Question Paper

Central Banking and Commercial Banking (MB3G2B): January 2009

Section A : Basic Concepts (30 Marks)

- This section consists of questions with serial number 1 - 30.
- Answer all questions.
- Each question carries one mark.
- Maximum time for answering Section A is 30 Minutes.

1. Credit administration is a critical element in maintaining the safety and soundness of a bank. Which of the following is **not** included in the credit administration process? <Answer>

(a) Keeping the credit file up to date
(b) Obtaining current financial information
(c) Establishing a sound credit granting process
(d) Sending out renewal notices
(e) Preparation of various documents.

2. RBI faces very challenging task in managing the Government's public debt. Which of the following institution(s) incur/s the public debt? <Answer>

I. Local Bodies.
II. Central Government.
III. State Government.

(a) Only (I) above
(b) Only (II)above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

3. When the economy is hit by supply shocks, in which of the following ways the Central Bank responds? <Answer>

I. Allows temporary rise in inflation.
II. Monetary policy will be restrictive.
III. Provides stability of output.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (I) and (III) above
(e) All (I), (II) and (III) above.

4. Towards providing greater operational transparency, which central bank regularly publishes future interest rate paths? <Answer>

(a) The Bank of Norway
(b) Bank of Japan
(c) Swiss National Bank
(d) Australian Central Bank
(e) Bank of Canada.

5. As per RBI guidelines on the loan system for delivery of bank credit borrowal accounts are classified as <Answer>

I. 'Standard'.
II. 'Sub-standard'.
III. 'Doubtful'.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

6. Which of the following arrangements has a very strong commitment to the exchange rate peg? <Answer>

(a) Currency boards
(b) Gold reserve system
(c) Minimum reserve system
(d) Free banking system
(e) Gold standard system.

7. Which loan facility gives the borrower money on the same day under various types of syndicated loan facilities? <Answer>

(a) Swingline facility
(b) Short-Term Commercial loan
(c) Revolving credit
(d) Evergreen facility
(e) Term loan.

8. In any syndicated loan agreement, the borrower has to pay various types of fees to the banks. The fee a borrower has to pay when the drawn portion exceeds 50% is called <Answer>

(a) Commitment fee
(b) Arrangement fee
(c) Utilization fee
(d) Agency fee
(e) Underwriting fee.

9. Which one of the following committees was set up in 1991 to examine the structure, organization, functions and procedures of the Indian financial system? <Answer>

(a) Padmanabhan committee
(b) Narasimham committee
(c) Kumaramangalam Birla committee
(d) Malhotra committee
(e) L.C.Gupta committee.

10. To protect the health of banks RBI came out with certain important measures in the form of Prudential Norms. Which of the following is/are **not** a/the guideline(s) on prudential norms? <Answer>

I. Income Recognition.
II. Asset –Liability management.
III. Provisioning for Bad and Doubtful Debts.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (I) and (III) above
(e) All (I), (II) and (III) above.

11. Which of the following statements is **true** with regard to supervision of banks in UK? <Answer>

(a) Bank of England does the supervision of banks in UK
(b) Off-site work is done by reporting accountants
(c) The supervision of banks in UK is mostly on-site
(d) Supervision of financial system is done by the Financial Services Authority(FSA)
(e) HM treasury does the supervision of banks in UK.

12. Loan approval process is the first step towards quality portfolio. The loan approval process should be compatible with <Answer>

I. The bank's credit culture.
II. Its risk profile.
III. The capabilities of its lenders.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

13. In which country the Prime Rate pricing based on the risk level is charged by banks from its borrowers? <Answer>

(a) Russia
(b) USA
(c) Canada
(d) Japan
(e) Germany.

14. A global market dynamics underline the need to have a right payment and settlement mechanism. In which of the following area(s) such need is/are keenly felt? <Answer>

I. Currency exchanges.
II. Trade in goods and services.
III. Currency trade by itself.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) All (I), (II) and (III) above.

15. BIS as an international organization, governed by international law was setup by <Answer>

(a) The Hague agreement
(b) EU Treaty
(c) Maastricht criteria
(d) League of Nations
(e) European Monetary institute.

16. During the late nineties, to improve Customer Relationship Management, which of the following service(s) was/were introduced by banks <Answer>

I. Online banking.
II. Voice Response Unit (VRU).
III. Consultation services.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

17. Which of the following is **not** the characteristics of a good collateral? <Answer>

(a) Durability
(b) Marketability
(c) Mobility
(d) Identification
(e) Stability of value.

18. Which of the following institution(s) can use the information provided by the CIBIL? <Answer>

I. NBFCs.
II. Housing Finance Companies.
III. Credit card companies.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above.

19. Loans are generally classified into secured and unsecured loans. Which of the following advance given by a bank is **not** classified as unsecured advance? <Answer>

I. An advance with the personal security of any individual.
II. An advance covered by bank/government guarantee.
III. An advance to a borrower with or without a guarantor.

(a) Only (I) above
(b) Only (II) above
(c) Both (I) and (II) above
(d) Both (I) and (III) above
(e) All (I), (II) and (III) above.

20. Under Non-Installment loans, individual borrowing needs are temporary. Which of the following is the characteristic of a non-installment loan? <Answer>

(a) Periodic payment of principal
(b) A single principal payment/and interest
(c) Periodic payment of interest
(d) Borrowed to cover extraordinary expenses
(e) Maturity ranges from two to five years.

21. In which of the following countries, as a key component of accountability, the Governor is required to appear before a parliamentary committee after the semi-annual Monetary Policy Report is released? <Answer>

(a) United States
(b) Australia
(c) Canada
(d) U.K.
(e) Japan.

22. Which of the following institutions has the power to regulate the overseas activities of the member banks? <Answer>

(a) Board of Governors
(b) Advisory Committee
(c) Federal Reserve Board
(d) Federal Advisory Council
(e) Federal Open Market Committee.

23. Mahila bank Limited has accepted a deposit of Rs.3,00,000 for a period of 2 years at the interest rate of 11% under quarterly compounding scheme? What is the maturity value of the deposit? <Answer>

(a) Rs.3,72,690
(b) Rs.3,71,640
(c) Rs.3,73,800
(d) Rs.3,69,630
(e) Rs.3,70,730.

24. What was the original structure of the RBI when it was first setup? <Answer>

(a) Government company
(b) Public limited bank
(c) Statutory company
(d) Private shareholders bank
(e) Chartered company under royal charter.

25. What is the instrument that is issued for automatic monetization of debt? <Answer>

(a) 182 days Treasury Bill
(b) Corporate deposit
(c) Ways and Means Advance
(d) Commercial paper
(e) Adhoc Treasury bill.

26. In loan syndication, the bank that heads the pact is known as <Answer>

(a) Lead Manager
(b) Participating bank
(c) The arranger
(d) The Agent
(e) Facility manager.

27. Which of the following terms provides the best description of the central bank's function to lend to the commercial banks during exigencies? <Answer>

(a) Financial guarantor
(b) Lender in due course
(c) Principal lender
(d) Lender of Last Resort
(e) Banker to the bank.

28. One of the alternatives given below **does not** represent a part of Financial Market Operations of the Bank of England. Identify. <Answer>

(a) Capital markets
(b) Banking services
(c) Foreign Exchange
(d) Gilt-edged and Money Markets
(e) Risk Analysis and Monitoring.

29. Which one of the following functions is **not** performed by the RBI in its role as the banker to the government? <Answer>

(a) Management of new issues of government loans
(b) Management of public debt
(c) Setting up of new financial institutions
(d) Advice on the timing of the issue of instruments
(e) Advise on the quantum of issue of the instruments.

30. Identify the income item which is accounted by RBI on receipt basis? <Answer>

(a) Dividend
(b) Exchange
(c) Discount
(d) The interest earnings
(e) Commission.

END OF SECTION A

Central Banking and Commercial Banking (MB3G2B): January 2009

Section B : Caselets/Problem (50 Marks)

- This section consists of questions with serial number 1 – 8.
- Answer all questions.
- Marks are indicated against each question.
- Detailed explanations/working should form part of your answer.
- Do not spend more than 110 - 120 minutes on Section B.

Caselet 1

Read the caselet carefully and answer the following questions:

1. Why are banks special? **(6 marks)** <Answer>
2. Can regulations take care of all risks? **(6 marks)** <Answer>

There has been significant debate on whether banks are special and should be treated as such. The rapid development of capital markets, increasing importance of non-bank sources of financial intermediation and the emergence of universal banking have led to the erosion of importance as well as uniqueness of banks as financial institutions. Banks particularly those with access to payments system are generally treated as a separate class in a regulatory framework, particularly in developing countries. In India, all banks are subject to the RBJ's regulation but the framework is not uniform in the sense that public sector banks, cooperative banks, and private banks are governed by significant differences and not all of them have access to the payments system. The Reserve Bank is a regulator of banks but is also the dominant owner of the largest commercial bank. Such close links were considered essential for effective coordination in financial sector as part of the early endeavors of planned development and the channelization of credit.

Regulation is often perceived to be a free good, available at no cost, but it is not so. There are costs of administering regulation; of compliance; and there are also structural costs. Excessive or inappropriate regulation can stifle efficiency, and invite problems of what are known as moral hazard and adverse selection. It may even provide incentives for the over-regulated business overtly or covertly, depending on the nature of the business, to move to entities that are not so regulated. Moreover, there are savers who are willing to have a portfolio with different degrees of risk and return and correspondingly there are investment avenues. An efficient regulatory policy providing avenues for a spectrum of risks and rewards makes it clear that regulation by itself does not guarantee risk-free transaction and ensures that overall benefits to the system are commensurate with the overall costs incurred. All failures of a regulated unit do not represent failure of regulation and a regulator cannot guarantee compensation for those affected by failures other than those covered by deposit insurance. But, a regulator has to maintain the credibility in terms of assurance of systemic stability and consumer protection, especially in terms of information availability in a timely and transparent manner particularly to retail customers. Public policy arrangements should never eliminate the incentive for consumers of financial services to exercise due care.

END OF CASELET 1

Caselet 2

Read the caselet carefully and answer the following questions:

3. Why are Central Banks vital for any economy? **(6 marks)** <Answer>
4. What can Central Banks do to achieve growth by keeping inflation stable through macro policies? **(6 marks)** <Answer>

In recent years, in New Zealand as in many other countries, the public have come to believe that Central Banks can achieve much more than they can; in fact, they can really deliver. There is a serious risk that, when the realization dawns that the power of Central Banks is not in fact unlimited, or when economies which have been performing extremely well in recent years go through a period of slower growth, Central Banks will receive far more than their fair share of blame. Indeed, there are already signs of this blame and anger emerging in the United States for much of the last decade, Alan Greenspan was widely assumed to be able to walk on water. Now there are angry accusations from many quarters that imply that he should have been able to keep the US economy growing above its trend potential indefinitely, and prices in the US share-market growing with it.

Today, focus is on the responsibility the Central Banks have for keeping the value of money stable, for keeping inflation low, rather than on their responsibility for the financial system. The question now is to what extent the Central Banks make a contribution to economic growth and social justice by keeping the value of money stable.

Nobody seriously doubts that both hyperinflation and significant deflation can do real damage to economic growth, and that by avoiding both, Central Banks can make a considerable contribution. But what about the contribution to growth from keeping inflation in low single figures, as compared to the double-digit inflation which endured during much of the '70s and '80s.

Perhaps inevitably, this is still a matter of ongoing debate among economists.

Some claim that the contribution is negligible because beyond avoiding the catastrophies of hyperinflation and significant deflation, the contribution which inflation control makes to economic growth is very small. Others see a rather larger contribution, through the fact that the pricing system works more efficiently to allocate resources when prices are on an average stable; for example, through the avoidance of the distortions caused by the interaction of inflation and a tax system based on the assumption that prices are stable.

To see this latter point vividly the distortions caused by the interaction of even quite modest levels of inflation with a tax system designed on the assumption that prices are stable as being particularly relevant to the way in which keeping inflation under tight control can assist economic growth. It is hard to escape the conclusion that one of the reasons for New Zealanders' relatively heavy investment in property assets, and relatively low investment in financial assets in recent decades is related to the fact that, under the present tax regime, inflation results in an “under-taxation” of property investment and an “over-taxation” of financial assets. And if, as many believe, an increase in the government's share of GDP is associated with lower economic growth, this is another way in which inflation damages growth.

In many ways, keeping the value of money broadly stable makes a bigger contribution to social justice than it does to economic growth. When money is not stable, in other words, there is inflation or deflation, the value of financial assets and liabilities changes in potentially major and unexpected ways.

Therefore. Central Banks can probably make some modest contribution to trend growth through keeping inflation low and stable, and can help avoid the social injustices often caused by unstable money.

In seeking to keep inflation low and stable. Central Banks may also have a tendency to smoothen the economic cycle. It is now well understood that one of the more important determinants of changes in the inflation rate is the extent to which actual output diverges from potential output. When actual output falls short of what the economy could produce without difficulty where, in other words, resources of capital and labor are underutilized there is a tendency for inflation to fall. Conversely, when the economy is straining to produce more than it can on a sustainable basis, when capital is being used round-the-clock and the labor market is tight, there is a tendency for inflation to rise. For this reason, all Central Banks, even those with no formal mandate to be concerned about output or employment, have to watch carefully about what is happening to keep inflation under control. Indeed, once inflation has been brought down to a low-level, it is not much of an exaggeration to say that keeping inflation low and stable is mainly about trying to keep actual output tracking close to potential. Reducing economic and social dislocation caused by booms and busts is a useful contribution which Central Banks can make.

END OF CASELET 2

Caselet 3

Read the caselet carefully and answer the following questions:

5. How do the banks, seeking to reduce their exposure to corporate credits, view credit derivatives as compared to the traditional securitization? **(3 marks)** <Answer>

6. What are the motivations for banks the world over to use credit derivatives as a synthetic investment tool? **(4 marks)** <Answer>

7. What according to you does the future hold for credit derivatives? **(8 marks)** <Answer>

It was the new international rules of Basel Accord, 1988 that brought credit derivatives into existence. The Basel norms required banks to set aside some part of their capital against their loans. Banks seeking to reduce their exposure and related risk-based capital requirements to corporate credits have found credit derivatives to be more efficient than traditional securitizations. A credit derivative is a financial instrument used to mitigate or to assume specific forms of credit risk by hedgers and speculators. They are particularly useful for institutions with widespread credit exposures. It has the potential to herald a new form of international banking in which banks resemble portfolios of globally diversified credit risk more than purely domestic lenders. Today credit derivatives represent one of the fastest growing businesses in banking.

In any financial transaction the two primary types of risks faced by firms are market risk and credit risk. When the changes of interest rates, exchange rates, stock prices or commodity prices affect the firm's value it is market risk. However, when the firm fails to meet obligated payments of counter parties on time it is credit risk. The degree of risk is reflected in the borrower's credit rating, which defines the premium over the riskless borrowing rate it pays for funds and ultimately the market price of its debt.

Credit risk has two variables; market risk and firm-specific risk. Credit derivatives allow users to isolate, price and trade firm-specific credit risk unbundling a debt instrument or a basket of instrument into its component parts and transferring each risk to those best suited or most interested in managing it. Generally, firms enter into offsetting or hedging transactions to manage market risk. However, managing firm-specific risk is not that easy. Though banks and other financial institutions have dealt with credit risk for decades, the methodology used in the past was neither very sophisticated nor well suited to meet the needs of the present changed world. Today the financial markets deal with highly leveraged derivative transactions, often involving a multiplicity of parties determined by a large number of market variables. It was only when the over-the-counter derivatives activity accelerated the-importance of efficient management of credit risk was realized.

But how does the institutions measure credit exposure? There is no particular method to measure credit exposure. Different institutions measure credit exposure differently. However, a typical way to incorporate a short-dated total return swap on a long-dated note or bond into computation of credit exposure is to add it to the portfolio of deals with the relevant counterpart or credit name. Afterwards the credit VaR model, or any other relevant model may be run to verify the change in exposure.

Once the measurement part is complete, methods need to be designed to control it. Typical methods of controlling credit risk include, limiting the amount of business a party does with another party, requiring minimum counter party credit ratings, such as a triple-A from both Moody and S&P, periodically marking contracts to market, using collaterals and for some dealer firms the establishment of separately capitalized derivatives subsidiaries. There are also various traditional mechanisms to reduce credit risk including refusal to make a loan, insurance products, guarantees and letter of credit. However, these instruments are less effective during periods of economic downturn when risks that normally offset each other simultaneously default and financial institutions suffer substantial losses on their loans.

In recent years, credit derivatives have evolved as major risk management tools. Though the market was once confined only to banks, market participants have expanded to include insurance companies, hedge funds, mutual funds, pension funds, corporate treasuries and other investors looking for yield enhancement or credit risk transference.

This new innovation in the credit risk management appeared on the scene in the early 1990s. It was the launch of a new instrument to segregate market risk from credit risk and to allow the separate trading of credit risk called credit derivatives. There are four primary types of credit derivatives each addressing in some manner though not perfectly, the problem of segregating market risk from credit risk. The ultimate beneficiaries are those who borrow and lend and interact in the credit market and those who transact in derivatives that are subject to default.

The traditional methods of assessing credit risk have been more judgmental. They used to focus more on qualitative aspects with a modest degree of analysis. This is probably the first wave of credit risk analysis. The second wave made a distinguished analysis of financial statements and utilized credit-scoring models. These procedures incorporate quantitative measures of a borrower's financial position into a statistical model that assigned a score, called a z-score, to the borrower. Based on historical statistics, a z-score beyond a certain threshold was considered indicative of a high probability of default. The third wave of analysis is based on option pricing theory. It reflects the fact that default is an option. When a party repays a debt, the option expires in the money. However, when it defaults, the option expires out-of-the-money. All said and done, it is very difficult to go from theory to practice in the matter of credit risk.

END OF CASELET 3

<Answer>

8. Coastal Financial Institution Ltd., has been offering banking and investment services for the past 3 decades. It has a branch network of over 300. The working funds of CFI at the end of 2007-2008 are Rs. 1,400 crore. The average cash balances are maintained at 0.5% of the total working funds. Further, the management has decided that to ensure proper liquidity, the acceptance range for variance can be up to 6%.

With this data compute the following:

a. The average cash balance to be maintained and the acceptance range; **(2 marks)**

b. The average cash balance and the acceptance range, if the working funds have increased to Rs.2,200 crore. **(4 marks)**

c. If the average working funds register a decline to Rs.2,000 crore from Rs.2,200 crore due to circumstances beyond their control. **(5 marks)**

END OF SECTION B

Section C : Applied Theory (20 Marks)

- This section consists of questions with serial number 9 - 10.
- Answer all questions.
- Marks are indicated against each question.
- Do not spend more than 25 -30 minutes on Section C.

9. Advances cover all types of lending and must satisfy the bank's need for security and its wish to have the money repaid on the due date. What are the different types of advances offered by banks? <Answer>

(10 marks)

10. The Reserve Bank of India performs the role of setting up new institutions from time to time to attain the objective of equitable growth. The setting up of IDBI, NABARD, etc., are some examples in this regard. Explain the promotional role of the RBI in this regard. <Answer>

(10 marks)

END OF SECTION C

END OF QUESTION PAPER

Suggested Answers
Central Banking and Commercial Banking (MB3G2B): January 2009

Section A : Basic Concepts

	Answer	Reason	
1.	C	Credit administration includes all except option (c).Credit risk models are developed to help in measuring credit risk.	< TOP >
2.	E	RBI faces a very challenging task in managing the government's public debt. Public debt is the sum of the debt incurred by the Central government, State government and local bodies such as municipalities.	< TOP >
3.	A	When the economy is hit by supply shock, central banks respond by allowing a temporary rise in inflation to off set the decline in out put. If the economy is looking up the ideal monetary policy will be restrictive.	< TOP >
4.	A	The Bank Of Norway Regularly Publishes Future Interest Rate Paths.	< TOP >
5.	C	The loan system would be applicable only to borrowal accounts classified as Standard and Sub-standard Assets.	< TOP >
6.	A	The currency board arrangement is the example of fixed rate regime, wherein there is a very strong commitment to the exchange rate peg. The system of currency boards had succeeded well in small countries.	< TOP >
7.	A	Under swingline facility the borrower gets the money the same day.	< TOP >
8.	C	Utilization fee should be paid by the borrower when the drawn portion exceeds 50%.This is a compensation (fees) in a typical syndication.	< TOP >
9.	B	. The government had set up a high level committee in August 1991, under the chairmanship of shri M.Narasimham to examine all aspects relating to structure, organization, functions and procedures of the Indian financial system .L.C.Gupta committee on derivatives and Birla committee on corporate governance.	< TOP >
10.	B	.Asset liability management is related to liquidity management .Income recognition and provisioning for bad and doubtful debts relate to prudential norms.	< TOP >
11.	D	The Financial Services Authority carries out integrated supervision of financial system. The FSA system of bank supervision is essentially off-site with most of the on-site work being done by staff.	< TOP >
12.	E	The loan approval process is the first step towards good portfolio quality. The process should be compatible with the bank's credit culture, its risk profile and the capabilities of its lenders.	< TOP >
13.	B	Prime rate can be defined as a bench mark rate that a bank charges from its borrowers based on the risk level .LIBOR used in the UK markets and the prime rate in the USA markets are the examples of prime rate based pricing.	< TOP >
14.	E	In a global market, the dynamics of currency exchanges, trade in goods and services and currency trade by itself underline the need to have a right payment and settlement mechanism.	< TOP >
15.	A	Hague Agreement established BIS as an international organization governed by international law. The BIS was given the legal structure of a limited company.	< TOP >
16.	E	To add both value to their services and to satisfy their customers banks started selling on line services. Most banks focused upon reengineering the existing and introduced newer customer services like VRU and consultation services.	< TOP >
17.	C	Mobility is not a good characteristic of a good collateral. All others are good characteristic of a collateral.	< TOP >
18.	E	The main users of CIBIL are banks , Financial Institutions, NBFCs, Housing Finance Companies and credit card companies etc.	< TOP >

19.	B	If an advance given by the bank has personal security of any individual or the borrower with or with out guarantor it will be classified as unsecured advance. However advances with bank/government will be classified as secured advances.	< TOP >
20.	B	Non installment loan requires a single principal and interest payment. All others relate to installment credit loans.	< TOP >
21.	C	It has simply become a defacto standard, like in Canada, where the Governor is required to appear before a parliamentary committee after the Monetary policy Report is released.	< TOP >
22.	C	The Federal Reserve Board has broad discretionary powers to regulate the overseas activities of member banks and bank holding companies so that ,in financing US trade and investments overseas, US banks can be highly competitive against institutions.	< TOP >
23.	A	Maturity Value = PV × $\left(1+\frac{r}{m}\right)^{m\times n}$ Maturity Value = PV × $\left(1+\frac{0.11}{4}\right)^{8}$ Maturity Value = 300000 ×1.2423 = Rs.3,72,690.	< TOP >
24.	D	It was initially set up as a private share holders bank. RBI was nationalized on Jan 1, 1949.	< TOP >
25.	E	The process of automatic monetization of debt is in vogue through adhoc treasury bill system.	< TOP >
26.	A	The bank that heads the pact in loan syndication is called the Lead banker.	< TOP >
27.	D	During the times of financial crunch banks turn to the RBI for help. RBI sets aside certain amount of reserves for this purpose. It plays the role of LOR (Lender of Last Resort.)	< TOP >
28.	A	Financial Market Operations area includes all except capital markets.	< TOP >
29.	C	Setting up of new financial institutions is the promotional role of RBI. As a banker to government it RBI manages all other functions.	< TOP >
30.	A	Dividend is the only item that is accounted by RBI on receipt basis.	< TOP >

Central Banking and Commercial Banking (MB3G2B): January 2009

Section B : Caselets/Problem

1. Banks are special, first, they are participants in the payments system and hence are the backbone of the financial system. The-systemic risks of any one bank being affected either on account of its banking operations or on account of non-banking operations are high. Second, the banks contract for liquid deposits to acquire illiquid assets and hence are vulnerable to liquidity crisis. This would underline the need for a lender of last resort. Third, the banks are the major service providers for retail customers and are, therefore, on a separate footing in terms of consumer protection, especially since the customers of a bank are typically risk-averse. In other words, while retaining incentive for banks to be always solvent, there is constructive ambiguity in extending liquidity by lender of last resort. < TOP >

2. Regulation policy should recognize and admit that the fact of regulation does not guarantee that there will be no risk of failure or insolvency of a regulated unit. In fact, a zero failure system is likely to be sub optimal. There is always a danger that people perceive that mere act of an entity being regulated provides a guarantee from the regulator that it is risk-free to transact business with the unit. The risks arise due to several problems, mainly related to lack of information. First, it is difficult to precisely assess even for the regulator that how good the internal controls in a regulated entity are on an ongoing basis. Frauds that occur in connivance with the management of the bank are even more difficult to detect if they occur between two inspections, as the off-site surveillance may not throw up this information. Second, there is no way of perfect and continuous assessment of adherence to the external rules imposed by the regulator. Third, even under most prudent circumstances, there is a residual risk. < TOP >

3. In all developed countries and most developing countries, the Central Bank is charged with promoting stable money and a stable financial system. And these are extremely important goals. To see just how important, it is worth reflecting on the economic and human cost incurred by many countries when Central Banks got policy wrong and contributed to the strong deflation of the thirties, or reflecting on the economic and human cost incurred by those countries which experienced hyperinflation at some stage during the last century or reflecting on the economic and human cost incurred by those countries, including many in our own region, which experienced severe banking sector crises in recent years. When Central Banks get it wrong, when they allow the value of the money which they issue to fluctuate substantially, as in the case of serious deflation or high inflation, or when they allow banking systems to become unstable, the damage which can be done is enormous. Savings can be destroyed as also businesses and jobs. < TOP >

   So, not to understate the importance of the role which Central Banks can play. When central banking is done well, it not only avoids those catastrophic results which have been seen around the globe from time to time, but also makes some positive contribution to economic growth, to social justice, and perhaps even to the integrity of society itself.

4. There is nothing fair, just, or even honest in a monetary system which steals people's savings, or rewards those lucky enough to go heavily into debt at the right time. There can be little doubt that some of those who today are wealthy became wealthy as much through having the real value of their borrowings evaporate before their eyes as through their own efforts and initiative. And this sends absolutely the wrong message to everyone making saving, spending and investment decisions. < TOP >

   Because in most societies interest rates are used as a way to try to compensate savers for the erosion of the principal value of their savings through inflation, there is an additional problem which often makes it particularly difficult for those with low incomes or few other assets to borrow at a time of high inflation. The problem arises from the fact that, when inflation is high and nominal interest rates are similarly high, the cash-flow problem of servicing a loan is quite difficult in the first few years of the loan, but very easy in the last few years of the loan. Putting it in another way, using interest rates to compensate savers for the effects of inflation on their savings has the effect of front-loading the real burden of debt service. This may effectively deny those on low incomes any access to borrowing facilities in times of high inflation, even though the real interest rate on the loan is at a moderate level.

5. The latest trend among banks in Europe is to look at securitization and credit derivates not as alternatives but as complementary. An increasing number of European bank Collateral Loan < TOP >

Obligation/Co I lateral Bond Obligation transactions are now coming by way of synthetic securitizations, which is a combination of securitization and credit derivatives. As a matter of fact, credit derivatives have helped securitization to get into its new avtar: a device of risk transfer and not merely a device of funding. Synthetic securitizations were developed only in 1997, but in a short period of time, they have become extremely popular. In some markets, for example - Germany, the growth in synthetic securitization is far faster than that in traditional securitizations.

6. From the point of view of the investing bank, there are two clear motives. One, there is an issue of risk diversification. A banker selling protection under a default swap or a total return swap is indirectly exposing oneself in the portfolio created by someone else, and benefiting from the returns thereof. < TOP >

Two, many investors also look at credit linked notes as a yield kicker. Credit linked notes have carried impressive spreads. They enable banks to convert a 100% risk weighted asset into a lower risk asset, thereby giving a substantial boost to capital adequacy.

7. The future of credit derivatives seems to be very rosy. Everybody in the business is busy predicting how credit derivatives will change the face of finance in the coming years. Global credit markets still display discrepancies in the pricing of the same credit risk across different asset classes, maturities, rating cohorts, time zones, currencies and so on. These discrepancies persist because arbitrageurs have traditionally been unable to purchase cheap obligations against expensive ones in order to extract arbitrage profits. < TOP >

Over the years, as credit derivative liquidity position improves, players in the credit derivatives market will definitely exploit such opportunities, just as the evolution of interest rate derivatives prompted arbitrage activity in the 1980s. This will lead to the gradual disappearance of the credit pricing discrepancies thereby making the market more mature and efficient. Though the credit derivatives market is still at a nascent stage, it will continue to grow exponentially for the foreseeable future, driven by a knowledgeable user base, an accommodating regulatory environment and, most important a compelling cache of investment, corporate finance and risk management applications. With the improvement in technology, brilliant research works in various financial institutions and the accumulation of significant body of knowledge on credit experience and analysis, credit derivatives are at the threshold of becoming an inevitable tool of risk management.

8. a. < TOP >

Average cash balance = 1400 × 0.005 = 7 crore

Acceptance range = 7 ± (7 ×0.04)

Acceptance range = 7 ± (0.28) = Rs.6.72 crore to Rs.7.28 crore

Thus, the cash balances of MMFI can lie between Rs.6.72 crore to Rs.7.28 crore.

b. Average cash balance with increased working funds = 2200 × 0.005 = 11 crore

Acceptance range = 11± (11× 0.04) = Rs.10.56 crore to Rs.11.44 crore

Thus, if the working funds of bank are increased to Rs.2,200 the range for maintaining cash balances will be Rs.10.56 crore to Rs.11.44 crore.

c. If the working funds decline to Rs.2,000 crore from Rs.2,200 crore,

Average cash balance with decreased working funds = 2000 × 0.005 = Rs.10 crore

Acceptance range = 10 ± (10 × 0.04) = Rs.9.60 crore to Rs.10.40 crore

Thus, if the working funds of bank decrease to Rs.2,000 crore the range for maintaining cash balances will be Rs.9.60 crore to Rs.10.40 crore.

Section C: Applied Theory

9. Types of Advances < TOP >

Loans are generally classified into secured or unsecured loans. Their features are discussed below:

Unsecured Advances: When the advance given by the bank has a personal security of any individual or the borrower with or without a guarantor, it will be classified as an unsecured advance. In the absence of any tangible security, though personal security is given by an individual by way of an obligation for repayment, the loans are treated as unsecured.

However, all those loans that have the guarantee of a bank/government are categorized as "Advances covered by Bank/Government Guarantees" and hence are not reported under unsecured loans category. An unsecured loan is also a loan without any collateral being offered as security. Two examples of unsecured loans are, a Letter of Credit (LOC) and Signature Loans. If the borrower defaults on an unsecured loan, the creditor has no priority claim against any particular property of the borrower. The creditor can try to obtain just a money judgment against the borrower. Until a small business has an established credit history, it cannot usually get unsecured loans because of the business's risk.

Secured Advances: Secured advances on the other hand, have impersonal security, i.e., the security has to be a tangible asset against which the loan is to be granted. Primary security is an asset against which the loan is given and collateral security is a security, which is given in addition to the existing primary security. These primary and collateral securities can be movable or immovable assets and depending on the same the charge created on the security may vary. Because the value of pledged collateral is critical to a secured lender, loan conditions and covenants, such as insurance coverage, are always required of a borrower.

Charge on the movable properties can be created in the following five different ways:

- Pledge
- Hypothecation
- Assignment
- Banker's Lien
- Set-off.

10. A Central Bank in any developing economy will have a major role to play in the development of the country's financial market place. The need for such promotional role for the Central Bank arises because: < TOP >

- In a developing economy, it has to be ensured that there is a proper credit allocation - among the various sectors of the economy.
- The imperfections present in the various financial markets will have to be removed, which in turn requires the development of the market place and the market players.

Likewise, the Reserve Bank of India also has a major role to play in the development of the Indian Financial System. It acts as the promoter of financial institutions in the country and expects its policies to be effective in promoting economic growth as per the guidelines and policies formulated by the government. When the RBI was incorporated, India lacked a well developed Commercial Banking System and a money market. After its nationalization, the RBI took steps to promote and develop financial institutions in line with its objective of pursuing appropriate credit and monetary policies for economic growth and development. Its efforts culminated in the emergence of an impressive network of financial institutions both in the public and cooperative sectors. With the help of branch networking, banking could reach out to hitherto unbanked areas, thereby mobilizing the untapped savings. The RBI played a key role in the establishment of various financial institutions like the IDBI, NABARD, NHB, EXIM Bank, UTI etc., set-up to serve different sectors. Incidentally, development could also be witnessed in the other financial markets viz., the capital market, the foreign exchange market and the money market. This promotional role of the RBI is a continuous process. It serves to encourage and conduct various research activities, which aid to enhance the operational efficiency of the economy.

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