ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ, ସମ୍ବଲପୁର, ଓଡ଼ିଶା
Odisha State Open University, Sambalpur, Odisha
Established by an Act of Government of Odisha.

Entrepreneurship Development

MP-11

Role of Commercial Banks
and
Government Assistance and Support

Block

4

Unit-1

Role of Commercial Banks

Unit-2

Government Assistance for Small Enterprises

Unit – 1
Role of Commercial Banks

Learning Objectives:

After completion of the unit, you should be able to:

- Understand the definition of a bank.
- Know the functions of RBI.
- Make out the classification of banks.
- Understand the functions of commercial banks.
- Appreciate the role of commercial banks in the economy.

Structure :

DEFINITION OF BANK

In India, the definition of the business of banking has been given in the Banking Regulation Act, (BR Act), 1949. According to Section 5(c) of the BR Act, 'a banking company is a company which transacts the business of banking in India.' Further, Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, order or otherwise.' This definition points to the three primary activities of a commercial bank which distinguish it from the other financial institutions. These are: (i) maintaining deposit accounts including current accounts, (ii) issue and pay cheques, and (iii) collect cheques for the bank's customers.

EVOLUTION OF COMMERCIAL BANKS IN INDIA

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank, a bankers' bank and a banker to the Government. The Imperial Bank of India was established with mainly European shareholders. It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end. In 1860, the concept of limited liability was introduced in Indian banking, resulting in the establishment of joint-stock banks. In 1865, the Allahabad Bank was established with purely Indian shareholders. Punjab National Bank came into being in 1895. Between 1906 and 1913, other banks like Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. After independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank taking over the Imperial Bank of India and integrating with it, the former state-owned and state-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries. To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalization of another six private banks in 1980. With the nationalization of these banks, the major segment of the banking sector came under the control of the Government. The nationalization of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilization, thereby giving boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases, and banks getting burdened with large non-performing assets. To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system. One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. Following this decision, new banks such as ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up. Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions. Further, the share of long-term financing (in total bank financing) to meet capital goods and project-financing needs of industry has also increased over the years.

CENTRAL BANKING AUTHORITY – RBI

The central bank of the country is the Reserve Bank of India (RBI). It was established in April 935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2, 20,000.

Reserve Bank of India was nationalized in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Boards consist of five members each Central Government appointed for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank.

The Bank was constituted for the need of following:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

Objective

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Functions of Reserve Bank of India

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank the Reserve Bank of India.

I. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-was period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

II. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

III. Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the RBI.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

IV. Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

(a) It holds the cash reserves of all the scheduled banks.

(b) It controls the credit operations of banks through quantitative and qualitative controls.

(c) It controls the banking system through the system of licensing, inspection and calling for information.

(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

V. Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. Though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the

International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the IMF.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

VI. Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalization of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

VII. Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilize savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

CLASSIFICATION OF BANKS

COMMERCIAL BANKS

Meaning

A banking company is one which transacts the business of banking which means accepting for the purpose of lending all investments, of deposits of money from the public, repayable on demand or otherwise and withdraw able by cheque, draft or otherwise. There are two essential functions that a financial institution must perform to become a commercial bank. These are

a) Accepting deposit form the public

b) Lending money to the needy

Commercial banks include public sector banks, private banks and foreign banks.

Main features:

a. It accepts deposits from the public, which can be withdrawn by cheque and are repayable on demand.
b. A commercial bank uses the deposited money for lending and for investment in securities.
c. It is a commercial institution, whose aim is to earn profit.

Categorization of Commercial Banks

The commercial banking structure in India consists of:

A. Scheduled Commercial Banks: the Scheduled Commercial Banks are the banks, which are listed under the Second Schedule of the Reserve Bank of India Act, 1934.
   - With listing in second schedule banks are conferred with some benefits in terms of access to accommodation by RBI during the times of liquidity constraints.
   - The scheduled status also subjects the bank certain conditions and obligation towards the reserve regulations of RBI.

B. Unscheduled Banks: The banks other than the scheduled banks are Unscheduled Banks.

Criteria for inclusion in the list of scheduled banks

- Minimum paid up capital and total reserve Rs 5 lakhs
- It must be a company under Section 3 of the companies Act
- Its affairs are not detrimental to the interest of the depositors
- It must have earned profit for last three years

PRIVATE BANKS

Categorization of Private Banks

The private banks those got established after 1993 i.e. after banking sector reform bracketed as New Generation Private Sector Banks and they are well distinguished from old generation private sector banks.

Features of new generation Private sector banks

a. Technology- The private banks have used technology to provide quality service through lower cost delivery mechanisms.

b. Convergence- The new private banks are able to provide a range of financial services under one roof, thus increasing their fee based revenues.

c. High-end Customers- The new generation private sector banks mainly concentrate on high-end and high middle income segments.

d. Priority sector targets - The new generation private sector banks which rely on indirect financing to accomplish the priority sector targets.

e. Lucrative Business Areas - They made a strong presence in the most lucrative business areas in the country because of technology up gradation.

f. Operating Expenses - their operating expenses is low as compared to the PSU banks and their efficiency ratios (employee's productivity and profitability ratios) is also high.

g. Value added services to customers and they undertake all most all the modern method of banking such as the internet banking, mobile banking, etc.

Advantage over public sector banks

They took advantage of the following problems concerning the nationalized / state sector banks

1. Large number of unprofitable branches
2. Excess staffing
3. Mounting Non Performing Assets on account of intervention of Govt.
4. Laggard in technology
5. Development of innovative consumer oriented products
6. Lesser focus on marketing

They have made banking more efficient and customer friendly. In the process they have jolted public sector banks out of complacency and forced them to become more competitive.

Disadvantages of Private Banks

- Private Banks runs like a business. Even though, there are lots of advantages to this, the major disappointment comes on the service charges, which is very much higher.
- Unorganized HR System
- The minimum balance for deposit accounts is much higher than the public sector banks.
- Low focus on priority sector lending and financial inclusion.

COOPERATIVE BANKS

Meaning

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. They are often created by persons belonging to the same local or professional community or sharing a common interest.

Features

1. Principle of self-help - Co-operative Banks are basically organized and managed on the principle of co-operation, self-help, and mutual help and they function with the rule of "one member, one vote".
2. Customer-owned entities - The needs of the customers meet the needs of the owners, as the members are at both the ends. Hence, the first aim of a co-operative bank is not to maximize profit but to provide the best possible products and services to its members. Some co-operative banks only operate with their members but most of them also admit non-member clients to benefit from their banking and financial services.
3. Democratic control - Since they are owned and controlled by the members, the board of directors get elected democratically by the members , usually having equal voting rights, in tune with the co-operative principle of "one member , one vote".
4. Principle of no profit, no loss - They function with the principle of "no profit, no loss" and generally do not pursue the goal of profit maximization.
5. Profit allocation - Here a significant part of the annual profit, benefits or surplus is usually allocated to constitute reserves and a part of this profit are also distributed to the members, through a patronage dividend,(the use of the co-operatives products and services by each member, or the interest / dividend, related to the number of shares subscribed by each member)

6. Localized set up- They are deeply rooted inside local areas and communities and are involved in local development as well as contribute to the sustainable development of their communities.
7. Regulatory prescriptions- Co-operative Banks are subject to regulatory requirements of RBI/ NABARD. However, they are allowed with preferential treatments in comparison to commercial banks.

Classifications of Co-operative Banks

1. Statutory Classifications- Some co-operative bank are scheduled banks, while others are non-scheduled banks. For instance, State co-operative banks and some Urban co-operative banks are scheduled banks but other co-operative bank are non-scheduled banks
2. According to Terms of Lending- From Terms of lending point of view, they are of two categories :

   a. Short term lending oriented co-operative Banks – within this category there are three sub categories of banks viz state co-operative banks, District co-operative banks and Primary Agricultural co-operative societies.
   b. Long term lending oriented co-operative Banks – within the second category there are land development banks at three levels state level, district level and village level.

STRUCTURE OF COOPERATVE BANKING

The cooperative banking structure in India is divided into 4 components:

a) Primary cooperative credit society
b) Central cooperative banks
c) State cooperative banks
d) Land development banks

a) Primary Agricultural Credit Societies (PACSs) - A Primary agricultural credit society can be started with 10 or more persons normally belonging to a village or a group of villages. The value of each share is generally nominal so as to enable even the poorest farmer to become a member. It gives loans and advances to needy members mainly out of these deposits.

   The Urban Co-operative Banks (UCBs) refers to primary cooperative banks located in urban and semi-urban areas.

b) Central Co-operative Banks (CCBs)-The central co-operative banks are located at the district headquarters or some prominent town of the district. Their main function is to lend to primary credit society and now a days they have been undertaking normal commercial banking business like - attracting deposits from the general public and lending to the needy against proper securities.

c) State Co-operative Banks (SCBs)-The state Co-operative Banks, finance, co-ordinate and control the working of the central Co-operative Banks in each state. They serve as the link between the Reserve bank and the general money market on the one side and the central co-operative and primary societies on the other. They obtain their funds mainly from the general public by way of deposits, loans and advances from the Reserve Bank and their own share capital and reserves.

d) Land development Banks- The land development banks are organized in 3 tiers namely, state, central and primary level and they meet the long term credit requirements of the farmers for developmental purposes. The state land development bank overseas the primary land development banks situated in the districts and tehsils in the state. They are governed both by the state government and Reserve Bank of India. Recently, the supervision of land development banks has been assumed by National Bank for Agriculture and Rural Development (NABARD). The sources of funds for these banks are the debentures subscribed by both central and state government. These banks do not accept deposits from the general public.

Functions

Co-operative Banks belong to the money market as well as to the capital market and are financial intermediaries only partially, in view of limited financial products. Now days they are performing all the main banking functions of deposit mobilization, supply of credit and provision of remittance facilities.

1. Primary agricultural credit societies provide short term and medium term loans.
2. Land Development Banks (LDBs) provide long-term loans.
3. SCBs and CCBs also provide both short term and term loans.
4. The co-operative banks in rural areas mainly finance agricultural based activities including farming, cattle, milk, hatchery, personal finance etc. along with some small scale industries and self-employment driven activities
5. The co-operative banks in urban areas mainly finance various categories of people for self-employment, industries, small scale units, home finance, consumer finance, personal finance, etc.
6. Co-operative banks are playing a more proactive role than scheduled commercial banks (SCBs) in achieving financial inclusion
7. They are also playing a pivotal role in micro finance

The exponential growth of Co-operative Banks is attributed mainly to their much better local reach, personal interaction with customers, and their ability to catch the nerve of the local clientele.

REGIONAL RURAL BANKS

The Narasimham committee on rural credit recommended the establishment of Regional Rural Banks (RRBs) on the ground that they would be much better suited than the commercial banks or co-operative banks in meeting the needs of rural areas.

Objectives of Regional Rural Banks

Regional Rural Banks were established with the following objectives in mind:

1. Taking the banking services to the doorstep of rural masses, particularly in hitherto unbanked rural areas
2. Bridging the credit gap in rural areas
3. Check the outflow of rural deposits to urban areas
4. Reduce regional imbalances and increase rural employment generation
5. Making available institutional credit to the weaker sections of the society who had by far little or no access to cheaper loans and are forced to depend on the private money lenders.
6. Mobilize rural savings and channelize them for supporting productive activities in rural areas.
7. Generating employment opportunities in rural areas and bringing down the cost of providing credit to rural areas.

With these objectives in mind, knowledge of the local language by the staff is an important qualification to make the bank accessible to the people.

Nature

- Status of scheduled commercial banks
- Combines basic features of the commercial banks and cooperative societies

Amalgamation of Regional Rural Banks

The total number of Regional Rural Banks (RRBs) were 196 and now stands at 86 following the process of their amalgamation initiated by the government in 2005, so as to strengthen and consolidate RRBs. There were 196 Regional Rural Banks operating in the country as on March 31, 2004. Most of the sponsor banks were operating more than one RRB in one state and in order to give a further boost to profitability of these banks and to strengthen them further a need was felt to amalgamate more than one RRB of same sponsor bank operating in the same state.

FOREIGN BANKS

Features

1. They are operating in Urban and Metropolitan cities only with limited number of branches; catering to elite clientele
2. The foreign banks having considerable international exposure are able to launch new products besides providing better services.
3. Foreign banks tend to follow "exclusive banking" by offering services to a small number of clients, instead of "inclusive banking".
4. Foreign banks charge higher fees from customers for providing banking services and maintaining a bank account requires substantial financial resources.
5. These banks have been complying with the 32% requirement under Priority Sector Lending but mostly concentrate on Retail Banking.
6. The low Credit Deposit ratio indicates that more than lending to business and industry, they resort to investment operations.

Role of foreign banks

- Foreign banks play a relatively minor role in the Indian economy,
- The role of foreign banks is vital and tends to elevate the efficiency and working system of the local banking system by introducing sophisticated financial services. Acquiring reports, SMS alerts, tele-banking, internet banking, and many more are some of the catchy services that plays a crucial role in satisfying the customers
- They cover 65% of the foreign exchange transactions in India.
- They have limited number of branches.
- They are not lending money to small and medium-sized enterprises (SMEs), small traders, informal sector and farmers.

FUNCTIONS OF COMMERCIAL BANKS

Prof. Syers, defined banks as "institutions whose debt—usually referred to as 'bank deposits'—are commonly accepted in final settlement of other people's debts". According to Banking Regulation Act of 1949, "Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise". From the above definitions we can analyze that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

I. Receiving deposits from the public - The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity. The aggregate deposits of scheduled commercial banks in India rose rapidly from Rs. 822 crores in 1951 to Rs. 3,763 crores in 1967. The total deposits of commercial banks were Rs. 4,661 crores in 1969 that increased to Rs. 34,237 crores by 735 per cent by 1979. The total deposits of commercial banks increased in the decade of 1981 to 1991 from Rs. 40,413 crores to Rs. 2,00,569 crores by 5 times. Out of which the proportion of current, saving and fixed deposits were Rs. 6,286, Rs.11,805 and Rs. 22,322 crores which is almost 1: 2: 3 ratio increased to Rs. 30,335, Rs. 56,152 and Rs. 114082 crores i.e., almost 5 times during one decade with almost same proportion. The total deposits with commercial banks by the end of 2005 increased to Rs. 21,00,000 crores.

II. Giving loans and advances - The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and silver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and foreign banks, the other commercial banks also started giving loans and advances not only to their traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.

III. Use of cheque system and credit cards - The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

IV. Credit creation - Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

V. Financing foreign trade - The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

VI. Transfer of funds - Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transferring funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.

VII. Agency functions - The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. 8. Miscellaneous functions. The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc. Commercial Banks 33 advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds.

ROLE OF COMMERCIAL BANKS

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture.

There is acute shortage of capital. People lack initiative and enterprise. Means of transport are undeveloped. Industry is depressed. The commercial banks help in overcoming these obstacles and promoting economic development. The role of a commercial bank in a developing country is discussed as under.

I. Mobilising Saving for Capital Formation:

The commercial banks help in mobilising savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich. By mobilising savings, the banks channelise them into productive investments. Thus they help in the capital formation of a developing country.

II. Financing Industry:

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. Income of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry.

In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire- purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

III. Financing Trade:

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

IV. Financing Agriculture:

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc.

They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

V. Financing Consumer Activities:

People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

VI. Financing Employment Generating Activities:

The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young person's studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help inhuman capital formation but also in increasing entrepreneurial activities in developing countries.

VII. Help in Monetary Policy:

The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

Thus, the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

SUMMARY

Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, order or otherwise.'

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank.

The main functions of a commercial bank can be segregated into three main areas: (i) Payment System (ii) Financial Intermediation (iii) Financial Services.

It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end.

State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries. To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalization of another six private banks in 1980.

To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

KEY WORDS

Capital Formation – Transfer of savings from individuals or households to the business sector, directly through investments or indirectly through bank deposits which are loaned out to firms.

Monetary Policy - Economic strategy chosen by a government in deciding expansion or contraction in the country's money supply. Applied usually through the Central bank, a monetary policy employs three major tools (i) buying or selling national debt, (ii) changing credit restrictions and (iii) changing the interest rates by changing reserve requirements.

SELF ASSESSMENT QUESTIONS WITH ANSWERS

Q1. Discuss the roles of commercial banks.

Ans. The roles of commercial banks are as follows

I. Mobilising Saving for Capital Formation:

The commercial banks help in mobilising savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich. By mobilising savings, the banks channelise them into productive investments. Thus they help in the capital formation of a developing country.

II. Financing Industry:

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. Income of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry.

In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire- purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

III. Financing Trade:

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

IV. Financing Agriculture:

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc.

They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

V. Financing Consumer Activities:

People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

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The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

Thus, the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

Q2. Discuss the functions of RBI.

Ans. The functions of RBI are

I. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-was period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

II. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

III. Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the RBI.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

IV. Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

(a) It holds the cash reserves of all the scheduled banks.

(b) It controls the credit operations of banks through quantitative and qualitative controls.

(c) It controls the banking system through the system of licensing, inspection and calling for information.

(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

V. Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. Though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the IMF.
Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

VI. Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalization of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

VII. Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilize savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

FURTHER READINGS

- Harihara Krishnan – Banking India: Accepting deposit for the purpose of lending (Partridge India)
- IIBF – Advanced Bank Management (Macmillan)

MODEL QUESTIONS

1. Explain the functions of commercial banks.

2. Elaborate the classification of banks.

Unit-2

Government Assistance for Small Enterprises

Learning Objectives

After completion of the unit, you should be able to:

- Understand the definition of Small Scale Enterprises.
- Know the role of Small Scale Enterprises.
- Make out the classification of Small Enterprises.
- Understand the problems of Small Scale Enterprises.
- Appreciate the recent initiatives by the Government.

Structure

Introduction

The industrial policy resolutions have given special role to the small scale sector. The small scale sector plays a pivotal role in the Indian economy in terms of employment, output and exports. The growth in this sector has resulted into wider dispersal of industrial and economic activities and ensures better use of local resources. The small sector covers a wide spectrum of industries and small scale services and business enterprises and thus is referred to as small scale Enterprises (SSEs). SSEs include modern small scale industries (SSIs), tiny enterprises, small scale service enterprises and village and cottage industries.

Definition of Small Scale Enterprises (SSEs)

The definition of SSEs is based on the criterion of value of plant and machinery which has been revised over the years. At present the small industrial unit has been classified as follows:

i) Small Scale Industrial Units (SSI) units having investment in plant and machinery upto Rs.1 crore.

ii) Ancillary Industrial Units having investment in plant and machinery upto Rs.1 crore. Such an undertaking must sell not less than 50 percent of its output to other industrial undertakings.

iii) Export-oriented Units having investment in plant and machinery upto 1 crore. The unit must export at least 30 percent of its output by the end of three years from the date of commencement of production.

iv) Tiny Units having investment in plant and machinery upto Rs.25 lakhs irrespective of location.

The investment limit in plant and machinery in case of specified Hi-tech and export oriented units has been raised to Rs. five crore to ensure suitable technology up gradation and to enable them to attain competitive edge.

Definitions of Micro, Small & Medium Enterprises under Micro, Small & Medium Enterprises Development (MSMED) Act, 2006

In accordance with the provision of (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified in two Classes:

(a) Manufacturing Enterprises: The enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the first schedule to the industries (Development and regulation) Act, 1951). The Manufacturing Enterprise are defined in terms of investment in Plant & Machinery.

(b) Service Enterprises: The enterprises engaged in providing or rendering of services and are defined in terms of investment in equipment.

Thus the new definition have clearly included industrial as well service into Small Scale Enterprises(SSEs).The limit for investment in plant and machinery / equipment for manufacturing / service enterprises are as under:

Manufacturing Sector	
Enterprises	Investment in plant & machinery
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees
Service Sector	
Enterprises	Investment in equipments
Micro Enterprises	Does not exceed ten lakh rupees
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five crore rupees.

(Self Test Questions)

1. What is the significance of Small Scale Enterprises?

2. Explain the following terms:

   (a) Ancillary units

(b) Export-oriented units

(c) Tiny units

Modern vs. Traditional Cottage SSEs

Traditional SSEs are labor-intensive, requires specialized skills and craftsmanship which are often handed down from one generation to another. The cottage industries are generally located in the rural areas, mostly make use of local resources and cater to the local demands. These industries involve the production of conventional goods.

Modern SSEs are capital-intensive and involves high-tech in the production. These are generally concentrated in the urban areas and may procure raw materials from distant places and produce sophisticated goods that are sold both in national and international markets. These industries produce sophisticated goods.

Role of SSEs

SSEs have acquired prominent role in the industrial and economic development. It has contributed significantly to the socio-economic welfare of the country. The SSEs continue to be a vibrant sector of the Indian economy. It contributes significantly to the growth of Gross domestic product (GDP), employment generation, exports and creation of entrepreneurial base. These are discussed as follows:

1) Employment Generation: The small scale sector contributes about four-fifth of manufacturing employment in India. The SSEs are generally labor-intensive and thus create more employment for the given amount of capital. SSEs provide employment to locally available semi-skilled and unskilled workers who would otherwise be unemployed.

Further, SSEs develop self-employment and entrepreneurial base in the country. Given the acute unemployment problem in India, creation of employment opportunities largely depends upon the development of SSEs.

During Xth plan period (2002-07), SSEs register around 4.57 percent growth in employment where as large industries growth was around 0.85 percent. It is the segment which provides employment next to agriculture. The growth in employment in this sector is much above the population growth of India (i.e1.5 percent) The employment intensity of this sector can be judged from the fact that 1 person is employed for every Rs.1.49 lakh rupees invested in fixed assets of SSEs as against 1 person for every Rs. 5.56 lakh in the large organized sector.

2) Equitable distribution of Income and wealth: The equitable distribution of income and wealth occurs as the large numbers of SSEs are dispersed in wide range of regions and is held by large number of people. The number of SSEs account for more than 95 percent of total industrial units in the country. Large scale industries on the other hand are owned by few big owners and so led to concentration of income and wealth in the hands of few. Further, SSEs possess much larger employment potential as compared to large enterprises. Small sector thus enable a vast majority of people to derive the benefits of economic development.

3) Mobilization and utilization of local latent resources: SSE mobilizes the latent i.e. unused or idle resources in terms of surplus labor, idle capital and deploys these resources in the productive activity. The SSEs provide opportunities to develop entrepreneurial skills and encourage the innovations at the grassroots level. It provides large amount of supply links by sourcing inputs from the local areas and so have greater local multiplier effect than large enterprises. This is a definite gain to the society as a whole.

4) Regional Dispersal of Industries: SSEs are dispersed across wide range of areas and regions. The large scale industries are concentrated in big metropolitan cities as these cities provide an easy access to the basic facilities of power, transport, roads, banking etc. as such it resulted into regional disparities with already well-off states developed faster than other. The small scale industries with localized operations spread in the remote corner of the economy. These industries can be easily set up in different parts of the country and energizes the village industries. This led to reduction of regional economic disparities.

5) Contribution toward GDP and output growth: SSEs contribute around 39 percent of gross manufactured output. The output in Xth plan recorded a growth rate of 8.87 percent p.a.

6) Contributes towards Foreign Exchange: SSEs hold a significant share in exports earnings. The products like handicrafts, gems, jewelry, carpets, carpets, silk which is a forte of SSEs possess huge demand in foreign market. These products require low import-content. Further, the financial constraints and small size of SSEs inhibit the sourcing of raw inputs from abroad and greater use of local resources and save foreign exchange. Thus SSEs contribute to the precious foreign exchange of the country. The direct exports from SSEs accounts for nearly 34 percent of total exports.

Besides direct exports SSEs indirectly contribute to the export earnings in terms of production of parts or components for use in exportable goods or export order from large units. Further, the non-traditional products account for more than 95 percent of total SSEs exports. The products groups' where SSEs dominates are sports goods, readymade garment, processed food and leather products.

7) Arrest Rural-Urban Migration: The rapid increase of population and lack of enough job opportunities in the rural areas has caused migration of rural population to urban areas. This excessive migration has resulted into problems like housing shortage, low level of civic facilities, growth of slums and additional social problems like theft etc. The development of SSEs in the rural areas can provide employment opportunities near the homes of rural people and so reduce rural migration.

(Self Test Questions)

3. How small scale enterprises create more quantum of employment generation?

4. Explain how mobilization and utilization of local latent resources are done by SSEs?

Problems of SSEs in India

Concurrent with an impressive growth SSEs face number of problems which are manifested in such a way that this sector fails to achieve the required amount of dynamism and growth. The problems of SSEs are discussed as follows:

1) Financial Problems: Finance is the most important aspect for any industrial development. The scarcity of finance and credit is the main obstacle in the growth of SSEs. These enterprises are generally organized in sole-proprietary and partnership

concerns and so have no access to the capital market. There exists insufficient equity type institutional support. Delays in institutional finance, unhelpful attitude of banks are the common problems of SSEs. The delay in sanctions of loans occur due to lengthy procedural formalities, insistence upon certificate from local authorities such as village office, block development officers etc and over-emphasis on collateral security. Banks generally avoid financing smaller SSEs due to high mortality rate, low overall recovery performance and high cost of servicing SSEs loans. In this scenario SSEs have to depend upon high interest non-institutional finance.

2) Slow Technological Progress: Paucity of funds is the major area for the slow adoption of innovative practices in the business. The unsatisfactory technology delivery mechanism such as arrangement for demonstration of cost and use of new technology also cause low technical progress in SSEs. SSEs especially the cottage and village industries have to depend upon outdated and obsolete production technique. This adversely affects the quality of output and increases manufacturing cost.

3) Marketing –Related Problems: The problem of marketing products of SSEs generally arise due to small scale production causing high product cost, lack of standardization of product, adequate marketing research, competition from big industrial units and insufficient research and holding capacity. Another related problem is the weak bargaining power of tiny and village industries vis-à-vis large buyers which is causing long overdue from these buyers. SSEs thus fail to obtain fair and timely price for their products. Lack of proper marketing is an important factor causing sickness in SSEs. The inadequate organized marketing support for cottage and village industries also causes low promotion of their products.

4) Lack of Proper Planning: Planning comprises of the outlay of the quantum of output, time framework of implementation, product and marketing strategies. The performance feasibility study are often neglected by SSEs due to time and cost factors. As a consequence, SSEs face large sickness at early stage of their operation.

5) Sickness: There exists large level of sickness amongst SSEs. The incipient sickness (ie. Sickness at an early stage of existence) is largely due to lack of planning, professional management and financial problems. The sickness causes wastage of large amount of finances that remain locked into these units. Further, sickness also leads to various socio-economic problems such as lower production, employment and exports.

6) Shortage of Raw Material: Raw material scarcity caused disruption in the production process. SSEs fail to make bulk purchases and thus have to pay higher price for inputs. The suppliers of scarce raw material give preference to buyers. SSEs have to depend upon low quality localized high price raw material. Further, SSEs fail to make alternative arrangements for critical inputs such as power due to financial constraints. These factors adversely affect product quality and cost of production.

Government Measures

An important place is assigned to SSEs sector in the development policy of the country. Till 90's Government focused more on protectionist policy towards SSEs. The shift in policy paradigm towards this sector occurred since1991 to impart more vitality and growth-impetus to the sector. The sector has been substantially delicensed. The regulations and procedures have been reviewed and modified to instill competition and efficiency in this sector. The policy initiatives adopted to promote this sector are discussed below:

1. Reservation: The policy of reservation was initiated in 1967 primarily as a promotional and protective measure for exclusive production in SSEs. The number of items reserved is continually revised by Government. In 1967, 47 items were reserved for exclusive production by SSEs which expanded to 873 in October 1984. The rationale of reservation policy was to expand employment opportunities through setting up of SSEs and to protect them from competition by large enterprises. In the new global scenario with WTO agreement Government is required to remove quantitative restrictions on imports of items. A large number of items exclusively reserve for SSEs can now be freely imported. Thus the reservation has cost its relevance so the government has drastically reduced the number of items reserved for exclusive manufacture by micro small and medium enterprises (MSME). As on March 2007, the list of items for exclusive production contains 114 items which was further reduced to 35 in February 2008. Non-MSME units can undertake manufacture of reserved items only if they undertake 50 percent export obligations.

2. Financial Support: Government has made efforts to ensure adequate and timely availability of financial assistance to SSEs. RBI has issued guidelines to public sector banks to ensure 20 percent growth in credit to SSEs. Small Industries Development Bank of India (SIDBI) which is an apex institution and coordinates the financial assistance availability to SSEs has scaled up and strengthens its credit operations to this sector. The branch network of SIDBI has been increased. In order to improve an access to the capital market, the equity participation by other industrial undertaking not exceeding 24 percent of total shareholding has been allowed. The legislative changes are under way to allow limited liability partnership for SSEs. This would limit the financial liability of some partners who have invested capital. Risk capital fund has been created to provide equity-type long term loans to SSEs. The credit guarantee fund scheme is launched by government in 2000 to allow collateral free credit to SSEs.

3. Fiscal Support: Government has allowed tax concessions in terms of lower excise duty on production, lower sales tax on sales, tax-holiday and extended the time limit for payment of excise duty by SSEs.

4. Marketing Support Measures: In order to provide market support to SSEs, Government has taken following measures:

(i) Preferential Purchases and Price Preferences by Government: The Government organizations are statutorily required to make specified level of purchase from SSEs and the same has to be disclosed in their annual reports. At present the number of items for exclusive purchase from SSEs stood at 358. Government also provides price preference to SSEs in their purchases over large scale units.

(ii) Financial Assistance is allowed for participation in the international trade fair by representatives of SSEs.

(iii) Training Programmes on various aspects of marketing like marketing management, export marketing etc are conducted by Government.

(iv) Institutional Marketing Support is provided by National Small Industries Corporation (NSIC) and Small Industries Development Organization (SIDO).

5. Institutional Support: Government has established various organizations to help SSEs. These institutions assist SSEs in purchase of raw material, marketing of goods, technological and skill improvement and arranging credit. The important organization established are Khadi and Village Industries Commission and commodity specific organizations such Handloom Board, Cottage Industries Board, Coir Board etc. Specialized financial and consultancy institutions such as SIDBI, NABARD (for supporting rural industries), SIDOs, NSIC has been established to provide financial, marketing and managerial assistance to SSEs.

6. Raw Material Assistance: The institutional support is provided to allow availability of raw material (both indigenous and imported) at fair price. The centers have been established to distribute scarce raw material to SSEs. Buffer stocks are maintained for raw materials. This has helped SSEs to focus on production of quality products.

Recent Initiatives by the Government

In view of liberalization and globalization and reduced Government intervention in market-driven economy the protectionist policies has been replaced by supportive policies. The recent measures adopted by government are as follows:

(i) Legislative Measures: Micro, Small and Medium Enterprises Development Act, 2006 has been enacted to facilitate the promotion and development of SSEs. This Act seeks to facilitate promotion and development and enhancing competitiveness of these enterprises. It provides the first-ever legal framework for recognition of the concept of “enterprise” (comprising both manufacturing and services) and integrating the three tiers of these enterprises, namely, micro, small and medium. The basic purpose is to develop the consultative mechanism at the national level that represents stakeholders from three classes of enterprises. The act provides for the establishment of specific funds to support SSEs. The progressive credit policy with targeted growth of credit to SSEs has been incorporated in the Act. The mechanism has been designed to reduce the problems of delayed payment to SSEs.

(ii) Support for Cluster-Based Development: The holistic approach is adopted to develop cluster of SSEs so as to provide common facilities in these clusters. The existing industrial infrastructure will be upgraded and new facilities will be created in the public-private partnership mode.

(iii) Technology and Quality Up Gradation: The support is provided by establishing training-cum product development centres.

(iv) Strengthening of Entrepreneurial and Managerial Development Programmes: Financial assistance is provided to B-schools to conduct tailor-made management courses for SSEs. Entrepreneurial clubs are established in the Colleges or Universities.

(v) Empowerment of Women-Owned Enterprises: The concessions, marketing and credit facilities on priority basis are provided to enterprises owned and managed by women.

(vi) Strengthening of Data base for SSEs: It is decided to collect database on SSEs through annual sample surveys and quinquennial (i.e. happening every five years) census so that policy decisions can be framed for SSEs based on systematic data that provides inputs for systematic policy initiatives.

Let’s Sum-up

SSEs enjoy inherent advantages over their larger counterparts in terms of generation of employment opportunities, equality of income and wealth and greater export potential. The globalize economy has ushered in greater accessibility to the market, need of greater linkage of SSEs with larger companies and improved manufacturing techniques. The measure adopted by Government have been attempted to alleviate the problems of SSEs. The recent initiatives have changed the outlook of business from protection to liberalization. It has created a sense of competition amongst SSEs.

Key Terms

Small Scale Industrial Units are the units having investment in plant and machinery up to Rs.1 crore.

Ancillary Industrial Units having investment in plant and machinery up to Rs.1 crore. Such an undertaking must sell not less than 50 percent of its output to other industrial undertakings.

Export-oriented Units having investment in plant and machinery up to 1 crore. The unit must export at least 30 percent of its output by the end of three years from the date of commencement of production.

Tiny Units having investment in plant and machinery up to Rs.25 lakhs irrespective of location.

Cluster-Based Development is the holistic approach to provide common facilities to all the small scale enterprises within the cluster.

Self-Assessment Questions

1. Distinguish between Small Scale and Cottage Industries.
2. Explain the role and importance of Small-Scale Enterprises in Indian Economy.
3. What are the problems facing SSEs in India?
4. Discuss Indian Government's measures to improve the development of SSEs.

Further Readings

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Model Questions

1. How does a small scale enterprise contribute towards socio-economic welfare of the country?
2. Explain the role of Small-Scale Enterprises in relation to the export-oriented units.
3. What are the major differences between the modern and traditional SSEs in India?
4. Discuss about the recent initiatives by the Government to improve upon the SSEs.