CHAPTER II

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The powers of the Reserve Bank over the commercial banks are derived in a large measure from the Banking Regulation Act, 1949 as well as from the Reserve Bank of India Act, 1934. This chapter deals with the main provisions of the above said two Acts in so far as they pertain to the operations of the Commercial banks in general and foreign banks in particular.¹

The development of an adequate and sound banking system for meeting the needs of trade, commerce, industry and agriculture is one of the most important responsibilities of the Reserve Bank of India. Under the Reserve Bank Act of 1934 and the Banking Regulation Act, 1949, the Reserve Bank has extensive powers of supervision and control over commercial as well as co-operative banks. The powers of the Reserve Bank extend to calling for information from and giving directions to even non-banking institutions receiving deposits from the public.

There was no separate, comprehensive banking law covering the entire banking system before the passing of the Banking Regulation Act of 1949. Prior to the passing of the above mentioned Act, banking companies along with other companies were governed by the Indian Companies Act of 1913, which contained a few provisions specially applicable to banks and a few ad hoc enactments such as the Banking Companies Ordinance (Inspection)

¹ The Reserve Bank of India Act, 1934,
The Banking Regulation Act 1949,
The Reserve Bank of India "Functions and Working", 1970.
1946 and the Banking Companies (Restriction of Branches) Act, 1946 covering particular regulatory aspects. These half-hearted, piecemeal efforts were of no avail. Undesirable features in the Indian banking began assuming serious, alarming proportions. On the one hand there were bank failures and on the other indiscriminate expansion of banks. Mismanagement and malpractices had reached such a level that the Government was constrained to enact a new legislation in 1949, known as the Banking Companies Act. The name was later changed in 1966 to Banking Regulation Act. The Banking Regulation Act was amended in 1950, 1953, 1956, 1959, 1963, 1965 and 1969 to enlarge and amplify the powers and responsibilities of the Reserve Bank of India and to impart flexibility to the relative provisions.

The Reserve Bank regulates the banking business in India right from the establishment of banks to their final liquidation. It has the sole authority to issue licences, permit branch expansion, limit liquidity of their assets, amalgamation, reconstruction and to instruct about methods of working of banks. Complete control over the banks in India is exercised by the Reserve Bank through periodic inspections conducted by its own staff and by calling for returns and other necessary information from the banks.

The objectives of the Banking Regulation Act are:

(i) elimination of objectionable features in the working of commercial banks;

(ii) ensuring observance by them of sound banking practices; and
(iii) promotion and development of commercial banking on sound and healthy lines.²

**BANKING DEFINED:**

Although very many writers have tried to define 'banking', a clear, precise and comprehensive definition is neither available nor possible. It has been aptly remarked that a banker is easier to recognize than define.³

The Banking Regulation Act, 1969 has defined 'banking' and 'banking company' under Section 5 (b) and (c). Section 5 (b) reads "'banking' means the 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.

Section 5 (c) reads - 'banking company' means any company which transacts the business of banking (in India)."

The essential characteristics of banking business are, therefore, (1) accepting deposits from the public, (2) deposits may be repayable on demand or on the expiry of a specified date, (3) withdrawal may be cheque or by any other means agreed to by the bank and the depositor, and lastly (4) the deposits are accepted for the purpose of lending or investment.

In other words, the combination of trading with banking, which was the bane of banking in India in the earlier period,


3. Ibid., p. 187.
is prohibited.

While Section 5 (b) deals with the primary functions of a bank, Section 6 enables the bank to undertake other business also.

Section 6 (1) In addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely:-

(a) the borrowing, raising, or taking up of money, the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promisory notes, coupons, drafts, bills of lading and railway receipts, warrants, debentures, certificates, scripts and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scripts or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scripts or valuable on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) acting as agents for any Government or local authority or
any other persons or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a (managing agent or secretary and treasurer) of a company;

(e) contracting for public and private loans and negotiating and issuing the same;

(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of any shares, stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

(e) carrying on and transacting every kind of guarantee and indemnity business;

(f) managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) acquiring and holding and generally dealing with any property or any right, type or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) undertaking and executing trusts;

(i) undertaking the administration of estates as executor, trustee or otherwise;
(j) establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowance and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purpose of the company;

(l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(m) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this subsection;

(n) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Section 6 (2) No banking company shall engage in any form of business other than those referred to in sub-section (l).

Section 6 is reinforced by Section 8 which prohibits banks from engaging in trading activities, except in realisation
of the security given to or held by it, or in connection with bills of exchange received for collection or negotiation.

To prevent a possible misuse by the unscrupulous of the provisions of Section 6, Section 9 lays down that immovable property held by a bank, other than that needed for its own use, has to be ordinarily disposed of within seven years from the date of acquisition unless further extension (upto a maximum period of five years) is given by the Reserve Bank under the second proviso to Section 9.

As a further safeguard against the misuse of the provisions of Section 6, Section 19 has been added which provides that a banking company cannot form any subsidiary company except for the purpose of undertaking and executing of trusts, administration of estate as executor, trustee or otherwise and providing of safe deposit vaults. A banking company can, however, with the previous permission of the Reserve Bank form a subsidiary company for carrying on the business of banking exclusively outside India or for such other purposes as are incidental to the business of banking. Similarly, under the same Section a bank can not hold shares in any company, whether as a pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or of its own paid-up share capital and reserves, whichever is less.

These provisions are intended to prevent banking companies from acquiring a controlling interest, financial or otherwise, thereby carrying on business other than that of banking through
such a company.

**Licensing of Banks:**

Before the Banking Regulation Act was enacted there was no restriction on the opening of new banks. The net result was the coming into existence of a large number of mushroom banks. To put an end to the indiscriminate growth of banks, provision for the licensing of both old and new banks has been made.

Every bank wishing to commence banking in India is required in terms of Section 22 of the Banking Regulation Act, to obtain a licence from the Reserve Bank. Banks in existence at the time the Act came into force have to apply to the Reserve Bank for a licence within six months from the commencement of the Act. All existing banks were allowed to continue to carry on banking business till they were either granted a licence or they were informed in writing by the Reserve Bank that they had been refused a licence in which case they would have to cease doing banking business. No existing bank could be refused a licence by the Reserve Bank within a period of 3 years from the commencement of the Act. This means that the existing banks were given a 3 year grace period to set their house in order.

The obtaining of a licence was intended to ensure the continuance and growth only of banks which were established and were operating on sound lines and to prevent indiscriminate flotation of banking companies. Before the grant of a licence, the Reserve Bank generally satisfies itself by an inspection of the bank’s books and accounts and method of operation, that
the bank is or will be in a position to pay its present or future depositors in full as their claims accrue, and that its affairs are not being or are not likely to be conducted in a manner detrimental to the interests of its present or future depositors. Additional requirements in the case of foreign banks are that the carrying on of banking business by them in India is in the public interest and that the law or the Government of the country of incorporation does not discriminate in any way against banks incorporated in India.

The Reserve Bank generally takes into consideration various factors like the capital base and reserves, the earning capacity of the bank, the policies followed for the management of banks funds, the efficiency of the bank's managerial staff etc., before arriving at a decision whether a particular bank is carrying on its affairs in a satisfactory manner. The condition applicable to foreign banks alone regarding public interest was included in the Section by the Banking Companies Amendment Act of 1962. This provision enables the Reserve Bank to refuse a licence already granted to a bank incorporated outside India if it feels that the functioning of such a bank would not be in the public interest. Before this amendment in 1962 the Reserve Bank could not legally cancel the licence so long as the foreign bank was in a position to pay its depositors and so long as it was carrying on its affairs in a manner not detrimental to the interests of its depositors. After the above mentioned amendment, the Reserve Bank can cancel the licence of any particular foreign bank on the ground that the continuance of banking business in India by the concerned foreign bank was
not in public interest.

The method adopted by the Reserve Bank in the matter of granting licences to banks is that after inspection, they are informed about their defective features if any observed in their working and are asked to take remedial steps. Reports are called for by the Reserve Bank to watch their progress in rectifying the defects specially when those defects are due to ignorance of sound banking principles. If the periodic reports prove an improvement in their working, licences are generally issued. It is only in exceptional cases of bank's failure to show improvements in their management and methods of working, even after giving ample time, is a licence refused or it is cancelled where it has already been granted. The licences of banks are cancelled automatically in case they have transferred their assets and liabilities to other banks due to amalgamation, voluntary or otherwise or when they have ceased to carry on banking business in India, so that they are debarred legally from accepting deposits in India.

**OPENING OF NEW BRANCHES:**

Banks intending to open new branches have to obtain the prior permission of the Reserve Bank of India. According to Section 23 of the Banking Regulation Act, banks are required to obtain permission from the Reserve Bank for opening new places of business either in India or abroad.

During and immediately after the Second World War there was an indiscriminate increase in the growth of branch banking
which tended to accentuate the concentration of banking offices in urban centres leaving large areas of the country either unbanked or banked inadequately.

Under the same Section even a change in the location of an already existing branch needs prior permission from the Reserve Bank. Similarly for opening of temporary offices also sanction from the Reserve Bank has to be obtained.

Permission to open new branches is granted on the Reserve Bank being satisfied that the financial condition and management of the applicant bank are sound, that its capital structure is sufficiently adequate, that there are prospects for the new branch to earn profits and finally that the opening of the new branch would serve public interest.

Till 1962 there was no positive branch licensing policy. But in 1962 a new procedure was adopted by the Reserve Bank of India for the extension of banking facilities to all places in the country in a planned and systematic manner, especially to areas which were deficient in or devoid of such facilities. An attempt was made to co-ordinate the individual programmes of banks for branch expansion and weave them into integrated pattern. The spheres of influence of different banks were demarcated so that the bigger all-India banks would not crowd out the smaller but financially sound banks. The Indian banks, excluding the State Bank and its subsidiaries, were advised to secure (by a circular issued in July 1962) the Reserve Bank's approval in advance in the matter of their respective programmes for a period of three years. A list showing the unbanked towns in India was
supplied to banks so that they can draw up a programme of branch expansion to serve unbanked towns and rural areas. With the nationalisation of 14 Indian banks the branch expansion received a big boost. The 'Lead Bank' scheme was introduced, making the 'Lead Bank' responsible for taking the lead in surveying the potential for banking development, in extending branch banking and in expanding credit facilities.

There is no general restriction as such on the opening of new offices in the country by a foreign bank, except the provision contained in Section 22 of the Banking Regulation Act that the Government or the law of the country in which it is incorporated should not discriminate in any way against the banking companies registered in India. Due weightage is given to certain specialised services, which, because of their global affiliations, these foreign banks can render to the export-import trade or in providing a meeting ground for Indian and foreign businessmen for facilitating business collaboration or for arranging for loans in foreign countries to Indian concerns. It is in this context, among other relevant factors, that the Reserve Bank considers the requests of foreign banks to open new offices on a limited scale and that too generally in port towns.4

**CAPITAL, RESERVES AND LIQUID ASSETS:**

To see that banks are organised and operated on sound financial lines, Sections 11, 17, 18 and 24 of the Banking Regulation Act have prescribed minimum requirements of paid-up capital

4. Reserve Bank of India - Functions and Working, p. 79
and reserves, cash reserves and other liquid assets. According to the geographical coverage of a bank's operations, the minimum paid-up capital and reserves vary as per Section 11 of the Act. An Indian bank commencing business after the coming into effect of the Banking Companies (Amendment) Act, 1962, the minimum requirement is 5 lakhs of Rupees in case the bank has offices in more than one state or any such office is at Bombay or Calcutta. For banks incorporated before 1962, the minimum varies between Rs. 50000 and Rs. 10 lakhs.

As far as foreign banks are concerned as per Section 11 clause (2), in the case of a banking company incorporated outside India -

(a) the aggregate value of its paid-up capital and reserves shall not be less than 15 lakhs of rupees and if it has a place or places of business in the city of Bombay or Calcutta or both, twenty lakhs of rupees; and

(b) (the banking company shall deposit and keep deposited with the Reserve Bank either in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities.

(i) an amount which shall not be less than the minimum required by clause (a); and

(ii) as soon as may be after the expiration of each calendar year, an amount calculated at twenty percent of its profit for that year in respect of all business transacted through its branches in India, as disclosed in the profit and loss account prepared with reference to that year under Section 29).
"For obvious reasons, a foreign bank cannot have its 'share capital' in India and the Act stipulates that every foreign bank should deposit the required minimum amount either of Rs. 15 lakhs or Rs. 20 lakhs and keep it deposited with the Reserve Bank either in cash or in approved securities. The Act also provides that the foreign bank should keep 20 percent of their annual profits with the Reserve Bank as an additional deposit. In other words, the deposits towards minimum requirement regarding paid-up capital and reserves rises every year to the extent of 20 percent of the annual profits of the foreign banks concerned. The Act, however, empowers the Central Government to allow exemption to a foreign bank for a specified period from the requirement in respect of additional deposit."

Under Section 17 of the Act, banks are required to build up reserves by transferring thereto sums not less than 20 percent of their annual profits. All scheduled banks are to maintain minimum balances with the Reserve Bank. Even non-scheduled banks are, under Section 18 of the Act, to maintain a minimum holding of cash equivalent to 3 percent of their total demand and time liabilities. Under Section 24 of the Act, banks both scheduled and non-scheduled have to maintain in India (in addition to the minimum of cash balances under Section 18) cash, gold or unencumbered approved securities at the close of business on any day of an amount not less than 25 percent of their total demand and time liabilities in India. Under Section 25 of the Act, banks are required to maintain in India as at the last Friday

5. Vaswani, T.A. op. cit., p. 197
of each quarter, assets which are not less than 75 percent of their demand and time liabilities in India. This Section is intended to make sure that the resources raised in India are largely invested in this country itself, especially so, in the case of foreign banks.

**INSPECTION OF BANKS**

A very powerful weapon in the hands of the Reserve Bank of India is the right to inspect banks as and when it likes. Although Reserve Bank used to inspect banks in consultation with the Government of India and with the prior consent of the banking companies concerned, they were in fact carried out with a very limited objective only. The object was to decide about the eligibility or otherwise of a particular bank to be included in the Second Schedule of the Reserve Bank Act.

But under the Banking Regulation Act, the Reserve Bank has statutory powers to carry out inspections of any bank, its books and accounts, at such interval as it may consider appropriate and for such purposes as it may choose to do. Statutory inspection of banking companies by the Reserve Bank is very significant from the point of view of proper and scientific management of banks on sound financial lines. According to Section 35 of the Banking Regulation Act, the Reserve Bank can, at any time, cause an inspection to be carried out by its officers of any bank in India and its books and accounts. In particular the Reserve Bank is empowered to inspect, make an enquiry or determine the position in respect of matters specified under various Sections of the Act, e.g. to satisfy itself
regarding the adequacy of capital in terms of Section 11 of the Act, eligibility for licences (Section 22), opening of branches (Section 23), amalgamation (Section 44 A), suspension of business and compromise or arrangement with creditors (Sections 37, 44 B and 45) or compliance with any directions issued by the Reserve Bank under Section 21.

The fundamental objective of bank inspections is the maintenance of a sound banking system with its constituent units operating under proper management, in conformity with the bank laws and regulations of the country and public and national interest. In the course of inspection, the Reserve Bank examines a bank's affairs with particular reference to the methods of operation, its investments and lending policies, the state of assets, the quality of management, the extent to which it has complied with the various statutory provisions. Periodic inspection is conducted by the Reserve Bank. An element of surprise also is introduced. The inspections now cover a large number of branches and are more thorough and detailed in their scope, so as to include measures taken by banks for providing increased finance to agriculture, small scale industries and the export sector and in the field of deposit mobilisation. Action in regard to the working of banks is normally taken after their management have had an opportunity to represent their viewpoints in regard to the various aspects covered by the inspection. On the basis of the findings of the inspection, necessary steps are taken by the Reserve Bank to bring about the desired degree of improvement in the position and working of banks or changes in the management of the bank concerned. In cases where the
findings of the inspection call for a stricter control over the affairs of the concerned banks, suitable directions, which are mandatory (Section 35 A of the Banking Regulation Act), are issued to them by the Reserve Bank. 6

In certain cases, the banks are advised to appoint advisers to help them place their affairs on a sound basis. Where necessary, the Reserve Bank deputes its own officers for the same purpose. Where the affairs of a bank are found to be beyond redemption the Reserve Bank may even cancel its licence or apply to the High Court for winding up the bank. The system of inspection, sometimes without prior notice, has proved very useful as a corrective to unsound banking methods and practices and has toned up the standards of management.

CONTROL OVER MANAGEMENT:

Bank failures in the past have been mainly due to inefficiency, unsound policies pursued and sometimes outright corruption on the part of management. Provisions, therefore, have been inserted in the Banking Regulation Act to make sure that banks are under proper management. According to Section 10 of the Act, no bank can employ or be managed by a managing agent. Similarly a bank can not employ a person who has been adjudicated insolvent, or has been convicted by a criminal court of an offence involving moral turpitude. Also a bank cannot employ any person whose remuneration takes the form of commission, or of a share in the profits of the company or is, in the opinion of the Reserve Bank, excessive. Moreover a

bank cannot be managed by a person who is a director of another company or is engaged in any other business or vocation. The bank manager's term of office is restricted to five years at a time. Under Section 16 of the Act a bank cannot have as a director any person who is a director of any other bank or of companies having in the aggregate voting rights in excess of 20 percent of the total voting rights of all the share holders of the bank. With effect from February 1, 1969, under Section 10 A a minimum of 51 percent of the total number of members of the Board of Directors of a bank has to consist of persons who have special knowledge of or practical experience in one or more of matters like banking, co-operation, economics, agriculture and rural economy, finance, law, small scale industry etc. Similarly under Section 10 B, every bank is to have a whole time chairman who is not an industrialist but a professional banker and his term of office is not to exceed five years at a time.

To cap it all, under Sections 10 A, 10 B, 36 B, 36 AA and 36 AB, the Reserve Bank is vested with powers of appointment, removal or termination of the services of not only the chairman of the board of directors of a bank, but also any director, chief executive officer, or any other officer or employee of a bank. In the exercise of these powers the Reserve Bank takes into consideration not only the interest of the bank or its depositors but also the interest of banking policy and public interest.
CONTROL ON BANKING OPERATIONS:

Strict control is exercised by the Reserve Bank for ensuring that the banks do not fritter away funds in improper investments and injudicious advances. Specifically, Section 8 of the Act prohibits banks from engaging in trading activities, except in realization of the security given to or held by it, or in connection with bills of exchange received for collection or negotiation. Similarly, immovable property held by a bank, other than that needed for its own use, has to be ordinarily disposed of within seven years from the date of acquisition unless further extension (up to a maximum period of five years) is given by the Reserve Bank under Section 9 of the Act. Moreover, under Section 19, a bank cannot hold shares in any company, whether as a pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or of its own paid-up share capital and reserves, whichever is less. Again, under Section 20 of the Act, a bank cannot grant any loan or advance on the security of its own shares or enter into commitment for granting any loan or advance to or on behalf of any of its directors, firms and companies in which the directors are interested and individuals with whom they are connected as partners or guarantors.

All these Sections mentioned above have already been dealt with in the earlier part of this chapter and are more or less negative in nature. But Section 21, which is a very important provision, gives the Reserve Bank the power to regulate and direct the lending policies of banks. Section 21 reads as follows -
21 (1) Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest or in the interest of depositors so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy so determined.

(2) Without prejudice to the generality of the power vested in the Reserve Bank under sub-Section (1), the Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to -

(a) the purpose for which advances may or may not be made,
(b) the margins to be maintained in respect of secured advances,
(c) the maximum amount of advances or other financial accommodation which, having regard to the paid-up capital, reserves and deposits of a banking company and other relevant considerations, may be made by that banking company to any one company, firm, association of persons or individual,
(d) the maximum amount upto which, having regard to the considerations referred to in clause (c), guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual, and
(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.

(3) Every banking company shall be bound to comply with any
directions given to it under this Section.

It will thus be seen that the Reserve Bank has been vested with ample powers to control the lending operations of banks. In point of fact the Reserve Bank has used these powers very frequently.

Moreover, the Reserve Bank has, under Section 35 A, power to give directions to banking companies generally or any banking company in particular when it is satisfied that directions are to be issued in the public interest, in the interest of banking policy or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company or to secure the proper management of the banking company. Further under Section 36 sub-Section (1) clause (a) of the same Act, the Reserve Bank may caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions.

Thus the Reserve Bank has wide ranging powers over the banks in India. These powers include every aspect of banking like capital structure, management or lending policy. It has used these powers to meet the needs of a complex and varying economic situation. In recent years, particularly after nationalisation, the control and regulation of the banking business by the Reserve Bank of India have become more effective.