BANKING THEARY LAW AND PRACTICE

BCM 33

UNIT -1

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ORIGIN OF BANKING

THE EARLY PHASE OF BANKING IN INDIA – UP TO 1947:
Beginning of Banking in India

- Laid the foundations of the Indian banking system.
- The first bank of a joint stock variety was Bank of Bombay, established in 1720 in Bombay
- Bank of Hindustan in Calcutta, which was established in 1770 by an agency house.
- Trade was concentrated in Calcutta after the growth of East India Company's trading and administration.
- With this grew the requirement for modern banking services, uniform currency to finance foreign trade and remittances by British army personnel and civil servants.
- The first 'Presidency bank' was the Bank of Bengal established in Calcutta on June 2, 1806 with a capital of Rs.50 lakh.

Contd..

- **The presidency banks were amalgamated into a single bank, the Imperial Bank of India, in 1921.**
- **The Imperial Bank of India also functioned as a central bank prior to the establishment of the Reserve Bank in 1935.**
- **The Reserve Bank of India Act 1934 was enacted paving the way for the setting up of the Reserve Bank of India.**
- **The issue of bank failures and the need for catering to the requirements of agriculture were the two prime reasons for the establishment of the Reserve Bank.**
- **The banking sector came under the purview of the Reserve Bank in 1935.**

The Bank of Bombay was the second Presidency bank set up in 1840 with a capital of Rs.52 lakh.

Bank of Madras the third Presidency bank established in July 1843 with a capital of Rs.30lakh.

They were known as Presidency banks as they were set up in the three Presidencies that were the units of administrative jurisdiction in the country for the East India Company.

The Presidency banks were governed by Royal Charters.

The first Indian owned bank was the Allahabad Bank set up in Allahabad in 1865,

The second, Punjab National Bank was set up in 1895 in Lahore, and

The third, Bank of India was set up in 1906 in Mumbai.

All these banks were founded under private ownership.

•The Reserve Bank of India Act, 1934 gave the Reserve Bank powers to regulate issue of bank notes, the custody of the commercial banks' cash reserves and the discretion of granting them accommodation.

The Reserve Bank's main functions could be classified into the following broad categories
(a) to act as a banker to the Government
(b) to issue notes
(c) to act as a banker to other banks and
(d) to maintain the exchange ratio.

SOCIAL CONTROL OVER BANKS - 1967 TO 1991

The main objectives of social control was

- to achieve a wider spread of bank credit
- prevent its misuse, direct a larger volume of credit flow to priority sectors and
- make it more effective instrument of economic development.

On July 19, 1969, 14 major banks were nationalized.

BANKING IN THE EARLY YEARS OF INDEPENDENT INDIA - 1947 TO 1967

When the country attained independence, Indian banking was entirely in the private sector.

In addition to the Imperial Bank, there were five big banks, each holding public deposits aggregating Rs.100 crore and more,viz. Central Bank of India Ltd., Punjab National Bank Ltd., Bank of India Ltd., Bank of Baroda Ltd. and United Commercial Bank Ltd.

A major development during this period was the enactment of the Banking Regulation Act and supervise the banking sector. empowering the Reserve Bank to regulate

In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India".

It was established under State Bank of India Act, 1955.

First Phase of Reforms: 1991-92 to 1997-98

The main issues faced at the beginning of this sub-phase (1991-92 to 1997-98) were

- the poor financial performance,
- low asset quality, weak capital position of banks and
- the absence of adequate competition.

- Several measures, therefore, were initiated by the Government, the Reserve Bank and the banks themselves to improve their profitability, financial health and capital position.

Major measures initiated included

- introduction of objective prudential norms,
- reduction in statutory pre-emptions and operational flexibility and
- functional autonomy to public sector banks.

BANKING: Definition

- According to Banking Regulation Act, "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, and an order or otherwise".

BANKING: Definition

- Oxford Dictionary defines a bank as "an establishment for custody of money, which it pays out on customer's order.“

What is banking regulation act 1949?

The Banking Regulation act 1949 is a legislation in India, that states all banking firms will be regulated under this act. There are a total of 55 Sections under the banking regulating act. Initially the law was only applicable to banks, but after 1965, it was amended to make it applicable to co-operative banks and also to introduce other changes. The act provides a framework that regulates and supervises commercial banks in India. This act gives power to the RBI to exercise control and regulate banks under supervision.

Introduction of banking regulation act 1949:

The act came into force on March 16th 1949. It relates to various aspects vis-a-vis banking in India. The main objective of the banking regulation act is to ensure sound banking through regulations covering the opening of branches and the maintenance of liquid assets.

SEE ALSO: Free Credit Score

Objectives of banking regulation act 1949:

The Banking Regulations Act was enacted in February 1949 with the following objectives:

- The provision of the Indian Companies Act 1913 was found inadequate to regulate banks in India. Therefore a need was felt to introduce a specific legislation having comprehensive coverage on issues relating to the banking business in India.

- Due to inadequacy of capital, many banks failed and therefore prescribing a minimum capital requirement was felt necessary. The banking regulation act brought in certain minimum capital requirements for banks.
- The key objectives of this act was to cut competition among banks. The act has regulated the opening of branches and also changing the location of existing branches.
- To prevent random opening of new branches and ensure balanced development of banks through the system of licensing.
- Assigning power to RBI to appoint, reappoint and remove the chairman, director and officers of the banks. This could ensure the smooth and efficient functioning of banks in India.
- To protect the interest of depositors and public at large by incorporating certain provisions like prescribing cash reserve ratio and liquidity reserve ratios.

- Provide compulsory amalgamation of weaker banks with senior banks, and thereby strengthen the banking system in India.
- Introduce provisions to restrict foreign banks investing funds of Indian depositors outside India.
- Provide quick and easy liquidation of banks, when they are unable to continue operations or amalgamate with other banks.

Importance of Banking Regulation Act 1949:

- Banking Regulation Act gives the power to RBI to license banks and also the regulation of the shareholding.
- It grants power to RBI to conduct appointment of the boards and management members of banks.
- It also lays down directions for audits to be managed by RBI, and control merging and liquidation.
- RBI issues directives on banking policy in the interests of public good and can impose penalties if required.
- Co-operative Banks were incorporated under this act in the amendment of 1965.

Role of Banks in Economic Development

Banks play a very important and dynamic role in the economic development of every nation. A study of the economic history of western country shows that without the evolution of commercial banks in the 18th and 19th centuries, the industrial revolution would not have taken place in Europe. The economic importance of commercial banks to the developing countries can be categorized into :

- Promoting capital formation
- Encouraging innovation
- Monetization
- Influence economic activity
- Facilitator of monetary policy

Promoting capital formation

A developing economy needs a high rate of capital formation to accelerate the speed of economic development, but the rate of capital formation depends upon the rate of saving. But in underdeveloped countries, savings are very low. Banks afford facilities for saving and, thus encourage the habits of thrift in the community. They mobilize the idle and latent capital of the country and make it available for productive purposes.

Encouraging innovation

Innovation is another factor responsible for the economic development of a country. The entrepreneur in innovation is largely dependent on the mode in which bank credit is allocated and utilized in the process of economic growth. Bank credit facilitates entrepreneurs to innovate and invest, and thus uplift economic activity and progress.

Monetization

Banks are the manufactures of currency notes.

Banks monetize debts and also assist the backward subsistence sector of the rural economy by expanding their branches in to the rural areas. They should be replaced by the modern commercial bank's branches.

Influence economic activity

Banks can influence economic activity in a country by their influence on the interest rates and many other factors. They are in a position to influence the rate of interest in the money market through the supply of funds. Banks may follow an economical money policy with low interest rates which will tend to stimulate economic activity.

Facilitator of monetary policy

Thus monetary policy of a country must be conductive to economic development. But a well-developed banking system is an essential pre-condition to the effective implementation of monetary policy. Under-developed countries can never ignore this fact.

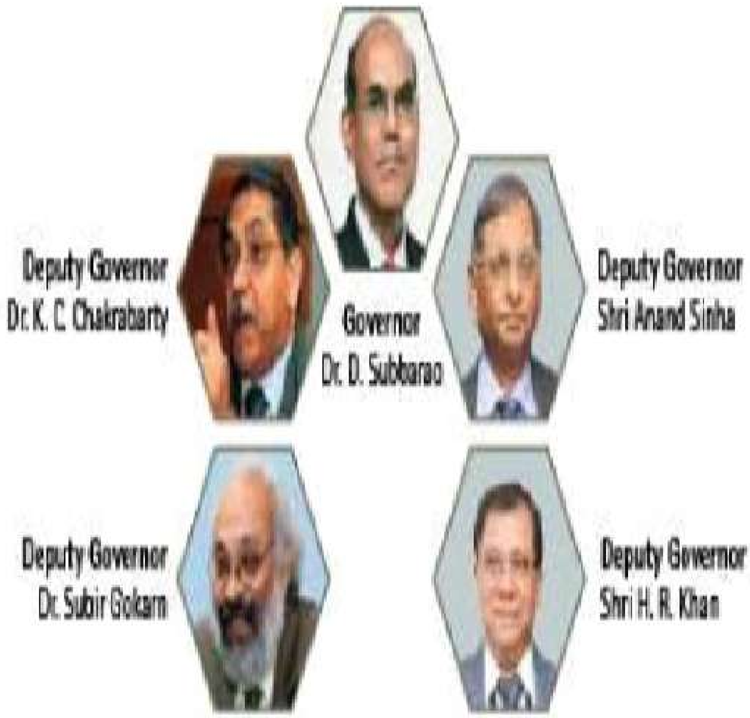
Reserve Bank of India

Role and Functions

Lecture objectives

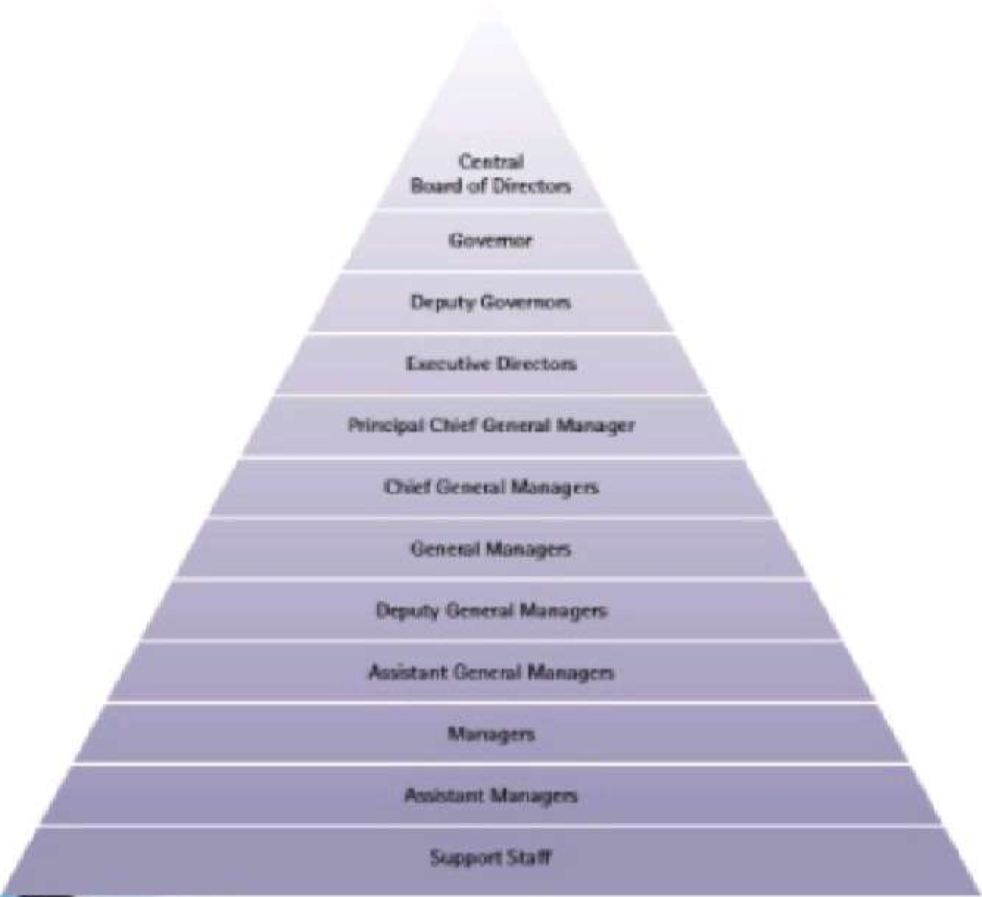
- An overview of organization structure and management of RBI.
- An understanding of the various functions performed by RBI.
- To understand the various tools used by RBI to perform its functions effectively.

Central Board of RBI



- The Reserve Bank is wholly owned by the Government of India.
- The Central Board of Directors oversees the Reserve Bank's business.
- The Governor is the Reserve Bank's chief executive. The Governor supervises and directs the affairs and business of the Reserve Bank.

Organization



Functions of the Reserve Bank

- Monetary Authority
- Issuer of Currency
- Banker to Government
- Banker to Banks
- Regulator of the Banking System
- Manager of Foreign Exchange
- Regulator and Supervisor of the Payment and Settlement Systems
- Developmental Role

Functions of the Reserve Bank

1. Monetary Authority

- Frames monetary policy with the following main objectives:
  - ✓ Maintaining price stability.
  - ✓ Ensuring adequate flow of credit to the productive sectors to support economic growth.
  - ✓ Financial stability.
- Tools to achieve objectives:
  - ✓ Cash Reserve Ratio
  - ✓ Statutory Liquidity Ratio
  - ✓ Repo / Reverse Repo
  - ✓ Open Market Operations – purchase or sale of government securities
  - ✓ Bank rate

2. Issuer of Currency

- The Reserve Bank is the nation's sole note issuing authority.
- Ensures adequate supply of clean and genuine notes.
- Routinely address security issues and target ways to enhance security features to reduce the risk of forgery.
- Printing of notes and minting of coins.
  - ✓ Four printing presses – Dewas in Madhya Pradesh, Nasik in Maharashtra, Mysore in Karnataka and Salboni in West Bengal.
  - ✓ Four mints are in operation – Mumbai, Noida in U.P, Kolkata and Hyderabad.
- RBI's clean note policy.
- Exchange of torn, mutilated or defective notes at currency chests of commercial banks.
- Indian Coinage Act.

Functions of the Reserve Bank

3. Banker to Government

- Undertaking banking transactions for the central and state governments to facilitate receipts and payments and maintaining their accounts.
- Managing the governments' domestic debt with the objective of raising the required amount of public debt in a cost-effective and timely manner.
- Developing the market for government securities to enable the government to raise debt at a reasonable cost.

Functions of the Reserve Bank

4. Banker to Banks

- Enabling smooth, swift and seamless clearing and settlement of inter-bank obligations.
- Providing an efficient means of funds transfer for banks.
- Enabling banks to maintain their accounts for purpose of statutory reserve requirements and maintain transaction balances.
- Acting as lender of the last resort.

Functions of the Reserve Bank

5. Regulator of Banking System

- Supervises the nation's financial system.
- Financial system comprises of:
  - ✓ Regulatory authorities
  - ✓ Financial institutions
  - ✓ Financial markets
  - ✓ Financial instruments
  - ✓ Payment and settlement

Functions of the Reserve Bank

6. Manager of Foreign Exchange

- Regulating forex transactions and facilitating the development of the foreign exchange market.
- Managing the foreign currency assets and gold reserves of the country.

7. Regulator and supervisor of payment and settlement system.

- Systematic transfer of money, paper instruments and various electronic channels.
- NEFT, RTGS etc.

Functions of the Reserve Bank

8. Development role

- Deposit Insurance and Credit Guarantee Corporation (1962) – guarantee cover to credit facilities extended to certain categories of small borrowers.
- Unit Trust of India (1964), the first mutual fund of the country.
- Industrial Development Bank of India (1964), a development finance institution for industry.
- National Bank for Agriculture and Rural Development (1982), for promoting rural and agricultural credit.
- Ensures development by:
- ✓ Priority sector lending
- ✓ Lead bank scheme
- ✓ Strengthening and supporting small and local banks
- ✓ Financial inclusion

Credit control method

भारतीय रिज़र्व बैंक

Reserve Bank of India

India's Central Bank

Credit Control Methods of RBI: Explained

Credit control method

Credit control is most important function of Reserve Bank of India. Credit control in the economy is required for the smooth functioning of the economy. By using credit control methods RBI tries to maintain monetary stability.

There are two types of methods:

- Quantitative control to regulates the volume of total credit.
- Qualitative Control to regulates the flow of credit

Methods of Credit Control

Quantitative or General Methods

1. Bank Rate
2. Open Market Operations
3. Variable Cash Reserve Ratio

Qualitative or Selective Methods

1. Credit Rationing
2. Direct Action
3. Moral Persvasion
4. Publicity
5. Regulation of Consumer's Credit
6. Regulating the Margnal Requirements on Security Loans.

VARIABLE RESERVE RATIO:

All commercial banks have to keep a minimum cash reserve with the RBI depending on the deposits of the commercial banks. During inflation, this variable reserve ratio is increased & at the time of deflation, the ratio is decreased. (CRR AND SLR)

- Cash Reserve Ratio Cash reserve ratio refers to that portion of total deposits in commercial Bank which it has to keep with RBI as cash reserves.
- Statutory Liquidity Ratio SLR refers to that portion of deposits with the banks which it has to keep with itself as liquid assets(Gold, approved govt.

Qualitative Control to regulates the flow of credit

This approach is also known as 'Selective Credit Control Methods'.

FIXATION OF MARGIN: (LOAN SECURITIES)

- The Banker will be lending money against the price of securities. The amount of loan will be depending upon the margin requirements of the banker. The word 'margin' in the above statement means the difference b/w the loan value & market value of securities.
  The RBI will be having the power to change the margins, which limits the loan amount to be sanctioned by the commercial banks. During inflation, the margin would be higher & it will be lower at the time of deflation.

REGULATION OF CONSUMER CREDIT:

- The buyer gets this kind of foreign exchange reserves & exchange value of the Rupee in relation to other country's currencies. Currencies should only be exchanged with RBI or its authorised banks.

DIRECT ACTION:

- To control the volume of bank loans the RBI may issue instructions to the commercial banks from time to time. The instructions may be in the form of oral or written statements or appeals or warnings. By means of these instructions, the central bank may increase or decrease the volume of credit.

RATIONING OF CREDIT:

- It is a system of regulating & controlling purpose for which credit is guaranteed by the commercial bank. It is of two types.

i. **Variable Portfolio Ceilings:**
In this, the RBI fixes a maximum amount of loans & advances for every commercial bank.

ii. **Variable Capital Assets Ratio:**
In this technique, the RBI fixes a ratio, which the capital of the commercial bank must bear to the total assets of the bank. By varying this ratio the credit can be controlled.

MORAL SUASION:

Psychological means and informal means of selective credit control.

This is a tactful technique followed by RBI. In this technique, the RBI will give advice & suggestions to the bankers to follow the directives given by it, by sending letters & conducting the meeting of the Board of Directors.

Conclusion

These are methods to control & flow of credit in our economy.