

CHAPTER 1

AN OVERVIEW OF THE BANKING SECTOR

SECTION – I: BANKING SYSTEM IN INDIA

1.1 Introduction ^{[1] [2]}

A bank is a financial institution that provides banking and other financial services to their customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. There are also non-banking institutions that provide certain banking services without meeting the legal definition of a bank. Banks are a subset of the financial services industry.

A banking system also referred as a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolios, through out the day. The banking system in India, should not only be hassle free but it should be able to meet the new challenges posed by the technology and any other external and internal factors. For the past three decades, India's banking system has several outstanding achievements to its credit. The Banks are the main participants of the financial system in India. The Banking sector offers several facilities and opportunities to their customers. All the banks safeguards the money and valuables and provide loans, credit, and payment services, such as checking accounts, money orders, and cashier's cheques. The banks also offer investment and insurance products. As a variety of models for cooperation and integration among finance industries have emerged, some of the traditional distinctions between banks, insurance companies, and securities firms have diminished. In spite of these changes, banks continue to maintain and perform their primary role—accepting deposits and lending funds from these deposits.

1.2 Need of the Banks

Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time the interest rates were very high. Again there were no security of public savings and no uniformity regarding loans. So as to overcome such problems the organized banking sector was established, which was fully regulated by the government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers. The following functions of the bank explain the need of the bank and its importance:

- To provide the security to the savings of customers.
- To control the supply of money and credit
- To encourage public confidence in the working of the financial system, increase savings speedily and efficiently.
- To avoid focus of financial powers in the hands of a few individuals and institutions.
- To set equal norms and conditions (i.e. rate of interest, period of lending etc) to all types of customers

1.3 History of Indian Banking System ^{[6] [7]}

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865, was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with head quarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to

form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935.

At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government's ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks were opened. The following are the major steps taken by the Government of India to Regulate Banking institutions in the country:-

- 1949 : Enactment of Banking Regulation Act.
- 1955 : Nationalisation of State Bank of India.
- 1959 : Nationalization of SBI subsidiaries.
- 1961 : Insurance cover extended to deposits.
- 1969 : Nationalisation of 14 major Banks.
- 1971 : Creation of credit guarantee corporation.
- 1975 : Creation of regional rural banks.
- 1980 : Nationalisation of seven banks with deposits over 200 Crores.

1.3.1 Nationalisation ^[3]

By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensued about the possibility to nationalise the banking industry. Indira Gandhi, the-then Prime Minister of India expressed the intention of the Government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled "*Stray thoughts on Bank Nationalisation*". The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalised the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayan, a national leader of India, described the step as a "*Masterstroke of political sagacity*". Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August, 1969.

A second step of nationalisation of 6 more commercial banks followed in 1980. The stated reason for the nationalisation was to give the government more control of credit delivery. With the second step of nationalisation, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19. After this, until the 1990s, the nationalised banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. The nationalised banks were credited by some; including Home minister P. Chidambaram, to have helped the Indian economy withstand the global financial crisis of 2007-2009.

1.3.2 Liberalisation ^[3]

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalisation, licensing a small number of private banks. These came to be known as *New Generation tech-savvy banks*, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of

Commerce, Axis Bank(earlier as UTI Bank), ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 49% with some restrictions.

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. Currently (2007), banking in India is generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate-and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.

In March 2006, the Reserve Bank of India allowed Warburg Pincus to increase its stake in Kotak Mahindra Bank (a private sector bank) to 10%. This is the first time an investor has been allowed to hold more than 5% in a private sector bank since the RBI announced norms in 2005 that any stake exceeding 5% in the private sector banks would need to be voted by them. In recent years critics have charged that the non-government owned banks are too aggressive in their loan recovery efforts in connection with housing, vehicle and

personal loans. There are press reports that the banks' loan recovery efforts have driven defaulting borrowers to suicide.

1.3.3 Government policy on banking industry (*Source:-The federal Reserve Act 1913 and The Banking Act 1933*)

Banks operating in most of the countries must contend with heavy regulations, rules enforced by Federal and State agencies to govern their operations, service offerings, and the manner in which they grow and expand their facilities to better serve the public. A banker works within the financial system to provide loans, accept deposits, and provide other services to their customers. They must do so within a climate of extensive regulation, designed primarily to protect the public interests.

The main reasons why the banks are heavily regulated are as follows:

- To protect the safety of the public's savings.
- To control the supply of money and credit in order to achieve a nation's broad economic goal.
- To ensure equal opportunity and fairness in the public's access to credit and other vital financial services.
- To promote public confidence in the financial system, so that savings are made speedily and efficiently.
- To avoid concentrations of financial power in the hands of a few individuals and institutions.
- Provide the Government with credit, tax revenues and other services.
- To help sectors of the economy that they have special credit needs for eg. Housing, small business and agricultural loans etc.

1.3.4 Law of banking ^[3]

Banking law is based on a contractual analysis of the relationship between the *bank* and *customer*—defined as any entity for which the bank agrees to conduct an account.

The law implies rights and obligations into this relationship as follows:

- The bank account balance is the financial position between the bank and the customer: when the account is in credit, the bank owes the balance to the customer; when the account is overdrawn, the customer owes the balance to the bank.
- The bank agrees to pay the customer's cheques up to the amount standing to the credit of the customer's account, plus any agreed overdraft limit.
- The bank may not pay from the customer's account without a mandate from the customer, e.g. cheques drawn by the customer.
- The bank agrees to promptly collect the cheques deposited to the customer's account as the customer's agent, and to credit the proceeds to the customer's account.
- The bank has a right to combine the customer's accounts, since each account is just an aspect of the same credit relationship.
- The bank has a lien on cheques deposited to the customer's account, to the extent that the customer is indebted to the bank.
- The bank must not disclose details of transactions through the customer's account—unless the customer consents, there is a public duty to disclose, the bank's interests require it, or the law demands it.
- The bank must not close a customer's account without reasonable notice, since cheques are outstanding in the ordinary course of business for several days.

These implied contractual terms may be modified by express agreement between the customer and the bank. The statutes and regulations in force within a particular jurisdiction may also modify the above terms and/or create new rights, obligations or limitations relevant to the bank-customer relationship.

1.3.5 Regulations for Indian banks ^[4]

Currently in most jurisdictions commercial banks are regulated by government entities and require a special bank license to operate. Usually the definition of the business of banking for the purposes of regulation is extended to include acceptance of deposits, even if they are not repayable to the customer's order—although money lending, by itself, is generally not included in the definition.

Unlike most other regulated industries, the regulator is typically also a participant in the market, i.e. a government-owned (central) bank. Central banks also typically have a monopoly on the business of issuing banknotes. However, in some countries this is not the case. In UK, for example, the Financial Services Authority licenses banks, and some commercial banks (such as the Bank of Scotland) issue their own banknotes in addition to those issued by the Bank of England, the UK government's central bank.

Some types of financial institutions, such as building societies and credit unions, may be partly or wholly exempted from bank license requirements, and therefore regulated under separate rules. The requirements for the issue of a bank license vary between jurisdictions but typically include:

- Minimum capital
- Minimum capital ratio
- 'Fit and Proper' requirements for the bank's controllers, owners, directors, and/or senior officers
- Approval of the bank's business plan as being sufficiently prudent and plausible.

1.4 Classification of Banking Industry in India ^{[1] [2] [9] [13]}

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc). The

unorganized sector, which is not homogeneous, is largely made up of money lenders and indigenous bankers.

An outline of the Indian Banking structure may be presented as follows:-

1. Reserve banks of India.
2. Indian Scheduled Commercial Banks.
 - a) State Bank of India and its associate banks.
 - b) Twenty nationalized banks.
 - c) Regional rural banks.
 - d) Other scheduled commercial banks.
3. Foreign Banks
4. Non-scheduled banks.
5. Co-operative banks.

1.4.1 Reserve bank of India

The reserve bank of India is a central bank and was established in April 1, 1935 in accordance with the provisions of reserve bank of India act 1934. The central office of RBI is located at Mumbai since inception. Though originally the reserve bank of India was privately owned, since nationalization in 1949, RBI is fully owned by the Government of India. It was inaugurated with share capital of Rs. 5 Crores divided into shares of Rs. 100 each fully paid up.

RBI is governed by a central board (headed by a governor) appointed by the central government of India. RBI has 22 regional offices across India. The 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 Governmental 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 the four nominated director by the Central Government to represent the four local boards with the headquarters at Mumbai, Kolkata, Chennai and

New Delhi. Local Board consists 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 RBI Act 1934 was commenced on April 1, 1935. The Act, 1934 provides the statutory basis of the functioning of the bank. The bank was constituted for the need of following:

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

Functions of RBI as a central bank of India are explained briefly as follows:

Bank of Issue: The RBI formulates, implements, and monitors the monetary policy. Its main objective is maintaining price stability and ensuring adequate flow of credit to productive sector.

Regulator-Supervisor of the financial system: RBI prescribes broad parameters of banking operations within which the country's banking and financial system functions. Their main objective is to maintain public confidence in the system, protect depositor's interest and provide cost effective banking services to the public.

Manager of exchange control: The manager of exchange control department manages the foreign exchange, according to the foreign exchange management act, 1999. The manager's main objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

Issuer of currency: A person who works as an issuer, issues and exchanges or destroys the currency and coins that are not fit for circulation. His main objective is to give the public adequate quantity of supplies of currency notes and coins and in good quality.

Developmental role: The RBI performs the wide range of promotional functions to support national objectives such as contests, coupons maintaining good public relations and many more.

Related functions: There are also some of the related functions to the above mentioned main functions. They are such as, banker to the government, banker to banks etc....

- Banker to government performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks maintains banking accounts to all scheduled banks.

Controller of Credit: RBI performs the following tasks:

- It holds the cash reserves of all the scheduled banks.
- It controls the credit operations of banks through quantitative and qualitative controls.
- It controls the banking system through the system of licensing, inspection and calling for information.
- It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

Supervisory Functions: In addition to its traditional central banking functions, the Reserve Bank performs 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 nationalisation 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 realisation 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.

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.

1.4.2 Indian Scheduled Commercial Banks

The commercial banking structure in India consists of scheduled commercial banks, and unscheduled banks.

Scheduled Banks: Scheduled Banks in India constitute those banks which have been included in the second schedule of RBI act 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42(6a) of the Act. "Scheduled banks in India" means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the State Bank of India (subsidiary banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve bank of India Act, 1934 (2 of 1934), but does not include a co-operative bank". For the purpose of assessment of performance of banks, the Reserve Bank of India categories those banks as public sector banks, old private sector banks, new private sector banks and foreign banks, i.e. private sector, public sector, and foreign banks come under the umbrella of scheduled commercial banks.

Regional Rural Bank: The government of India set up Regional Rural Banks (RRBs) on October 2, 1975 ^[10]. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs. Initially, five RRBs were set up on October 2, 1975 which was sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank of India. The total authorized capital was fixed at Rs. 1 Crore which has since been raised to Rs. 5 Crores. There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio, lower statutory liquidity ratio, lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training. The RRBs are under the control of NABARD. NABARD has the responsibility of laying down the policies for the RRBs, to oversee their operations, provide refinance facilities, to monitor their performance and to attend their problems.

Unscheduled Banks: “Unscheduled Bank in India” means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank”.

1.4.3 NABARD

NABARD is an apex development bank with an authorization for facilitating credit flow for promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts. It also has the mandate to support all other allied economic activities in rural areas, promote integrated and sustainable rural development and secure prosperity of rural areas. In discharging its role as a facilitator for rural prosperity, NABARD is entrusted with:

1. Providing refinance to lending institutions in rural areas
2. Bringing about or promoting institutions development and
3. Evaluating, monitoring and inspecting the client banks

Besides this fundamental role, NABARD also:

- Act as a coordinator in the operations of rural credit institutions
- To help sectors of the economy that they have special credit needs for eg. Housing, small business and agricultural loans etc.

1.4.4 Co-operative Banks ^[10]

Co-operative banks are explained in detail in Section – II of this chapter

1.5 Services provided by banking organizations ^[2]

Banking Regulation Act in India, 1949 defines banking as “Accepting” for the purpose of lending or investment of deposits of money from the public, repayable on demand and withdrawable by cheques, drafts, orders etc. as per the above definition a bank essentially performs the following functions:-

- Accepting Deposits or savings functions from customers or public by providing bank account, current account, fixed deposit account, recurring accounts etc.
- The payment transactions like lending money to the public. Bank provides an effective credit delivery system for loanable transactions.
- Provide the facility of transferring of money from one place to another place. For performing this operation, bank issues demand drafts, banker’s cheques, money orders etc. for transferring the money. Bank also provides the facility of Telegraphic transfer or tele- cash orders for quick transfer of money.
- A bank performs a trustworthy business for various purposes.
- A bank also provides the safe custody facility to the money and valuables of the general public. Bank offers various types of deposit schemes for security of money. For keeping valuables bank provides locker facility. The lockers are small compartments with dual locking system built into strong cupboards. These are stored in the bank’s strong room and are fully secured.
- Banks act on behalf of the Govt. to accept its tax and non-tax receipt. Most of the government disbursements like pension payments and tax refunds also take place through banks.

There are several types of banks, which differ in the number of services they provide and the clientele (Customers) they serve. Although some of the differences between these types of banks have lessened as they have begun to expand the range of products and services they offer, there are still key distinguishing traits. These banks are as follows:

Commercial banks, which dominate this industry, offer a full range of services for individuals, businesses, and governments. These banks come in a wide range of sizes, from large global banks to regional and community banks.

Global banks are involved in international lending and foreign currency trading, in addition to the more typical banking services.

Regional banks have numerous branches and automated teller machine (ATM) locations throughout a multi-state area that provide banking services to individuals. Banks have become more oriented toward marketing and sales. As a result, employees need to know about all types of products and services offered by banks.

Community banks are based locally and offer more personal attention, which many individuals and small businesses prefer. In recent years, online banks—which provide all services entirely over the Internet—have entered the market, with some success. However, many traditional banks have also expanded to offer online banking, and some formerly Internet-only banks are opting to open branches.

Savings banks and **savings and loan associations**, sometimes called thrift institutions, are the second largest group of depository institutions. They were first established as community-based institutions to finance mortgages for people to buy homes and still cater mostly to the savings and lending needs of individuals.

Credit unions are another kind of depository institution. Most credit unions are formed by people with a common bond, such as those who work for the same company or belong to the same labour union or church. Members pool their savings and, when they need money, they may borrow from the credit union, often at a lower interest rate than that demanded by other financial institutions.

Federal Reserve banks are Government agencies that perform many financial services for the Government. Their chief responsibilities are to regulate the banking industry and to help implement our Nation's monetary policy so our economy can run more efficiently

by controlling the Nation's money supply—the total quantity of money in the country, including cash and bank deposits. For example, during slower periods of economic activity, the Federal Reserve may purchase government securities from commercial banks, giving them more money to lend, thus expanding the economy. Federal Reserve banks also perform a variety of services for other banks. For example, they may make emergency loans to banks that are short of cash, and clear checks that are drawn and paid out by different banks.

The money banks lend, comes primarily from deposits in checking and savings accounts, certificates of deposit, money market accounts, and other deposit accounts that consumers and businesses set up with the bank. These deposits often earn interest for their owners, and accounts that offer checking, provide owners with an easy method for making payments safely without using cash. Deposits in many banks are insured by the Federal Deposit Insurance Corporation, which guarantees that depositors will get their money back, up to a stated limit, if a bank should fail.