CHAPTER - THREE

CONCEPT AND SIGNIFICANCE OF CD RATIO

Credit is an engine of growth. It plays vital role in creating additional purchasing power in the hands of the mass of the economy. Purchasing power in the form of credit is one important aspect of credit while its real significance arises when it utilize to invest in the productive purposes. By investment, it helps in capital formation and therefore income, employment and output.

In an economy the penetration of credit could be measured in terms of credit deployed against the deposit received, technically it is denoted by C D Ratio. Credit-deposit ratio is the proportion of loan-assets created by banks from the deposits received. The higher the ratio, the higher the loan-assets created from deposits and vice-versa.

Fairly, it is straightforward indicator of the performance of scheduled commercial banks. But in its own way, it sheds a lot of light on the type of society and economy we live in. The importance of disbursing credit out of mobilized saving for
productive purpose is well documented in the studies of Finance, and Economic Growth.\textsuperscript{20}

Historically, the issue of C D ratio has considered as most debated monetary matter for regional growth and development due to unequal deployment bank credit among the various states of the country. Some of the states of our country especially from central region, north-eastern, and eastern India has witnessed poor C D ratio since the nationalization of commercial banks.

**Hypothesis of the Circular Flow of Saving and Investment:**

There is general perception that for balanced regional development credit deployed by banks must be equivalent to deposits received.

Household saving contributes significant part in the aggregate saving of any economy. However, form of the household saving depends upon the nature of financial system of that economy. In a country like India where commercial banks plays important role in the formation financial system of the economy receives a large part of the household saving. As per statistics

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issued by RBI during the period of 2003-04 to 2006-07, the contribution of household saving in total financial saving with commercial banks was 23.8 percent of the total private sector saving of the country. While private corporate saving was 6.6 percent during the same period. The size and nature of household saving also vary, depending upon the accessibility to the capital market and their instruments, naturally in the area like Bihar where capital market accessibility is very limited, household of the state is bound to keep its major part of financial saving with commercial banks. Apart from this the negligible presence of private corporate and public sector units in the state also indicates that major part of deposits maintained by commercial banks of the state is comes from household saving. So, to balancing the effect of net saving, it must be circulated within the state in the form of credit.

**Analysis of the Circular Flow of Income by S-I Approach**

In the simple analysis of circular flow of income in two sector model, leakage in the form of saving must be equivalent to the injection of investment. Hence, Commercial banks as a major player of financial system in general and for states’ economy in particular provides the platform for balancing the development from bottom by equalizing the deposit received (leakage) and credit
deployed (injection) at regional levels. Inequality between withdrawals (saving) and injection (investment) will reduce the volume of circular flow and leave the potential unutilized.

**Evolution of C D Ratio**

The matter of poor C D ratio first came in the eyes of RBI in 1980, that the most of the backward regions of the India have yet not attained the national average of C D ratio. RBI first advised PSBs to achieve a CDR of 60 percent in their rural and semi urban branches on a continuing basis. This was done in order to encourage reduction in inter-regional imbalance in credit delivery and to persuade banks to lend in the same areas where they mobilized deposits.

In both, in concept and origin this targeted was provided as an ‘advisory’ to banks in order to correct the ‘known ignorance’ in their lending portfolios. The CD ratio is not meant as a yardstick to evaluate the performance of PSBs at the regional, state, or district levels. But, to all intent and purposes, the credit deposit ratio is now quoted as a yardstick to assess the commitment of SCBs.
Credit Deposit Ratio and the State of Bihar

The low credit-deposit ratio of the scheduled commercial banks in Bihar has been a subject of intense debate during the present time period. Periodically, the state government has raised the issue; lash out at the ‘negative attitude’ of the banks for the lack of development of the state. Bihar reports one of the lowest ratio, the credit amount disbursed is one of the lowest while deposit amount almost comparable to the all-India level. The low credit amount is owing to the lack of credit deployment (excluding priority sector lending) in industry, trade and general finance. As per the current statistics, out of 38 districts of divided Bihar 28 districts have C D R less than the minimum stipulated norms of 40 percent. Starting from 2001-2002 the state has touched ever highest CDR in the year of 2006-2007, which was close to 35 percent.

Regarding the poor C D ratio of the state, banks are of the view that since the repayment of loan scenario is yet to witness a positive trend in the state; the CD ratio has also not been improving. Till March 31, 2011 at least 3, 26,359 certificates cases were pending involving the bank amount of Rs 1100 crore. Besides, lack of business environment, poor law and order in the past years, poor credit absorption capacity of the state, and delay
in government run mechanism has created obstacles in way of credit deployment by commercial banks.

**Pattern of credit creation and money multiplier**

The commercial banks accepts deposit from public/institutions and grant loans to the traders, industrialist, farmers, self employed, salaried, and professionals either for productive purpose, or to create assets or for direct consumption, but in all cases the loan amount is credited in borrowers’ account. As the bank, credit the loaned amount in borrowers account it creates a fresh deposit for the bank, for this bank is liable to create credit once again and in this way the process of credit creation get started against the initial deposit. However, the banks’ credit creation capacity is based upon the value of money multiplier \((m)\), lower the value of required reserve increases the value of money multiplier and therefore credit creation capacity of banks or money supply in the economy \((M)\). The value of money multiplier \((m)\) and money supply \((M)\) calculated as follows;

\[
m = \frac{(1+c)}{(c+r)}
\]

Where,
c is currency deposit ratio, and r is reserve requirement ratio.

Both currency and term deposits form the part of total money supply (M) so, we take the ratio of both as people keep part of money as currency and part as deposits. The relation between currency, term deposit and reserve ration gives us the money multiplier (m). A reduction in r leads to an increase in the money multiplier and vice versa. Thus, credit creation capacity of bank is the product of size of total deposits and money multiplier (m) so, we may write it as follows;

Money or, credit creation = total deposits * money multiplier.

Measuring, credit creation capacity of banks’ is an aggregate concept (value of m is calculated by RBI, at fortnightly basis for entire economy) therefore, its usefulness is very restricted and cannot be used for measuring credit creation capacity of banks’ for a particular region or state.

Credit creation capacity of banks and credit deposit ratio maintained by banks are two different concepts, the former shows credit absorption capacity of the economy while later shows credit received by it. Historically, India has witnessed a big gap
between these two. As on 31st March 2006 the all India total deposit of SCBs was stood at Rs 2091174 cr. and size of credit was Rs 1513842 cr. i.e. national C D ratio, maintained by SCBs was 72.4 while credit creation capacity was Rs 8782930.8 cr. (In, 2006 m = 4.2). So, fundamentally there is big gap between credit deployed by banks in the entire economy and potential demand for credit of the economy. Thus, the problem of low C D ratio is more severe than what we expect.

**Magnitude of the problem of low C D Ratio**

The situation is worse than severe in some states of India where C D ratio is abysmally low. We see that, lower C D ratio does not mean only poor deployment of credit against deposit received but a big gap between potential demand and realized supply. However, besides granting credit against the size of deposits, there is also some other obligatory provisions of ratios, lien with banks. Generally, they are considered as,

1. Legal reserve ratio,

   - CRR
   - SLR

2. Investment deposit ratio,

3. Cash deposit ratio, and

4. Credit deposit ratio.
Out of the four, legal reserve ratio is determined by central monetary authority i.e. RBI. However, size of legal reserve ratio determines the other ratios maintained by commercial banks. Besides, LRR other important determinants are prevailing rate of interest, Government fiscal condition, level of banking habits of the economic units, and conducive environment for investment. Higher the size of LRR and poorer banking practices will automatically reduces the size of lonable fund.

But, one more factor is relevant in deciding the quantum of C D ratio in the state of Bihar; willingness of bankers to bear the risk involved in a poor state. A poor state faces many problems on the front infrastructure, marketing, and technical development of the state which in turn increases risk of failurness.

During my personal interaction with some of the management graduates and engineering graduates I have found that, receiving adequate banking facilities especially in the form of bank credit for commencing new projects within the state of Bihar is not easy task. However, with the same status of borrowers, it is easy in other states like Gujarat and Maharashtra; even in the state of Bihar the procedure of faith is easier for new medico
practicioners and for those who have sufficient collateral or strong co-borrowers.

The ability of an economic system to create credit is important for two reasons. First, it can compensate for the failure of the economic system to equalize planned saving and investment. Second, it provides the means by which growth is financed. This is the real significance of the invention of paper money and credit- permitting the economic system to expand in response to the continual opportunities for growth. Banks can help more in the deployment of credit by breaking down the sectoral bottleneck. However, commercial banks working in underdeveloped region rudimentary in nature. The ratio of bank deposit to \( \text{NDP}_{FC} \) and proportion of demand deposits to the total money supply remains low hence, the credit deployment capacity of banks remains low.

Credit deployment capacity of banks may be an aggregate concept but credit deployment by banks is a sectoral activity. So, balanced credit deployment by banks guaranteed not only inter-regional development but it also ensure intra-regional development. Banks in its annual credit plan prepare a roadmap for credit deployment at branch level. While preparing annual credit plan (ACP) each and every branch consider rules,
regulation, and norms fixed by authorities. Branch does not consider the local requirement and situations. But, the demand and deployment of credit by the borrowers and lenders respectively, is highly influenced by the localities.

**Application of C D Ratio**

The estimation of C D ratio is aggregate concept and is, applicable for entire economic system we do not calculate C D ratio for a particular sector or sub-sector because of technical limitations. However, there is some inter and intra-sectoral arrangement of credit deployment by banks on the basis of which we interoperate the state of credit deployment in general and for a sector in particular. Some expert 21 defined credit deposit ratio as; (number of credit accounts X average credit amount per account) divided by (number of deposit accounts X average deposit amount per account). This definition explain only magnitude of credit disbursed against the accepted deposit, it does not consider anything else.

In practice, place of sanctioning credit and place for its utilization may differ. Higher C D ratios accompanied by inter-regional imbalance as well as inter-sectoral imbalance cannot be accepted. Lower C D ratio is a problem in itself and may be caused due to market imperfection and other limitations of underdeveloped economy but, inter-sectoral disparity and inter-regional disparity arises due to reluctant attitude of banks, is more intense than the problem of low C D ratio.

**Important element of C D Ratio**

Banks attitude towards agricultural sector and their detouring condition has resulted into policy form i.e. provisions for ‘priority sector lending’. But, situation has not changed, and then finally, the government has come with the idea of rural infrastructure development fund (RIDF) in 1995, to offset the banks’ failureness in its risk appetite.

Funding through RIDF scheme for rural infrastructure is now an integral part to calculate C D ratio at various level. The key feature of the scheme started in 1995-1996, is that is a demand-driven non-concessional lending facility to the state Governments, Government run development agencies, non-government organizations, panchyati raj institutions, fully funded
by scheduled Indian commercial banks from the un lent portion of their prescribed minimum requirement for priority sector lending.

**Measurement of C D Ratio**

To make the concept of C D ratio more meaning full an Expert Group was constituted by Government of India under Chairmanship of Shri Y.S.P Thorat, M.D., NABARD to go into the nature and magnitude of the problem of low credit deposit ratio across States / Regions and to suggest steps to overcome the problem.

The Expert Group examined the problems and causes of low C D ratio and submitted its report to Government of India. The recommendations of the Group have since been examined and accepted by the Government of India with certain modifications. Accordingly, it has been decided that the C D Ratio of banks should be monitored at different levels on the basis of the following parameters; 22

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### Table No. 1

**Calculation of C D Ratio**

<table>
<thead>
<tr>
<th>Institution / Level</th>
<th>Indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual banks at Head Office</td>
<td>Cu + RIDF</td>
</tr>
<tr>
<td>State Level (SLBC)</td>
<td>Cu + RIDF</td>
</tr>
<tr>
<td>District Level</td>
<td>Cs</td>
</tr>
</tbody>
</table>

Here,

Cu = Credit as per place of Utilization,

Cs = Credit as per place of Sanction, and

The newly adopted methodology for calculating credit deposit ratio provides qualitative and quantitative analysis of the resources mobilization through banking intermediation. However, C D ratio calculated at any level does not reflect the sectoral deployment of bank credit which reduces its usefulness for development perspective.

We have some examples from the Indian states like Andhra Pradesh where C D ratio is above the national average in fact it is close to 110 percent in most of the years of the last
decade, in 2010-11, the credit deposit ratio of the state of A P has crossed the level of 100 percent, but we all know the facts.

Total agricultural advances to net bank credit ranged between 25 percent to 29 percent during most of the years. As on March 31st, 2010 the total outstanding priority sector advances was 1, 26,515 cr. against the total deposits of 2, 45,686 cr. While the share of agriculture and allied activities are only 68,658 cr. i.e. about 25 percent.

Expansion of priority sector activities, while keeping the minimum saturatory limit constant for credit deployment and providing the safe passage for escaping from its social obligation in the form of RIDF to these banking institutions has diverted the ‘surplus’ from its one of the best productive utilizations, in fact we have made vulnerable those, which have produced first surplus. So, in this context the higher C D ratio of Andhra Pradesh becomes meaningless.

However, higher C D ratio has definitely its own benefit like, Priority Sector Lending (PSL) normally depends on the C D ratio, that is, higher the C D ratio, higher will be the flow towards the PSL. The flow towards PSL is decided by the flow of net bank credit which in turn depends on C D ratio.
As per the RBI stipulation, at least 60 per cent of the C D ratio should be achieved by Commercial banks with 40 per cent of the net bank credit to priority sector and 18 percent of the net priority sector to agriculture sector. But, provision of RIDF and inclusion of education loan in the same category distorts the RBI’s stipulation and has reduced the size of credit as per place of utilization which has real power to affect the situations.

Thus, the process of accepting deposit and granting them in the form of credit is best productive utilization of monetized surplus. Credits deployed by banks not have only business aspect, but it also increase the total money supply in the economy. Increased money supply creates additional purchasing power which leads to increment in effective demand and prove its importance.

Further, it is significant because, it shows the involvement of commercial banks in any economic system. However, it does not states about the sectoral involvement of banks, most important, large size of C D ratio does not give the guarantee of development but it create the basis on which development can take place.