3.1 MILIEU OF BANKING PRACTICES IN INDIA:

Banking industry is considered as one of the oldest industries of the world. The first record of banking activity can be traced way back in 2000 BC in Assyria and Babylonia when merchants of ancient world made loans to farmers and traders that carried goods. The word ‘Bank’ came from French word *banque*, from Old Italian *banca*, from Old High German *banc*. It is said that benches were used as desks or exchange counters during the Renaissance by the Florentine bankers.

The 18th century saw the dawn of banking in the Indian sub-continent. The first banks were the General Bank of India, which started in 1786 and Bank of Hindustan, which started in 1790; which are currently non-existent. The East India Company in order to gain more power started raising funds and thus on 2nd June 1806 promoted the Bank of Calcutta. Later on the two other banks Bank of Bombay and Bank of Madras started its operation on 15th April, 1840 and 1st July, 1843 respectively. For many years the Presidency banks acted as quasi-central banks and so did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which became the State Bank of India in 1955 after India got its independence.

Foreign banks too started its operation particularly in Calcutta, in the 1860’s as it was the most active trading port in India, mainly due to the trade of the British Empire and hence became a banking center. The Comptoire d'Escompte de Paris opened a branch in Calcutta in 1860 and another in Bombay in 1862; henceforth branches in Madras, Pondicherry and then a French colony followed. HSBC established itself in Bengal way back in 1869. The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in Faizabad and operated till 1958. The other bank was the Punjab National Bank, established in Lahore in 1895, which is presently one of the largest nationalised banks in India.
The period between 1906 and 1911, witnessed the establishment of banks inspired by the Swadeshi movement. The Swadeshi movement motivated the local businessmen as well as political figures to establish banks of and for the Indian community. A number of banks that was created during that era and still in operation are Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. However, during the First World War (1914–1918) through the end of the Second World War (1939–1945), until the nation’s independence was a challenging period for the Indian banking sector.

3.1.1 ERA OF NATIONALISATION:

The banks in India except State Bank of India were in the hands of private persons despite of control and regulations of Reserve Bank of India. By 1960’s, the Indian banking industry had become an important tool to facilitate the development of the economy. At the same time, it had emerged as a large employer and a debate had started about the nationalization of the banking industry. The Government of India issued an ordinance and nationalised the 14 largest commercial banks with effect from 19th July, 1969 and the second phase of nationalization of 6 more commercial banks followed in the year 1980, controlling around 91% of the banking business of India. The main reason for nationalization was to give the government more control of credit delivery. Later in 1993, the government merged New Bank of India with Punjab National Bank and resulted in the reduction of the number of nationalised banks from 20 to 19.
3.1.2 LIBERALISATION PERIOD:

In the early 1990’s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks which included Global Trust Bank which was 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 step ahead along with the rapid growth in the economy revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, viz; government banks, private banks and foreign banks.

The next stage for the Indian banking has been set up 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 capital of 10%, at present it has gone up to 74% with some restrictions.

Private bank entry was restricted after nationalization, to prevent unfair competition, urban concentration and lending to rich and well known firms. This resulted in elimination of competition among public sector banks as well as reduction in the efficiency of performance and decline in the quality of customer service. Soon after nationalization, commercial banks were asked to cater the needs of priority sector. Opening of the economy, liberalization, privatization, deregulation and globalization have virtually led to the creation of a global village where in banking companies, for their survival, need to focus on cost, speed and quality of service to face intense competition and enormous challenges. As a result of liberalization the cut-throat competition among the public, private and foreign players in the areas of customer services, cost of funds, technological innovations, internal controls,
motivation of staff and risk and assets management increased manifold. The RBI has strengthened its supervisory machinery and at the same time ensured that enough freedom is given to the banks to operate within the prescribed rules and regulations.

In the recent time, it has been witnessed that the world economy is going through several complex circumstances as bankruptcy of banking and financial institutions, debt crisis in major economies of the world along with euro zone crisis. These poses some serious questions about the survival, growth and maintaining the sustainable development globally. However, amidst all this turmoil India’s banking industry has been amongst the few to maintain its resilience. The tempo of development for the Indian banking industry has been remarkable over the past decade. It is apparent from the higher pace of credit expansion; expanding profitability and productivity similar to banks in developed markets, lower incidence of non-performing assets and focus on financial inclusion have contributed in creating the Indian banking system vibrant and strong. Indian banks have initiated revising their growth approach and re-evaluate the prospects on hand to keep the economy rolling.

3.2 BANKING STRUCTURE IN INDIA:

Indian Banking Industry is functioning under the sunshade of Reserve Bank of India, the regulatory Central Bank of the country. A banking company could be a public sector bank, private sector bank, foreign bank or co-operative bank and the first three types of banks are called ‘commercial’ banks. Commercial banks can be divided into certain distinct categories depending on their method of establishment and pattern of ownership, namely public sector banks, i.e. (State Bank of India, its 7 associate banks and 19 nationalised banks); ‘old’ private sector banks i.e. those which were in
existence before the guidelines for floating new private banks were issued in 1993; ‘new’ private sector banks, foreign banks, and Regional Rural banks (RRBs).

The commercial banking structure in India consists of: Schedule Commercial Banks and Unscheduled Banks. Schedule Commercial Banks are those banks which are included in the Second Schedule of the Reserve Bank of India (RBI) Act, 1934. Reserve Bank includes only those banks under the second schedule which fulfils the criteria under section 42(60) of the Act. Banks under the second schedule enjoys some benefits by the RBI especially during the liquidity crises but they had to strictly follow the conditions and obligations laid down by the RBI. 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, 1970 (5 of 1970), or 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).

In public sector banks the majority stake is held by the Government of India and it together make up the largest category in the Indian banking system. These banks are playing a pivotal role especially in the rural areas where the numbers of public sector bank branches are significantly more in comparison to the private sector and foreign banks. Conversely, in private sector banks, the majority of share capital is held by the private individuals and corporate. All private sector banks were not nationalized in 1969 and 1980. The private banks which were not nationalized are collectively known as the old private sector banks and include banks such as the Jammu and Kashmir Bank Ltd., City Union Bank Ltd., ING Vysya Bank Ltd. etc.
Figure 3.2.1: Indian Banking System (Commercial Banks only)

Source: Varshney (1999) and Gupta et al. (2012)

Table 3.2.2: Different commercial banks operating in India

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>NATIONALISED BANKS (AS PER IBA)</th>
<th>PRIVATE SECTOR BANKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Allahabad Bank</td>
<td>City Union Bank Ltd.</td>
</tr>
<tr>
<td>2</td>
<td>Andhra Bank</td>
<td>ING Vysya Bank Ltd.</td>
</tr>
<tr>
<td>3</td>
<td>Bank of Baroda</td>
<td>SBI Commercial &amp; International Bank Ltd.</td>
</tr>
<tr>
<td>4</td>
<td>Bank of India</td>
<td>Tamilnad Mercantile Bank Ltd.</td>
</tr>
<tr>
<td>5</td>
<td>Bank of Maharashtra</td>
<td>Bank of Rajasthan Ltd.</td>
</tr>
<tr>
<td>6</td>
<td>Canara Bank</td>
<td>Catholic Syrian Bank Ltd.</td>
</tr>
<tr>
<td>7</td>
<td>Central Bank of India</td>
<td>Dhanalakshmi Bank Ltd.</td>
</tr>
<tr>
<td>8</td>
<td>Corporation Bank</td>
<td>Federal Bank Ltd.</td>
</tr>
<tr>
<td>9</td>
<td>Dena Bank</td>
<td>Jammu &amp; Kashmir Bank Ltd.</td>
</tr>
<tr>
<td>10</td>
<td>Indian Bank</td>
<td>Karnataka Bank Ltd.</td>
</tr>
<tr>
<td>11</td>
<td>Indian Overseas Bank</td>
<td>Karur Vysya Bank Ltd.</td>
</tr>
<tr>
<td>12</td>
<td>Oriental Bank of</td>
<td>Lakshmi Vilas Bank Ltd.</td>
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</tr>
<tr>
<td>Commerce</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Punjab &amp; Sind Bank</td>
<td>Nainital Bank Ltd.</td>
</tr>
<tr>
<td>14</td>
<td>Punjab National Bank</td>
<td>Ratnakar Bank Ltd.</td>
</tr>
<tr>
<td>15</td>
<td>Syndicate Bank</td>
<td>South Indian Bank Ltd.</td>
</tr>
<tr>
<td>16</td>
<td>UCO Bank</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Union Bank of India</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>United Bank of India</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Vijaya Bank</td>
<td></td>
</tr>
<tr>
<td></td>
<td>TOTAL OF 19 NATIONALISED BANKS</td>
<td>TOTAL OF 15 PVT BANKS [I]</td>
</tr>
<tr>
<td>II</td>
<td>State Bank of India (SBI)</td>
<td>NEW PRIVATE SECTOR BANKS</td>
</tr>
<tr>
<td>III</td>
<td>ASSOCIATES OF SBI</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>State Bank of Bikaner &amp; Jaipur</td>
<td>Axis Bank Ltd.</td>
</tr>
<tr>
<td>2</td>
<td>State Bank of Hyderabad</td>
<td>Development Credit Bank Ltd.</td>
</tr>
<tr>
<td>3</td>
<td>State Bank of Indore</td>
<td>HDFC Bank Ltd.</td>
</tr>
<tr>
<td>4</td>
<td>State Bank of Mysore</td>
<td>ICICI Bank Ltd.</td>
</tr>
<tr>
<td>5</td>
<td>State Bank of Patiala</td>
<td>IndusInd Bank Ltd.</td>
</tr>
<tr>
<td>6</td>
<td>State Bank of Travancore</td>
<td>Kotak Mahindra Bank Ltd.</td>
</tr>
<tr>
<td>7</td>
<td>-</td>
<td>YES Bank</td>
</tr>
<tr>
<td></td>
<td>TOTAL OF ASSOCIATES</td>
<td>TOTAL OF 7 NEW PVT BANKS [II]</td>
</tr>
<tr>
<td>IV</td>
<td>Other Public Sector Banks</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>IDBI Ltd.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>TOTAL OF PUBLIC SECTOR BANKS[I+II+III+IV] = 26</td>
<td>TOTAL OF PVT BANKS [I+II] = 22</td>
</tr>
</tbody>
</table>

Source: Retrieved on May 2012 from

3.3 PRESENT BANKING SECTOR IN INDIA:

With radical changes in the Indian Banking Industry since 1991 there has been a great surge for a quick and a quality customer service. It is highlighted that in modern banking, the fee charges ought to be transparent, efficient and expert IT staff, spreading of social relationship marketing, broadening of customer relationship management etc. (Uppal, 2009). Choudhary and Sharma (2011) emphasized that the major changes took place in the functioning of banks in India only after liberalization, globalisation and privatization. Increased competition, new information technologies and thereby declining processing costs, erosion of product and geographical boundaries and less restrictive governmental regulations have all played a major role for public sector banks in India to forcefully compete with private and foreign Banks. Goyal and Joshi (2012) stated that the level of consumer awareness regarding banking is significantly higher as compared to the previous years. Presently, the customers prefer internet banking, mobile banking and ATM services which simplify and ease out the banking transactions.

Indian banks the dominant financial intermediaries which have made good progress over the last five years, as evident from various parameters, including annual credit growth, profitability and trend in gross non-performing assets (NPA’s). While the banks have benefitted from the overall good economic growth over the last decade, setting up of credit information bureaus, internal improvement such as upgradation of technology infrastructure, tightening of the appraisal and monitoring processes and strengthening of the risk management platform have also contributed to the improvement. Currently, the banks are facing several challenges, such as increasing interest rates on saving deposits, possible deregulation of interest rates on
saving deposits, a tighter monetary policy, large government deficit, increasing infrastructure loans etc.

The private sector banks are witnessing progress as they are competing with the public sector banks in internet banking, mobile banking, ATM’s etc. On the other hand in the public sector banks, approximately 20% employee strength decreased in the wake of the Voluntary Retirement Scheme (VRS). Dominated by the public sector, the banking industry has so far acted as an efficient partner in the growth and development of the country. Driven by the concept of welfare state, public sector banks have long been the supporters of agriculture and other priority sectors and hence acts as a major channel of the government in its efforts to ensure equitable economic development. The norms for entry of new players have been tightened since 1993 when guidelines allowing license to banks in private sector were formulated.

The Reserve Bank of India in order to check unethical practices of granting loans and advances to the relatives of directors of the bank, directors of other banks and or their relatives, has issued guidelines that such loans aggregating Rs. 2.5 million and above should be invariably approved by the board of the bank and the concerned director shall not participate at the time of sanction of such loan. Loans for less than Rs. 2.5 million which can be sanctioned by competent authorities as per delegation of powers should be reported to the board.

Banking regulator has laid importance that each bank must have adequate policies, practices and procedures in place including strict ‘Know Your Customer’ (KYC) rules that promote high ethical and professional standards in the financial sector and prevents the bank being used intentionally and unintentionally by criminal elements. A number of instructions have been issued by the Government as well as
RBI to discourage the practice of unethical activities, such as, money laundering, e-fraud etc.

RBI has also emphasized in the installation of an effective banking supervisory system which consist of some form of both on-site and off-site supervision. The main instrument of supervision in India is the periodical on-site inspection of banks that is supplemented by off-site monitoring and surveillance. Bank supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business and that the bank publishes on a regular basis financial statements that fairly reflects its condition. It is mandatory for all the banks to get their annual accounts audited every year by statutory auditors appointed by the RBI or with its approval. The auditors are required to report whether the financial statements exhibit a true and fair view of affairs of the bank.

3.4 BANKING SERVICES:

Banking in India is defined under Section 5(A) of the Banking Regulation Act, 1949 as "any company which transacts banking business" and the purpose of banking business defined under Section 5(B),"accepting deposits of money from public for the purpose of lending or investing, repayable on demand through cheque/draft or otherwise". In the process of doing the above mentioned primary functions, they are also permitted to do other types of business referred to as Utility Services for their customers (Banking Regulation Act, 1949).

Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits and by issuing debt securities such as bank notes and bonds. Banks lend money by making advances to the customers, by making installment loans
and by investing in marketable debt securities and other forms of money lending. Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Banking services provided by banks include the primary services of accepting deposit through opening of different accounts and granting of loans and advances through loans, cash credits, overdrafts and discounting of bills. Besides these the banks perform a number of agency and general utility services.

NEW CHANNELS TO ACCESS BANKING SERVICES:

- Automated Teller Machines (ATM) for withdrawing cash, checking of bank statement etc. conveniently at any time.

- Mobile banking is an emerging concept of using one's mobile phone to conduct banking transactions. Telephone banking is a service which allows its customers to perform transactions over the telephone with automated attendant or when requested with telephone operator. Yet, its usage is not popular amongst the common customers.

- Online banking is becoming popular amongst the urban customers for performing various transactions, payments and account statements etc. with the help of internet.

- Many banks are replacing traditional cheques and deposit slips with electronic fund transfer (EFT) systems, which utilize sophisticated computer technology to facilitate banking and payment needs. Most banks accept cheque deposits via mail and use e-mail to communicate to their customers, e.g. by sending out statements. Routine banking by means of EFT is considered safer, easier and more convenient for customers.
• Relationship Managers, mostly for private banking, often visiting customers at their homes or businesses.

• Video banking for performing banking transactions or professional banking consultations via a remote video and audio connection. Video banking can be performed by means of purpose-built banking transaction machines or via a video conference enabled bank branch clarification.

3.5 BANK-CUSTOMER RELATIONSHIP:

When a person opens an account with a bank, it is hardly realised that a contract has been entered into between him and the bank and that the customer has entered into a relationship with the bank. The application for opening of an account is considered as a letter of agreement for starting the relationship. This simple proceeding will give existence to a debtor-creditor contractual relationship which, in its turn, establishes the duties of both parties (i.e. the bank and the customer). The nature of relationship depends upon the services rendered by the bank which generally has two aspects, viz; legal and behavioural. But the legal relationship between the customer and banker is varied according to the facts and the circumstances of the transaction involved. In regard to other services rendered by the bank, the bank at times is an agent of the customer.

Shankar (2004) asserts that customer service in banks means satisfying the needs of customers at the right time and in the right manner with accuracy, reliability, high service speed, security and enquiry facility for an efficient customer service. The excellent and managing customer relationship is the future of any business. Thus, customer focus is not viewed just as a business strategy but should also become a corporate mission. To reduce the complaints, bank should improve their services as
the survival of banking business is dependent on customer service. Dutta (2013) stated that the relationship between a banker and his customers depends upon the activities, products and services given by the bank to its customers. One factor which plays an imperative role in building and enhancing the banker-customer relationship is trust. The Banks have realised the importance of Customer Relationship Management (CRM) and its significance in attracting the potential customers, retaining the existence customers and maximize their lifetime value.

3.6 ACCOUNTIBILITY OF BANK TO THE CUSTOMER:

Banks, in their professional role as a fiduciary agent, owe a contractual duty to safeguard its customers from losses arising from providing banking services. The relationship between banks and customers has many duties, which banks have to perform for their customers.

- Honouring the cheques issued by the customer is the duty of the banker.
- Maintaining secrecy of the customer’s account is one of the prime duties of the banker as the relationship between the banker and the customer is a confidential one.
- Utmost care of the property or the article deposited by the customer for its safe custody in the bank with or without charge must be undertaken by the banker with due diligence.
- If the customer gives a standing order regarding to making payment on his behalf such as insurance premium etc., it needs to be abided by the banker.
- Banks usually maintains a database of customer information, such as occupation, business, income and other circumstances, to enable them to spot the transactions that are irregular or not in the ordinary course of the customer's business or otherwise suspicious.
However, a banker’s duty of confidentiality is not absolute. There are few grounds on which the banks disclose their customers’ information, viz:

- where the bank is compelled to provide the information as per the law;
- if disclosing of such information benefits the public;
- if the bank’s own interests require disclosure; and
- where the customer has asked to disclose the information.

3.6.1 BANKS’ OBLIGATIONS:

The Bank executes the following duties and responsibilities:

- Banker must act with due diligence while opening an account for its customer and it is his responsibility to make a proper inquiry before opening of the new account.

- The banker should act with reasonable care if he is instructed to receive and collect bill on behalf of the customer and the money should be credited to the customer’s account.

- The banker has an implied duty to honour the customer’s cheque, if the cheque is drawn properly and presented during the banking hours.

- The banker must be cautious regarding maintaining of secrecy and should not disclose any information to the third party.

3.6.2 BANKER’S RIGHT:

The banker enjoys the following rights:

- Banker’s have a right to dishonour his customer’s cheques where there is no adequate balance for payment.

- Banker’s have the right to lien in the traditional banking practice.
Banker could exercise the right of set-off. That is to say banker has a right to retain a credit balance in one account in place of a debt balance in another. This right enables bankers to combine his customer’s accounts, if the customer-borrower has defaulted in paying a debt having an account in the bank with a credit balance.

3.7 CUSTOMER’S RESPONSIBILITY TO THE BANK:

A customer has a number of duties to the bank which can help in curbing unethical practices, such as:

- Exercising reasonable care by the customer while drawing cheques;
- Immediately informing to the bank if he discovers a cheque purporting to have been signed by him has been forged;
- Reporting any suspected fraud;
- Not participating in any fraudulent activities;
- Not behaving in any way that enables others to commit fraud;
- To behave honestly with the bank and not to participate in any forms of malpractice;
- Following the policies of the bank relating to penalty payment that have been incurred because of unauthorized overdrafts or other breaches of those policies;
- Customer’s have the responsibility to update the banker regarding his personal records so that the bank correspondence can be made at the correct address to the right person;
- While availing any loan or purchasing any insurance policies, all the provisions are needed to be carefully followed;
• If the customers have any grievances regarding the banking terms or any other issue, then he can file a complaint at the bank’s grievance cell. If he is not satisfied regarding the response given then he can further proceed the compliant to the office of Banking Ombudsman for a fair judgment.

3.7.1 CUSTOMER’S RIGHT:

A customer must present cheques for payment and collection during the bank hours. The customer should draw the cheques very carefully and in such a way that there is no room left for any fraudulent practice. If the customer finds any forgery in the amounts of the cheque issued, it is his duty to inform the banker at the earliest opportunity.

Customer’s rights in customer-banker relationship are:

• Customer has a right to receive money in his account on his demand.
• Customer has a right to close his account.
• It is a right of a customer to receive the interest on his deposits.
• Customer has a right to draw cheques on his current account.

3.7.2 FAIR DEALING AND RESPONSIBILITIES TO CUSTOMERS:

Banks are expected to deal fairly with their customers, competitors, suppliers and teammates.

• Unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of facts or any other unfair-dealing practice.
• Bribes, kickbacks, promises or preferential extensions of credit should neither be accepted nor given.
• Orders, contracts and commitments based on objective business standards to avoid favoritism or perceived favoritism should be approved or awarded.
• Conspiracy in any way with competitors must not been done.

Banks encourage its employees and staff to promptly report if they encounter or notice any unethical behaviour or activity which they believe to be:
• A crime,
• A violation of law or regulation,
• A dishonest act, including misappropriation of cash or manipulation of accounts or window dressing of accounts,
• A breach of trust, and
• Any other activities that may conflict with the banks’ code of ethics.

3.8 CONFLICT OF INTEREST:

Conflict of Interest arises in any situation in which an interest interferes or has the potential to interfere, organisation’s ability to act in accordance with the interest of another party, assuming that the person, organisation or institution has a legal, fiduciary or conventional obligation to do so. It is prevalent that ethical dilemma which has been deprived of attention both from the legal perspective as well from the professional outlook (Argandona, 2004). Issacharoff (2003) makes a difference between ‘substantial regulation’ conflict of interest, which is easy to prepare and convenient for the law-makers to propose and ‘procedural regulation’ which pays attention on the procedure to resolve the conflict. Bolton et al. (2007) presented that in some markets, such as the market for financial services, sellers have better information than buyers regarding the matching between the buyer's needs and the good's actual characteristics. Depending on the market structure, this may lead to
conflicts of interest and (or) the under-provision of information by the seller. Argandona (2004) has identified some remedies to overcome the issues of concerning conflict of interest:

- Replacing the person who has the possibility for compromise in case of conflict of interest.
- Revealing private interest either before taking up the responsible post or when the conflict of interest arises, as disclosure is considered as a moral obligation and the finest approach to avoid conflict of interest.
- Structural changes in the organisation in which conflict of interest are expected to crop up. In banks and financial institutions initiatives has already been undertaken to organise different functions in separate legal entities with different management and different compensation system.
- If a person finds himself trapped in the arena of conflict of interest, then apart from following the rules and regulations laid down, he must consciously try to come out from such a situation by analysing the alternatives and doing justice to his duty.

The employees must not use alliance with the bank to move on with personal interests or act in any way that could harm the bank’s reputation or use their positions or confidential information to provide preferential help to anyone seeking employment with the bank or seeking to do business with the bank. Employees having access to confidential banking data from financial institutions or having direct responsibilities in the conduct of a relationship with a firm with which the bank has a regulatory, supervisory, or major contracting relationship are generally prohibited from directly owning securities of that firm. Employees must thereby enter into an arrangement to the satisfaction of the bank where they would refrain from any trades
to acquire more restricted investments, obtain prior approval of the bank before the
disposition of existing holdings or divest themselves of those securities. Employees
are required to consult a supervisor at the Officer or Senior Officer Level to engage in
external activities such as outside employment or business-related activities. The bank
does not have objection regarding employees engaging in external activities as a
volunteer or otherwise, provided that:

- the potential negative effect that the appearance of an employee’s external
  activity might have on the bank’s reputation;
- it does not interfere with their ability to perform their regular work for the bank;

and

- it is not incompatible with the bank’s policies.

Employees must never solicit gifts, hospitality or other benefits in connection
with their banking duties from any person, organisation who has a commercial
dealing with the bank and which are likely to affect the judgment and in executing the
banking duties of the employee.

A “conflict of interest” also occurs when personal interest of any member of the
Board of Directors and of the Core Management interferes or appears to interfere in
any way with the interests of the bank. The separation of ownership and management
can create conflict of interest if there is a breach of trust by managers on account of
intention, omission, negligence or incompetence. This can be taken care of by making
boards more accountable to all stakeholders and making their functioning transparent.

They are expected to perform their duties in a way that they do not conflict with
the Bank’s interest such as-

- EMPLOYMENT / OUTSIDE EMPLOYMENT:
The members of the Core Management are expected to devote their total attention to the business interests of the bank. They are prohibited from engaging in any activity that interferes with their performance or responsibilities to the bank or otherwise is in conflict with or prejudicial to the bank.

- **BUSINESS INTERESTS:**

  If any member of the Board of Directors and Core Management considers investing in securities issued by the bank’s customer, supplier or competitor, they should ensure that these investments do not compromise their responsibilities to the bank. Many factors including the size and nature of the investment; their ability to influence the bank’s decisions; their access to confidential information of the bank, or of the other entity and the nature of the relationship between the bank and the customer, supplier or competitor should be considered in determining whether a conflict exists. Additionally, they should disclose to the bank any interest that they have which may conflict with the business of the bank.

- **RELATED PARTIES:**

  As a general rule, the Directors and members of the Core Management should avoid conducting bank’s business with a relative or any other person or any firm, company or association in which the relative or other person is associated in any significant role.

  - If such a related party transaction is unavoidable, they must fully disclose the nature of the related party transaction to the appropriate authority. Any dealings with a related party must be conducted in such a way that no preferential treatment is given to that party.
• In the case of any other transaction or situation giving rise to conflicts of interests, the appropriate authority should after due deliberations decide on its impact.

3.9 SUPERVISION AND MANAGEMENT OF INDIAN BANKS:

Reserve Bank of India is entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act, 1949 and RBI Act, 1934. Subsequent to the economic liberalization of the 1990’s, RBI has been pursuing a steady and cautious approach towards banking liberalisation. This has been evident in the implementation of the report of the Narasimham Committee (1991) which granted operational autonomy to banks and financial institutions.

An expert group (under S. Padmanabhan) also conducted reviews of RBI’s supervisory processes viz. systems and procedures relating to the statutory inspections during the 1990’s and recommended measures for improving the efficiency and effectiveness of RBI’s approach to supervision of banks.

In view of the growing complexities in the banking business from the recent financial crisis that has led a thorough overhaul of the global regulatory and supervisory benchmarks viz. revised prescriptions for more resilient banks and banking systems (Basel III), revised core principles for effective bank supervision, principles for supervision of financial conglomerates and planning for recovery and resolution of global systemically important banks, there is a felt need for a relook at RBI’s existing supervisory processes and mechanism in order to make it more robust and capable of addressing emerging challenges.

Depositor protection and systemic risk are the two main reasons that are normally cited for putting in place a system of regulation and supervision of banks. In the wake of financial crisis and bank failure during the last two decades, there have
been attempts to limit the impacts of bank failure and contagion through ‘safety nets’ in the form of deposit insurance and the lender of last resort function by Central Banks. While the safety nets are triggered during crisis situations, supervision plays a vital role in preventing the occurrence of a crisis situation or bank failure.

3.9.1 KEY RECOMMENDATIONS BY VARIOUS STUDY GROUPS REGARDING BANKING SUPERVISION IN A NUTSHELL:

- WORKING GROUP (UNDER THE CHAIRMANSHIP OF S. PADMANABHAN, 1995):

  While re-emphasising the primacy of on-site inspection, recommended switching over to a system of ongoing supervision. It recommended a strategy of periodical full-scope ‘on-site examinations’ supplemented by an in-house ‘off-site monitoring system’ in between two statutory examinations. The Working Group recommended orienting supervision for enforcement of correction of deviations. It was decided that the periodic and full scope statutory examinations should concentrate on core areas of assessment, viz., (a) financial condition and performance (b) management and operating condition (c) compliance and (d) summary assessment in line with the internationally adopted capital adequacy, asset quality, management, earnings, liquidity and systems (CAMELS), including a CAMEL based rating model with systems and controls added to it for Indian banks and a CACS model (capital adequacy, asset quality, compliance, systems and controls) for foreign banks. Subsequently, examination of ‘liquidity’ was added to christen the model as CALCS. The periodic statutory examinations were to be supplemented by four types of regular and cyclical on-site assessments, viz., targeted appraisals, targeted appraisals at control sites, commissioned audits and monitoring visits.
• **WORKING GROUP (UNDER THE CHAIRMANSHIP OF VIPIN MALIK, 2001):**

This group recommended a framework for Consolidated Supervision which included preparation of Consolidated Financial Statements (CFS) for improving public disclosure, Consolidated Prudential Reports (CPR) for supervisory assessment of risks which may be transmitted to banks (or other supervised entities) by other group members and application of certain prudential regulations like capital adequacy and large exposures or risk concentration on a group-wide basis.

• **WORKING GROUP (CONVENER: SHYAMALA GOPINATH, 2004):**

This group recommended establishment of a monitoring system for Financial Conglomerates (FCs). It laid down norms for identification of a SIFI and its group entities as also a format for capturing financials, intra-group transactions and exposures amongst group entities, collective exposures on a group-wide basis and a mechanism for inter-regulatory co-operation on issues related to the identified FCs.

Prior to 1993, the Department of Banking Operations & Development (DBOD) looked after the supervision and regulation of commercial banks. In December 1993, the Department of Supervision (DoS) was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI. All the Scheduled Commercial Banks consisting of public sector banks, private sector banks, foreign banks and regional rural banks are under the supervisory jurisdiction of the Department of Banking Supervision of RBI.

The supervisory role of the Department of Banking Supervision includes:

- Planning for and conducting onsite inspection,
- Off-site surveillance, ensuring follow-up and compliance,
• Determining the criteria for the appointment of statutory auditors and special auditors and assessing audit performance and disclosure standards and monitoring of major financial sector frauds

• Exercising supervisory intervention in the implementation of regulations, which includes recommendation for removal of managerial and other persons, suspension of business, amalgamation, merger or winding up, issuance of directives and imposition of penalties.

3.9.2 SUPERVISORY PROCESSES:

Ongoing banking supervision typically consists of a differentiated mix of off-site surveillance and onsite examinations. Off-site monitoring involves analysing and reviewing periodic financial and other information relating to banks’ activities by the supervisor. These regulatory reporting requirements generally cover balance sheet and profit and loss statements, information on capital and liquidity levels, asset quality and loan loss provisions, profitability etc. The on-site inspections traditionally involve examinations by specialized supervisory staff for a hands-on assessment of qualitative factors such as management capabilities and internal control procedures that cannot be adequately captured in regulatory returns. In aggregate, it culminates in assessment of risks and suggestion of a risk mitigation plan.

• OFFSITE SUPERVISION:

As a part of the supervisory strategy, an off-site monitoring system for surveillance over banks was operationalized in RBI in March 1996. As a tool for “early warning signals” the Offsite Surveillance and Monitoring System (OSMOS) plays a key role in the identification of risks and monitoring banks on a continuous basis. OSMOS consists of a set of 28 structured returns that capture prudential and statistical information of banks at periodical intervals. The information gathered is
populated into the OSMOS database, enabling the offsite supervisor to undertake prudential analysis of bank’s Capital, Assets, Earnings, Liquidity, etc. on both solo and consolidated basis. Issues of concern arising out of such analyses are flagged for consideration of top management and also placed before the BFS. Along with bank specific analysis, certain macro-level analysis of the banking sector are also undertaken periodically to assess and identify the risks and potential concerns.

Table 3.9.2 (i): Off-site supervision of Indian commercial banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Significant changes of OSMOS since inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>The setting up of an off-site surveillance function in the Department based on a prudential / supervisory reporting framework.</td>
</tr>
<tr>
<td>1995</td>
<td>Tranche I Returns</td>
</tr>
<tr>
<td></td>
<td>Report on Asset liability and off balance sheet exposures (ALE) Monthly</td>
</tr>
<tr>
<td></td>
<td>Report on Capital Adequacy – Basel I (RCA) Quarterly</td>
</tr>
<tr>
<td></td>
<td>Report on Operating Results (ROR) Quarterly</td>
</tr>
<tr>
<td></td>
<td>Report on Asset Quality (RAQ) Monthly / Quarterly</td>
</tr>
<tr>
<td></td>
<td>Report on Large Credits (RLC) Quarterly</td>
</tr>
<tr>
<td></td>
<td>Report on Connected lending (RCL) Quarterly</td>
</tr>
<tr>
<td></td>
<td>Report on Ownership and Control (ROC) Half yearly – March &amp; September</td>
</tr>
<tr>
<td>1999</td>
<td>Tranche II Returns</td>
</tr>
<tr>
<td>Statement of Structural Liquidity (STL)</td>
<td>Monthly</td>
</tr>
<tr>
<td>Statement of Interest Rate Sensitivity (IRS)</td>
<td>Monthly</td>
</tr>
<tr>
<td>Statement of Maturity and Position (MAP)</td>
<td>Monthly</td>
</tr>
<tr>
<td>Statement of Interest Rate Sensitivity – Forex (SIR)</td>
<td>Monthly</td>
</tr>
<tr>
<td>Other returns:</td>
<td></td>
</tr>
<tr>
<td>Balance Sheet Analysis (BSA)</td>
<td></td>
</tr>
<tr>
<td>DSB (O) returns</td>
<td></td>
</tr>
<tr>
<td>Report on Asset Liability and Exposures (ALO)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Structural Liquidity (SSL)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Problem Credits (PCI)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Large Exposures (RLE)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Country exposures (CEM)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Profitability (ROP)</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Report on Fraud (ROF)</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>A quarterly return on “Subsidiaries / JV / Associates” under DSB Returns (RIS) (Tranche II) The OSMOS database upgraded to RDBMS environment with built in data-warehousing component</td>
</tr>
<tr>
<td>2001</td>
<td>Local Area Banks were instructed to submit 7 DSB returns (Tranche I).</td>
</tr>
</tbody>
</table>

• **ONSITE SUPERVISION:**

On-site supervision of banks is a key process in the overall supervisory framework. The on-site supervision involves an Annual Financial Inspection (AFI) of banks that is presently modeled around the CAMEL (Capital Adequacy, Asset classification, Management, Earnings appraisal, Liquidity) framework with an additional parameter of Systems and Controls (modified as CAMELS for Indian commercial banks and CALCS for Foreign banks). The present CAMELS is a transaction-based examination with a matrix used for arriving at a rating of each of the CAMELS components to give a final adjusted supervisory rating for each bank. Of late, the AFI has been giving considerable importance to risk management system in banks. Based on the concerns highlighted by the AFI reports and discussions with banks, a Monitorable Action Plan (MAP) is drawn for compliance and a memorandum covering supervisory concerns from AFI including supervisory rating is compiled for perusal of the BFS. In addition to AFI, a few need based targeted inspections and scrutinizes at the banks are also undertaken.

Table 3.9.2 (ii): On-site supervision of Indian commercial banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Significant changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre 1992-1993</td>
<td>Financial Inspections (FI) – at intervals ranging from two (for private &amp; foreign banks) to four years (for public sector banks); these included visits to Head Offices, Controlling Offices and a cross-section of branches for making detailed assessment of all aspects of a bank’s operations. Annual Financial Reviews (AFR) in respect of public sector banks (except SBI). These visits covered Head Office and a quarter of the Controlling</td>
</tr>
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<th></th>
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<tbody>
<tr>
<td>Annual Financial Inspections (AFI) with main accent on the assessment of the bank’s financial position. Biennial management audits by Senior Officials to look into the non-financial aspects i.e. Management and Systems. The time span of inspection including preparation of reports was reduced to maximum period of 4-5 months.</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>The format of the inspection report made more focused, by bifurcating into main report and explanatory note. Foreign banks with market share of asset size less than 0.1% and Financial Institutions having no systemic risks to be inspected only once in two years. Formation of twelve financial conglomerates for continuous supervision by Central Office of DBS</td>
</tr>
</tbody>
</table>


### 3.10 CAMEL RATING OF INDIAN COMMERCIAL BANKS:

CAMEL model of rating was first developed in the 1970’s by the three federal banking supervisors of the U.S (the Federal Reserve, the FDIC and the OCC) as part of the regulators’ “Uniform Financial Institutions Rating System”, to provide a convenient summary of bank condition at the time of its on-site examination. The banks were judged on five different components under the acronym C-A-M-E-L: Capital adequacy, Asset quality, Management, Earnings and Liquidity. The banks received a score of ‘1’ through ‘5’ for each component of CAMEL and a final
CAMEL rating representing the composite total of the component CAMEL scores as a measure of the bank’s overall condition. The system of CAMEL was revised in 1996, when agencies added an additional parameter ‘S’ for assessing “sensitivity to market risk”, thus making it ‘CAMELS’ that is in practice today.

Prior to 1998, the department of supervision (DoS) had been rating the banks in India on the basis of assessed ‘solvency’ relative to the impairment of the components of reported owned funds. The Padmanabhan Committee (1996) had recommended two separate models for Indian and foreign based banks based on a differential mix of rating factors: CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems & Control) for Indian banks and CALCS (Capital adequacy, Asset quality, Liquidity, Compliance, and Systems & control) for foreign based banks in India. Each parameter is awarded a rating A-D (A-Good, B - Satisfactory, C -unsatisfactory, and D-poor).

Prasad and Ravinder (2012) stated that this model helped in evaluating the performance of the bank. Capital adequacy reveals the financial health of the banks and also the potential of organization to meet the requirement of further capital. Capital Adequacy Ratio (CAR), Debt-Equity Ratio (D/E), Advance to Assets Ratio (Adv/Ast) and Government Securities to Total Investments (G-sec/Inv) the various ratios measuring capital adequacy of banks. The second parameter is Asset quality which is vital to gauge the strength of bank. It helps to determine the component of non-performing asset over the total asset. Management efficiency and effectiveness is another key aspect of the CAMEL Model. The earning quality is a very significant criterion that calculates the ability of a bank to earn consistently. Liquidity is yet another key factor that the bank has to balance between its liquidity provisions and investment in high return areas in order to stimulate sufficient profit.
Table 3.10.1: Significant changes in supervisory rating adopted by RBI over the years

<table>
<thead>
<tr>
<th>YEAR</th>
<th>METHODOLOGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>S. Padmanabhan Committee (1995) recommended for Indian banks, six rating factors viz. Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls (i.e. CAMELS), and for Foreign banks, four rating factors viz., Capital Adequacy, Asset Quality, Compliance, Systems and Controls (i.e. CACS)</td>
</tr>
<tr>
<td>1999</td>
<td>Circular on CAMELS and CACS rating framework including components rating and composite rating issued. As per the circular, each of the component was to be rated separately on a scale of 1 to 100 in ascending order of performance. Each of these six Components was to consist of several parameters with individual weight age i.e. 100 marks distributed among these parameters –</td>
</tr>
<tr>
<td>2002</td>
<td>The rating model of CACS modified to include the component ‘Liquidity’</td>
</tr>
<tr>
<td>2006</td>
<td>In order to appreciate nuances between two different banks having the same composite rating and to show granularity in the rating, 3 rating scales each were introduced under A, B and C making a total of ten rating scales including D</td>
</tr>
<tr>
<td>2007</td>
<td>The parameters and markings in respect of ‘Earnings Appraisal’ component of the rating revised for CAMELS</td>
</tr>
<tr>
<td>2009</td>
<td>The parameters and markings in respect of ‘Earnings Appraisal’ component of the rating revised once again only for CAMELS.</td>
</tr>
</tbody>
</table>


