25% till the first week of November 2008.⁵⁰

Submissions of monthly returns to ensure compliance:

Section 24(3) of the banking regulation act 1949 dealing with the submission of monthly return by all banks to ensure compliance with above provisions the section reads as such, For the purpose of ensuring compliance with the provisions of this section, every banking company, shall not later than twenty days after the end of the month to which it relates, furnish to the Reserve Bank in the prescribed form and manner a monthly return showing particulars of its assets maintained in accordance with this section, and its demand and time and liabilities in India at the close of business on each alternate Friday during the month, or if any such Friday is a public holiday, at the close of business on the preceding working day: Provided that every regional rural bank shall also furnish a copy of the said return to the National Bank.⁵¹

⁴⁶ *Recent Changes In Interest Rates Policy in India*, THE JOURNAL OF THE INDIAN INSTITUTE OF BANKERS (January-March 1992).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*, 397

⁵⁰ *Id.*

⁵¹ M.L. Tannan, TANNANS BANKING LAW AND PRACTICE IN INDIA, 397, (2010).

**RBI to furnish copy of return to NABARD:**

Every Regional Rural Bank (RRB) is also required to furnish a copy of the said return to National Bank for Agriculture and Rural Development (NABARD).

In the event of SCBs SLR holdings fall below the statutory requirement upto 2% of their DTL, they can avail the Marginal Standing Facility (MSF) upto 2% of their net DTL outstanding at the end of the second proceeding fortnight and they will 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).⁵²

III. RECOMMENDATIONS OF THE NARSIMHAM COMMITTEE

From the 1991 India economic crisis to its status of third largest economy in the world by 2011, India has grown significantly in terms of economic development. So has its banking sector. During this period, recognizing the evolving needs of the sector, the Finance Ministry of Government of India (GOI) set up various committees with the task of analysing India's banking sector and recommending legislation and regulations to make it more effective, competitive and efficient.[1] Two such expert Committees were set up under the chairmanship of M. Narasimham. They submitted their recommendations in the 1990s in reports widely known as the Narasimham Committee-I (1991) report and the Narasimham Committee-II (1998) Report. These recommendations not only helped unleash the potential of banking in India, they are also recognised as a factor towards minimizing the impact of global financial crisis starting in 2007.⁵³

Problem identified by committee:

The committee objected to the system of maintaining high liquid assets by commercial banks in the form of cash, gold and unencumbered government securities. In those days, in India, the SLR was as high as 38.5%. According to the M. Narasimham's committee it was one of the reasons for the poor profitability of banks. Similarly the cash reserve ratio (CRR) was as high as 15 %. Taken together, banks needed to maintain 53.5% of their recourses idle with the RBI.⁵⁴

Recommendation given by Narasimham Committee Report I -1991:

The committee recommended the reduction of the higher proportion of the statutory liquidity ratio and cash reserve ratio. Both of these ratios were very high at the time. The SLR then was 38.5% and CRR was 15%. This high amount of SLR and CRR meant locking the bank resources for government uses. It was hindrance in the productivity of the bank thus the committee recommended their gradual relaxation. SLR was recommended to reduce from 38.5% and CRR 15% to 3 to 5%.⁵⁵

IV. RESERVE REQUIREMENTS IN OTHER JURISDICTIONS**➤ CRR under other jurisdictions**

The reserve requirement (or cash reserve ratio) is a central bank regulation employed by most, but not all, of the world's central banks, that sets the minimum *fraction* of customer deposits and notes that each commercial bank must

⁵² *Id.* 398.

⁵³ Vijaiyesh Babu, *Details In Monetary Policy*, (November 2011) <http://vijaiyesh.blogspot.in/2011/11/m-narasimham-committee-recommendations.html>, (Last visited on November 24, 2013).

⁵⁴ Kiran Kumar, *Kalyan CityLlife*, (September 2010), <http://kalyan-city.blogspot.com/2010/09/narasimham-committee-report-1991-1998.html>, (Last visited on 24 November, 2013).

⁵⁵ *Id.*



hold as reserves (rather than lend out). These required reserves are normally in the form of cash stored physically in a bank vault (vault cash) or deposits made with a central bank.⁵⁶

The required reserve ratio is sometimes used as a tool in monetary policy, influencing the country's borrowing and interest rates by changing the amount of funds available for banks to make loans with.⁵⁷ Western central banks rarely alter the reserve requirements because it would cause immediate liquidity problems for banks with low excess reserves; they generally prefer to use open market operations (buying and selling government-issued bonds) to implement their monetary policy. The People's Bank of China uses changes in reserve requirements as an inflation-fighting tool,⁵⁸ and raised the reserve requirement ten times in 2007 and eleven times since the beginning of 2010.

An institution that holds reserves in excess of the required amount is said to hold *excess reserves*.

3.1 United States

In the United States, a reserve requirement (or liquidity ratio) is a minimum value, set by the Board of Governors of the Federal Reserve System, of the ratio of required reserves to some category of deposits held at depository institutions (e.g., commercial bank including US branch of a foreign bank, savings and loan association, savings bank, credit union). The only deposit categories currently subject to reserve requirements are net transactions accounts, mainly checking accounts. The total amount of all net transaction accounts held in USA depository institutions, plus US currency held by the nonbank public, is called M1.

A depository institution can satisfy its reserve requirements by holding either vault cash or reserve deposits. An institution that is a member of the Federal Reserve System must hold its reserve deposits at a Federal Reserve Bank. Non-member institutions can elect to hold their reserve deposits at a member institution on a pass-through basis.⁵⁹

The numerical amounts stated above are recalculated annually according to a statutory formula.

Effective December 27, 1990, a liquidity ratio of zero has applied to CDs, savings deposits, and time deposits, owned by entities other than households, and the Eurocurrency liabilities of depository institutions. Deposits owned by foreign corporations or governments are currently not subject to reserve requirements.⁶⁰

When an institution fails to satisfy its reserve requirements, it can make up its deficiency with reserves borrowed either from a Federal Reserve Bank, or from an institution holding reserves in excess of reserve requirements. Such loans are typically due in 24 hours or less.

An institution's overnight reserves, averaged over some maintenance period, must equal or exceed its average required reserves, calculated over the same maintenance period. If this calculation is satisfied, there is no requirement that reserves be held at any point in time. Hence reserve requirements play only a limited role in money creation in the USA - and since quantitative easing began in 2008, they have been even less important, as an enormous glut of excess reserves now exists (over the whole system; theoretically, though, individual banks may still run into temporary shortfalls).⁶¹

⁵⁶ Reserve Bank of India, *Glossary*, (2013), available at <http://rbi.org.in/scripts/Glossary.aspx>, (Last visited on November 26, 2013).

⁵⁷ Jaromir Benes and Michael Kumhof, *The Chicago Plan Revisited*, (IMF Working Paper, Research Department, WP/12/202).

⁵⁸ C. Whittlesey, *Banking and the New Deal*, 16, PUBLIC POLICY PAMPHLET, (Chicago, 1935).

⁵⁹ R. Werner, *NEW PARADIGM IN MACROECONOMICS*, (2005).

⁶⁰ K. Yamaguchi, *Workings of a Public Money System of Open Macroeconomics: Modeling the American Monetary Act Completed*, (Working Paper, 2011).

⁶¹ *Id.*



The International Banking Act of 1978 requires branches of foreign banks operating in the US to follow the same required reserve ratio standards.⁶²

3.2 Countries without reserve requirements

Canada, the UK, New Zealand, Australia and Sweden have no reserve requirements.

This does not mean that banks can - even in theory - create money without limit. On the contrary: banks are constrained by capital requirements, which are arguably more important than reserve requirements even in countries that have reserve requirements.

It also does not mean that a commercial bank's overnight reserves can become *negative*, in these countries. On the contrary: the central bank will *always* step in to lend the necessary reserves if necessary so that this does not happen - this is sometimes described as "defending the payment system". Historically, a central bank might once have run out of reserves to lend, and as a consequence might have had to suspend redemptions - but this cannot happen any more to modern central banks, due to the end of the gold standard worldwide, which means that all nations use a fiat currency.⁶³

It is sometimes argued that the requirement not to have a negative reserve balance at the central bank constitutes a reserve requirement of zero. However, mathematically, a requirement to hold zero reserves does not correspond to any ratio whatsoever; it is more permissive than any ratio. So this can only be true if a broader definition of reserve requirement is adopted. Moreover, such a zero reserve requirement cannot be explained by a theory that holds that monetary policy works by varying the quantity of money using the reserve requirement.⁶⁴

Even in the United States, which retains formal (though now mostly irrelevant) reserve requirements, the notion of controlling the money supply by targeting the quantity of base money fell out of favour many years ago, and now the pragmatic explanation of monetary policy refers to targeting the *interest rate* to control the broad money supply.⁶⁵

3.3 United Kingdom

In the UK the term clearing banks is sometimes used, meaning banks that have direct access to the clearing system. However, for the purposes of clarity, the term *commercial banks* will be used for the remainder of this section.

The Bank of England, which is the central bank for the entire United Kingdom, previously held to a voluntary reserve ratio system, with no minimum reserve requirement set. In theory this meant that commercial banks could retain zero reserves. However, the average cash reserve ratio across the entire United Kingdom banking system was higher during that period, at about 0.15% as of 1999.⁶⁶

From 1971 to 1980, the commercial banks all agreed to a reserve ratio of 1.5%. However, in 1981 this requirement was abolished.⁶⁷

⁶² Ahorny, Joseph, Saunders, The Effects of the International Banking Act on Domestic Bank Profitability and Risk, JOURNAL OF MONEY, CREDIT, AND BANKING (1985).

⁶³ Todd Keister and James J. McAndrews, *Why are Banks Holding so Much Excess Reserves?*, CURRENT ISSUES IN ECONOMICS AND FINANCE: FEDERAL RESERVE BANK OF U.S., (December, 2009) available at, http://www.newyorkfed.org/research/current_issues/ci15-8.pdf, (Last visited on November 26, 2013).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ Jagdish Handa, MONETARY ECONOMICS (2) (2008).

⁶⁷ Bank of England, *Sterling Operations - Implementation of Monetary Policy*, (2013), available at <http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/monetarypolicy.aspx>, (Last visited on 26 November 2013).



From 1981 until 2009, each commercial bank set out its own monthly voluntary reserve target in a contract with the Bank of England. Both shortfalls and excesses of reserves relative to the commercial bank's own target over an averaging period of one day⁶⁸ would result in a charge, incentivising the commercial bank to stay near its target - a system known as *reserves averaging*.

Upon the parallel introduction of quantitative easing and interest on excess reserves in 2009, banks were no longer required to set out a target, and so were no longer penalised for holding excess reserves; indeed, they were proportionally compensated for holding all their reserves at the Bank Rate (the Bank of England now uses the same interest rate for its bank rate, its deposit rate and its interest rate target).⁶⁹ Indeed, in the absence of an agreed target, the concept of excess reserves does not really apply to the Bank of England any more, so it is technically incorrect to call its new policy "interest on excess reserves".

3.4 Canada

Canada abolished its reserve requirement in 1992.⁷⁰

3.5 South Africa

Arguments in favour of, and against, enforcement of reserve requirements by legislation were as follows:

The centralisation of reserve balances in a central bank is a source of strength for the banking system of a country, for a number of reasons. *Firstly*, when reserve balances are pooled in a central bank that has the responsibility for monitoring the stability of the banking system of a country, such reserves can be employed effectively to meet seasonal fluctuations, or during a financial crisis. For instance, if circumstances arise where a particular bank needs additional funds, the central bank can utilise part of the cash reserves of that bank to tide the bank over the period during which the circumstances prevail. *Secondly*, centralised reserve balances facilitate the role of the central bank in supplying currency to banks. *Thirdly*, centralised reserve balances provide a central bank with a certain amount of funds with which it can operate, and strengthen, its⁷¹ financial position. Statutory provisions for banks to hold minimum reserve balances with central banks were introduced to secure such advantages of centralised cash reserves.

The present position is that, in many countries, irrespective of whether or not they have prescribed minimum reserve balances, commercial banks have grown accustomed to keeping most, if not all, of their cash requirements with the central bank. Commercial banks regularly draw currency from the central bank as required for operational purposes, and they deposit surplus currency as it accumulates.⁷²

Maintenance of minimum reserve requirements laid down by law is also a source of controversy. It is argued that such requirements promote the disintermediation of credit. The abolition of such requirements would allegedly create a more level playing-field for the entire financial system. Low or zero cash-reserve ratios diminish or remove the discrimination between financial institutions that are subject to the requirements and those that escape such requirements. In the South African context, the prudential need for minimum reserve balances has arguably become

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Jagdish Handa, *MONETARY ECONOMICS* (2) (2008).

⁷¹ H. F. Nel, *Minimum reserve requirements*, SOUTH AFRICAN RESERVE BANK, QUARTERLY BULLETIN, (December 2000) available at [http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/\\$File/Article1200.pdf](http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/$File/Article1200.pdf), (Last visited on November 26, 2024).

⁷² *Id.*



imperative as a result of the development of more sophisticated financial markets, the enhanced ability of banks to raise short-term funds, and the role of the Reserve Bank as the supervisor of the banking system.⁷³

In view of these drawbacks, some analysts argue that minimum reserve requirements should be abolished. Maintenance of such requirements can be supported, however, on the grounds that banks differ in one important respect from other financial institutions. The argument for the retention of minimum reserve requirements is linked to banks having access to assistance at the discount or accommodation window of central banks, in the form of overnight loans.⁷⁴

Banks that are subject to minimum reserve requirements, will try to avoid tying up significant amounts of funds in central-bank balances earning no, or minimal, interest. In countries where legal minimum reserve requirements are not enforced, voluntary balances held by commercial banks with central banks could well decline over time as payment systems develop further. Instead of cash balances, an accommodation facility can be used. The banks would still require "perfectly safe assets", for example, Treasury bills, as collateral, but would not need cash-reserve balances with the central bank.⁷⁵

Payment of interest on reserve requirements:

Originally, when central banks became the bankers of commercial banks, it was argued that no interest on such deposits should be paid for various reasons. *Firstly*, it was argued that it was important to be able to distinguish clearly the different natures of central banking and commercial banking. *Secondly*, it was argued that central banks should not compete with commercial banks for deposits and in the process, become a player in the market. When central banks did pay interest on these balances, an unhealthy competitive situation often developed between commercial banks and the central bank, particularly if the interest rates paid were market related. *Thirdly*, few central banks could afford to pay interest to banks on their reserve balances. For many central banks, these reasons still apply today.⁷⁶

In the case of South Africa, the De Kock Commission recommended that the Reserve Bank should be authorised to pay interest on reserve balances. This recommendation gave rise to the South African Reserve Bank Act being amended accordingly in 1984. The Reserve Bank, however, did not apply this new arrangement until 1992 and, then, only on a limited basis. Apart from considerations of profitability, the central bank did not regard itself as being in competition for deposits with private banks, causing the Reserve Bank to be somewhat reluctant to pay interest on such funds. Moreover, the burden on banks in meeting the minimum reserve requirements had diminished substantially, for the reasons set out below.⁷⁷

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ H. F. Nel, *Minimum reserve requirements*, SOUTH AFRICAN RESERVE BANK ,QUARTERLY BULLETIN, (December2000)*available at* [http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/\\$File/Article1200.pdf](http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/$File/Article1200.pdf), (Last visited on November 26, 2024).

⁷⁶ *Id.*

⁷⁷ *Id.*



Firstly, the minimum reserve requirements of banks had been reduced on more than one occasion since 1963, relieving the burden significantly. *Secondly*, in 1985, banks were granted a concession to include vault cash in their minimum reserve requirement, similarly relieving the burden.⁷⁸

Thirdly, upon the introduction of the new accommodation procedures by the Reserve Bank in 1998, and in an effort to simplify the cash-reserve requirements, a single reserve ratio (2,5 per cent of total liabilities) was announced. The supplementary requirement of 1 per cent of short-term liabilities was abolished in the process, which implied that the Reserve Bank had to do away with the payment of interest on the reserve balances of banks. Banks were, however, compensated partially for the loss of interest that they had earned on part of their cash reserves before the above changes, because the Reserve Bank decided to issue South African Reserve Bank debentures for the management of bank liquidity.⁷⁹ This implied that, instead of, for example, increasing minimum reserve requirements to reduce market liquidity, the Reserve Bank could issue debentures on which banks could earn a market-related interest rate.⁸⁰

The majority of the countries are not paying interest on the reserve balances of banks. The countries that form part of the G7 that do pay interest on these balances, namely, France, Germany, and Italy, fall under the auspices of the European Central Bank (ECB). The ECB takes responsibility for deciding on the reserve requirements of its member countries, as well as on the rate of remuneration, if any. Currently all ECB member countries' reserve balances are fully remunerated, with interest paid at the end of the maintenance period at the repurchase rate of that week. France and Germany did not pay interest on the reserve balances of banks before they joined the European Union (EU).⁸¹

Of the countries listed as "other countries", only Chile, India, Israel and Portugal pay interest on the reserve balances of banks. Portugal pays interest as a result of its membership of the EU (reserve balances were unremunerated prior to Portugal becoming an EU member), whereas Indian banks receive interest payment only on the reserves that they maintain in excess of the statutory minimum of 3 per cent specified by the Banking Regulation Act in India. Indian banks, therefore, earn interest on 5.5 per cent (8,5 per cent less 3 per cent) of⁸² their total reserve balances. The Bank of Israel has been paying a market interest rate on the reserve balances of banks since the middle of 1996, and in Chile, the central bank pays interest on both the local and foreign-currency reserves maintained by banks.⁸³

V. RECENT DEVELOPMENTS

➤ *Recent Developments in CRR*

Reserve Bank of India Governor Raghuram Rajan on Friday cut the percentage of cash reserve ratio (CRR) that banks must maintain with the central bank daily to 95% from 99%, but rejected bankers' contention that maintaining a high

⁷⁸ H. F. Nel, *Minimum reserve requirements*, SOUTH AFRICAN RESERVE BANK ,QUARTERLY BULLETIN, (December2000)*available at* [http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/\\$File/Article1200.pdf](http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/$File/Article1200.pdf), (Last visited on November 26, 2024).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² H. F. Nel, *Minimum reserve requirements*, SOUTH AFRICAN RESERVE BANK ,QUARTERLY BULLETIN, (December2000)*available at* [http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/\\$File/Article1200.pdf](http://www2.resbank.co.za/internet/Publication.nsf/LADV/1D834EB7338AEC9E42256B5100296FA8/$File/Article1200.pdf), (Last visited on November 26, 2024).

⁸³ *Id.*



balance was a major cost for them⁸⁴ "This (maintaining high daily CRR) is made out to be a much bigger hardship than what we have seen through the past data," Rajan said on Friday after announcing the mid-quarter review of monetary policy.⁸⁵

The RBI had in July increased daily cash reserve ratio (CRR)— or, the amount of deposits banks must keep with the central bank — to 99% from 70% as part of its liquidity tightening moves to check volatility in the foreign exchange market. The CRR is currently 4% of a bank's deposits and it's settled in every fortnight.⁸⁶ Rajan said that RBI data showed little impact on banks' fund position due to the increase in daily CRR requirement. "CRR that they maintain is with historic regard based on the number they already know. They were maintaining 102%," he said in a customary media interaction immediately after the policy announcement. He said the cut in daily CRR balance to 95% was in the interest of allowing bankers easier management of funds. Bankers welcomed the move.⁸⁷ "We will enjoy a little elbowroom in fund management with 95% maintenance of CRR," Arun Kaul, chairman and managing director at UCO Bank, said.⁸⁸

➤ *Recent Developments in SLR*

Banks keep SLR high as RBI tightens liquidity:

Even as the Reserve Bank of India (RBI) tries to keep liquidity in check, top public sector banks are sitting on excess government securities — that they hold as statutory liquidity ratio (SLR) — of 3-6%; that's worth around R14,000-85,000 crore. The total SLR in the system is estimated at 30% with State Bank of India (SBI), for instance, having excess SLR of about R80,000 crore. The excess R4 lakh crore, held by the banks as SLR, could fund around a 12th of the current outstanding advances in the banking system.⁸⁹

SLR refers to the amount of liquidity that banks maintain as gilts; currently, this is mandated at 23% of their net demand and time liabilities. While Punjab National Bank (PNB) is maintaining SLR at 29%, SBI and Bank of Baroda's SLR is at 28%. For Bank of India, it is at 26%. "We have a comfortable liquidity situation and it isn't as though demand for loans is very high. If there is a sudden demand, we always have the option to sell our bonds in the market," said a Bank of Baroda executive.⁹⁰

"Having excess SLR does not amount to having liquidity because in such a market, it would not be easy to sell your excess SLR," said BA Prabhakar, CMD of Andhra Bank, which has an SLR of 26%.

Weak demand for credit and the narrowing wedge between credit growth and deposit growth is another reason why some banks may choose to retain their excess SLR holdings until market yields fall to a level where banks can offload their holdings without incurring a loss. For the last four months, credit growth has remained below 15% due to lack of investment pick-up in the economy. For the fortnight ended July 12, non-food credit grew at a lacklustre pace of 14.4% y-o-y to R52,89,695 crore, the central bank said on its website. Meanwhile, deposit growth remained below

⁸⁴ ET Bureau , RBI cuts daily CRR requirement to 95%, THE ECONOMIC TIMES, (21 Sep, 2013).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ The Financial Express, *Banks keep SLR high as RBI tightens liquidity*, Thursday,(November 28,2013),<http://www.financialexpress.com/news/hindustan-copper-limited-share-sale-fully-subscribed-govt-gets-rs-260-cr/1148329>, (Last visited on 28th November 2024).

⁹⁰ *Id.*



14% for the seventh consecutive fortnight. For the fortnight ended July 12, y-o-y deposit growth was at 13.7% to R70,79,861 crore, according to the latest RBI data.⁹¹

VI. CONCLUSIONS AND SUGGESTIONS

➤ Problems of Reserve Computation

The present arrangement for computing the reserve ratio seems to give rise to, quite a few problems, which are apparently beyond the control of the banks. Consequently, the reserve balances reported by banks week after week do not seem to indicate the true position. The problems of reserve computation referred to here emerged from discussion with five important public sector banks.⁹² These five public sector banks have branches numbering about 8000 or about 50 per cent of the total number of branches of all public sector banks at the end of 1975.5 As of the same date, these five public sector banks accounted for 63 per cent of the total demand and time liabilities and 60 per cent of reserves of all public sector banks.⁹³

A major source of difficulties in re-serve computation is the growing size of banks as reflected in the manner of branches opened by them each year. Though many of the banks have, for administrative convenience, regions/ circles or divisions, this is not much of a help as the basic data will have to come from individual branches- spread a over the country. What is more important is the fact that a large number of these branches are located in rural and semi-urban areas which are yet to command an efficient communication system. In 1956, when the system of daily average balance was adopted, the total number of branches of scheduled banks rose to 20,307 by end 1975, i e, almost a seven-fold increase.⁹⁴

Again, the share of rural and semi-urban branches which was about 58 per cent at the end of June 1969 rose to over 66 per cent by the end of 1975.8 The net effect of the substantial increase in the number of branches is the extent of non-reporting of data relating to deposit liabilities and cash balances. The number of non-reporting banks is estimated to range between 10 per cent and 40 per cent in the case of the five public sector banks contacted. Consequently, the circle/regional offices entrusted with the task of obtaining the data cannot help repeating, in respect of non-reporting branches, data which are sometimes as old as 3 to 4 weeks.⁹⁵

Supplementing these physical difficulties is the fact that the reserves data are to be supplied to the Reserve Bank not later than 5 days after the date to which the data relate. As the data on deposit liabilities and cash balances are obtained daily as at the close of business for the day, the details flow in from branches/circles every day till the last crucial day, when the daily average balance is to be struck and decisions regarding making up deficiency or investing surplus cash are to be taken. In reality, therefore, the time available to banks for finalising the returns is not one week as it appears, but just a day or two. Consequently, the banks have to rush through many important decisions on the last day of the banking week. These limitations apart, the two components of the reserve ratio, i.e., deposit liabilities and cash balances, fluctuate daily -rendering calculations over the week more difficult.⁹⁶

⁹¹ *Id.*

⁹² T. K. Velayudham , *Reserve Ratio of Commercial Banks*, 13(49), ECONOMIC AND POLITICAL WEEKLY, 2016, (Dec. 9, 1978).

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Ibid.*

⁹⁶ T. K. Velayudham *Economic and Political Weekly*, Vol. 13, No. 49 (Dec. 9, 1978), pp. 2013-2016



The extent of fluctuation depends on the number as well as the size of items in transit. Cheques for large amounts issued by depositors may show up for payment with a lag and thus affect cash balances particularly if the transfers are between accounts of two different banks. Similarly, the cheques deposited by customers affect the level of deposits and of cash balances of a bank.

The problem gets compounded if the cheques relate to outstations. Unless individual banks evolve a system of monitoring the items in transit,⁹⁷ over-the-week fluctuations in deposits and cash balances are bound to vitiate the reserve ratios. A major source of instability in the deposit accounts is the institutional funds i.e., accounts of institutions like the LIC and the UTI. Withdrawals from these accounts happen to be sudden and sizeable and upset all reserve calculations, if these take place in the latter half of the week. - The maintenance of government accounts with a few scheduled banks seems to have added to the stability of the deposit accounts, as transactions put through these accounts are large and often unanticipated. Where the government accounts are in the nature of withdrawal accounts and not deposit accounts, the bank loses cash (without a corresponding reduction in its deposits) and until it obtains reimbursement, it has to find money for purposes of maintaining the reserve ratio.⁹⁸

The problems encountered by banks in computing the reserves as an average daily balance within the prescribed time limit, have forced many of them to resort to large-scale estimation for purposes reporting the weekly data. In the result, both deposit liabilities and the reserves maintained against these liabilities are no more than estimates for the concerned week.⁹⁹

➤ Implications

The present system of reserve accounting and the difficulties it is beset with, has quite a few implications for policy, for the interbank money market and for the banks generally. These may be considered briefly.¹⁰⁰

The important question that arises is: how reliable are these figures for policy? It is obvious from the preceding section that deposit figures are not entirely actual; more often, they are estimates based on certain assumed growth rates which may not materialise. The reserves figures which are derived by applying the prescribed percentage to the deposits, are also in effect estimates. Further, the daily average balance is not the real average; it can as well be a balance on a single day. Thus, as pointed out earlier, a bank may build up huge balances in the earlier part of the week (when the money market is not tight) and run down the balances towards the close of the week. It is admitted that banks do provide firm figures over a period of 2 to 3 months; but these belated figures are more useful for fixing up the penalty (in cases of shortfall) than for immediate needs of policy.¹⁰¹

The reasons for the change effected in 1956, in the basis of reserve computation have not been made clear anywhere. If the intention behind the change-over were to minimise 'window-dressing' by banks, the present system does not seem to be an improvement over the pre-1956 arrangement. Window-dressing in respect of reserve maintenance, seems to continue as before, though the methods employed may vary from time to time and as between banks. One obvious method of making up the deficiency in the required reserves is to borrow either from the inter-bank money market or from the Reserve Bank, depending upon which of the two sources is relatively cheaper. A method of

⁹⁷ Ibid.

⁹⁸ T. K. Velayudham, *Reserve Ratio of Commercial Banks*, 13(49), ECONOMIC AND POLITICAL WEEKLY, 2016, (Dec. 9, 1978).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*



window-dressing which is not so obvious but which seems to be widely practised by banks is the manipulation of the Statutory Liquidity Ratio (SLR).¹⁰²

This is possible, because, the SLR needs to be maintained only as of Friday, whereas the cash ratio is based on the daily average balance. A bank may build up huge reserve balances in the early part of the week (either out of its own resources or by borrowing from the market when conditions are easy), run down the balances towards the end of the week and invest the funds in Treasury bills which form part of SLR. Similarly, reserves may be maintained at lower than the required level in the early part of the week and the funds may be invested in Treasury bills in order to earn some income. These may be disinvested to fill up the gap in the reserves in the later part of the week. These movements of funds into and out of SLR explain to some extent the sharp variations in the banks' holdings of Treasury bills from week to week.¹⁰³

The implications of the present system of reserve accounting for the inter-bank call-money market may be noted. The need for maintaining re-serves on a weekly basis coupled with the manipulation of SLR and the movement of funds into and out of Treasury bills over the week, force the banks to continuously operate in the call-money market as lenders and borrowers. However, the pressure on the market reaches the peak towards the end of the banking week, when there is a scramble for funds to fill up the gaps in the required reserves and, as a consequence, call-money rates harden. After Friday when the pressure eases, call-money rates tend to move down. This weekly cycle in the call-money market is largely artificial, as the banks operate in the market not on the basis of actual cash position but on the basis of expected surpluses or shortfalls. The question is whether the call-money market would behave the same way as it does now, if the banks were to operate on the basis of more accurate information relating to their deposits and cash balances.¹⁰⁴

Normally, the reliance of banks on the call-money market for reserve purposes is expected to be marginal. However, quite a few banks seem to rely regularly and to a sizeable extent on borrowed funds, for purposes of reserve maintenance.¹⁰⁵ This may reflect partly the difficulties in obtaining accurate information in respect of deposits and cash balances and partly the inadequacies of cash management in banks. This also seems to suggest that banks employ a greater proportion of their own resources more profitably and use borrowed funds for purposes of reserve maintenance. This seems possible because, (a) the required reserves are average daily balances, (b) there is room for shuffling funds between the reserve ratio and SLR-the latter being maintained as of Friday of the week and (c) the rate of interest in the inter-bank call-money market is subject to a ceiling and is, therefore, lower relative to other short-term rates.

➤ Alternative Arrangements

The problems and implications arising from the present system of reserve accounting are important enough to warrant either alternative arrangements or modifications to the present system. Whatever the course of action proposed

¹⁰² T. K. Velayudham, *Reserve Ratio of Commercial Banks*, 13(49), ECONOMIC AND POLITICAL WEEKLY, 2016, (Dec. 9, 1978).

¹⁰³ *Id.*

¹⁰⁴ Himanshu Joshi, *The Interbank Money in India: Evidence on Volatility, Efficacy of Regulatory Initiatives and Implications for Interest Rate Targeting*, 25, (Reserve Bank of India Occasional Papers, Reserve Bank of India, 2004).

¹⁰⁵ Himanshu Joshi, *The Interbank Money in India: Evidence on Volatility, Efficacy of Regulatory Initiatives and Implications for Interest Rate Targeting*, 25, (Reserve Bank of India Occasional Papers, Reserve Bank of India, 2004).



to be followed, it should satisfy two important conditions: the first is that the alternative suggested should be, workable; secondly, it should not diminish the monetary significance of the reserve ratio.¹⁰⁶

Some bankers seem to hold the view that the system of reserve computation obtaining in the USA may be suitable to our situation. This view may be examined briefly. Provision D of the Federal Reserve Regulations" lays down in detail the procedure relating to reserve maintenance. The more important aspect of this procedure which is directly relevant to our analysis, relates to reserve computation. Prior to September 1968 reserves were maintained on a "contemporaneous basis" i.e., on the basis of deposits of the week in which reserve requirements had to be met. This basis was altered in September 1968 to provide for what has come to be known as lagged reserve maintenance. This revised arrangement stipulates that (i) required reserves would be computed from the daily average deposit aggregates through one settlement week (known as reserve computation period) and (ii) this reserve level would become affective two weeks later (known as the reserve maintenance period).¹⁰⁷ In plain terms, reserves are calculated on the basis of average level of deposits prevailing two weeks prior to the week in which the reserves are to be maintained.

The primary motive for introducing lagged reserve accounting seems to be to give banks time to adjust to deposit changes. This is understandable in the US situation, where legally required reserves vary not only as between demand and time deposits but also with the size of deposits. Besides, the number of bank offices to be covered across the country was almost 39,000 as of 1975."¹⁰⁸ A more important reason for the change in favour of lagged reserve accounting is that it provides the Federal Reserve with the advance knowledge of the banking system's aggregate reserve requirement; this knowledge makes it easier for the Federal Reserve to manipulate the banking system's reserves consistent with the needs of short-term monetary policy. The question is whether we should adopt the US system of reserve computation. Such considerations as the growing of bank offices, variability of deposits and cash balances and the physical difficulties in obtaining accurate information may seem to warrant the adoption of such a system.¹⁰⁹

However, there are more important considerations which cannot be lost sight of. First, in our case the reserve ratio is simple and straightforward, unlike in the USA where the ratio varies from bank to bank depending upon the size of deposits and the category of deposits. Our problem, therefore, seems more manageable without any drastic change in the basis of reserve computation. Secondly, the system of lagged reserve maintenance in the USA is more directly related to open market operations, which is an important instrument of short-term monetary policy. In our case, the link between bank reserves and open market operations is very remote or non-existent.¹¹⁰

Open market operations in India are a fiscal operation and not an instrument of monetary policy. Finally, in our case bank reserves have become an important policy variable and are acted upon directly without recourse to open market operations. Given this fact, it is necessary for policy that we have the bank reserve figures on "contemporaneous basis", i.e., on, the basis of current deposit accruals rather than on the basis of past deposits. Otherwise, the risks of high liquidity will increase: because, the basis for computing reserves will be 3 to 4 weeks old by the time reporting is complete, while the current accretion to deposits will be free for use during the period to the extent of 100 per cent.¹¹¹

To sum up, our situation is somewhat, different from that of the USA and the adoption of the lagged reserve accounting may not serve the interests of our monetary policy. In order to make the present system of reserve

¹⁰⁶ Baughn, William HubertStorrs, Thomas I.Walker, Charls E., THE BANKER'S HANDBOOK, (1988)

¹⁰⁷ *Id.*

¹⁰⁸ Dudley G Lockett, MONEY AND BANKING, (1976).

¹⁰⁹ *Id.*

¹¹⁰ O'Bannon (et al), MONEY AND BANKING: THEORY, POLICY AND INSTITUTIONS, (1975).

¹¹¹ *Id.*



accounting more realistic and operationally more meaningful two alternatives are suggested in this paper. The first is to exclude altogether the deposits of bank offices in rural areas, for purposes of reserve computation; that is, the reserve ratio may be calculated only in respect of deposits of bank offices in semi-urban, urban and metropolitan areas. As at the end of 1975, bank offices in rural areas accounted for 37 per cent of the total number of bank offices and about 9 per cent (Rs 1168 Crores) of the total deposits of scheduled commercial banks.¹¹² Thus, while a large proportion of the "problem offices" is excluded, the amount of deposits and of reserves omitted from calculations, would be around Rs 1200 Crores (or about 10 per cent) and about Rs 72 Crores (6 per cent) respectively. In fact, viewed in relation to the total balances maintained with the Reserve Bank, the quantum of reserves omitted would not be more than 5 per cent on the average. The suggestion made here will make available more reliable data in time, as only important offices will have to furnish the information. The banks may, however, file periodic returns, say once in a quarter, in respect of the omitted bank offices, so that the trends in the deposits and cash balances of these offices may be watched.¹¹³

The second alternative is to retain the present system of reserve accounting and to permit surpluses or shortfalls (without penalty) in the required reserve balances to be maintained by banks. The extent of surplus or shortfall should not exceed 10 per cent of the required reserve balances. Besides, these surpluses or shortfalls should be allowed to be carried over to the next reserve accounting period. The provision for carry-over¹¹⁴ of surpluses or deficits in the required reserve balances would enable the banks to manage their cash position carefully and without much disturbance either in their portfolio or in the call-money market. A surplus in the reserve balance may enable a bank to overcome any strain on its cash position in the next period; a deficit, on the other hand, would automatically prevent a bank from continuing the shortfall; because, carry-over of the shortfall implies that the quantum in reserve balance to be maintained in the next period would have to be correspondingly greater. On the basis of the average level of reserve balances maintained with the Reserve Bank during January 1977-March 1978 (Rs 1354 crores), a 10 per cent shortfall would mean a gap of Rs 135 crores; at the peak level of Rs 2023 crores of reserve balances on April 28, 1978, the shortfall would work out to about Rs 200 crores.¹⁸ The amount of shortfall would in itself be a fluctuating quantity, subject to the floor of 10 per cent. Of the two alternatives suggested here, the latter, i.e., the provision for shortfall coupled with carry-over facility, seems preferable; because, it is simple and straightforward and easy to operate; it would make the present reserve accounting system flexible from the point of view of banks, without reducing the importance of reserve ratio for policy. It would also tone up the call-money market by minimising the pressures which develop towards the close of each banking week.¹¹⁵

Within the framework of the suggested modifications to the present reserve accounting system, the banks should develop more efficient ways of monitoring the data relating to deposits, cash balances and large value items in transit. Simultaneously, the Reserve Bank should take steps to change the basis of maintaining the SLR so that there is no scope for banks to shuffle funds between the SLR and the reserve ratio. Probably, banks may be required to report SLR data on the same basis as reserves data. A general suggestion which may be made in conclusion is that those provisions of "the Reserve Bank of India Act and of the Banking Regulation Act, which may not fit in with the developments in Indian banking since nationalisation in 1969, may be re-examined and amended appropriately."¹¹⁶

¹¹² Reserve Bank of India, *Report on Currency and Finance*, (1976-77), (Last visited on November 26, 2024).

¹¹³ *Id.*

¹¹⁴ The provision for carry-over is one of the features of the US system of lagged reserve accounting.

¹¹⁵ Reserve Bank of India, *Report on Currency and Finance*, (1976-77), (Last visited on November 26, 2024).

¹¹⁶ *Id.*



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