II B.COM - BANKING THEORY ,LAW AND PRACTICE

UNIT – I

Origin of banks-Banking regulation act-1949-Role of banks and economic development- central banking and role of RBI and their functions –Credit control measures of central bank.

MEANING OF BANK

A bank is a financial institution which performs the deposit and lending function. A bank allows a person with excess money (Saver) to deposit his money in the bank and earns an interest rate. Similarly, the bank lends to a person who needs money (investor/borrower) at an interest rate. Thus, the banks act as an intermediary between the saver and the borrower.

ORIGIN OF BANKS

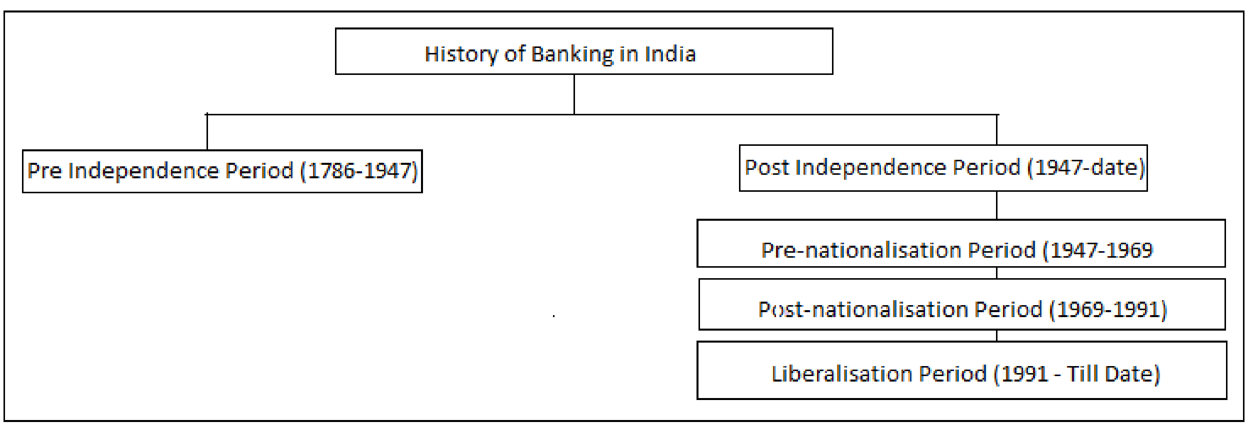
Banking in India forms the base for the economic development of the country and major changes in the banking system and management have been seen over the years with the advancement in technology and needs of the people.

The banking sector development can be divided into three phases:

Phase I: The Early Phase which lasted from 1770 to 1969

Phase II: The Nationalisation Phase which lasted from 1969 to 1991

Phase III: The Liberalisation or the Banking Sector Reforms Phase which began in 1991 and continues to flourish till date.



Pre Independence Period (1786-1947)

The first bank of India was the “*Bank of Hindustan*”, established in 1770 and located in the then, Indian capital, Calcutta. However, this bank failed to work and ceased operations in 1832.

During the Pre Independence period over 600 banks had been registered in the country but only a few managed to survive.

Following the path of Bank of Hindustan, various other banks were established in India. They were:

- The General Bank of India (1786-1791)
- Oudh Commercial Bank (1881-1958)
- Bank of Bengal (1809)
- Bank of Bombay (1840)
- Bank of Madras (1843)

During the British rule in India, The East India Company had established three banks: Bank of Bengal, Bank of Bombay and Bank of Madras and called them the Presidential Banks. These three banks were later merged into one single bank in 1921 which was called the "*Imperial Bank of India.*"

The Imperial Bank of India was later nationalised in 1955 and was named The State Bank of India, which is currently the largest Public sector Bank.

Given below is a list of other banks which were established during the Pre-Independence period:

Pre-Indepence Banks in India	
Bank Name	**Year of Establishment**
Allahabad Bank	1865
Punjab National Bank	1894
Bank of India	1906
Central Bank of India	1911
Canara Bank	1906
Bank of Baroda	1908

If we talk of the reasons as to why many major banks failed to survive during the during the pre independence period, following conclusions can be drawn:

- Indian account holders had become fraud prone

- Lack of machines and technology
- Human errors & time consuming
- Less facilities
- Lack of proper management skills

Post Independence Period (1947-1991)

At the time, when India got independence, all the major banks of the country were led privately which was a cause of concern as the people belonging to rural areas were still dependent on money lenders for financial assistance.

With an aim to solve this problem, the then Government decided to nationalise the Banks. These banks were nationalised under the Banking Regulation Act, 1949 and the Reserve Bank of India was nationalised in 1949.

Following it was the formation of State Bank of India in 1955 and other 14 banks were nationalised between the time duration of 1969 to 1991. These were the banks whose national deposits were more than 50 crores.

Given below is the list of these 14 Banks nationalised in 1969:

1. Allahabad Bank
2. Bank of India
3. Bank of Baroda
4. Bank of Maharashtra
5. Central Bank of India
6. Canara Bank
7. Dena Bank
8. Indian Overseas Bank
9. Indian Bank
10. Punjab National Bank
11. Syndicate Bank
12. Union Bank of India

    In the year 1980, another 6 banks were nationalised taking the number to 20 banks. These banks included:

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Comm.
5. Punjab & Sind Bank

6. Vijaya Bank

Apart from the above mentioned 20 banks, there were seven subsidiaries of SBI which were nationalised in 1959:

1. State Bank of Patiala
2. State Bank of Hyderabad
3. State Bank of Bikaner & Jaipur
4. State Bank of Mysore
5. State Bank of Travancore
6. State Bank of Saurashtra
7. State Bank of Indore

All these banks were later merged with the State Bank of India in 2017, except for the State Bank of Saurashtra, which was merged in 2008 and State Bank of Indore, which was merged in 2010.

The Regional Rural Banks in India were established in the year 1975 for the development of rural areas in India.

Liberalisation Period (1991-Till Date)

Once the banks were established in the country, regular monitoring and regulations need to be followed to continue the profits provided by the banking sector. The last phase or the ongoing phase of the banking sector development plays a very important role.

To provide stability and profitability to the Nationalised Public sector Banks, the Government decided to set up a committee under the leadership of Shri. M Narasimham to manage the various reforms in the Indian banking industry.

The biggest development was the introduction of Private sector banks in India. RBI gave license to 10 Private sector banks to establish themselves in the country. These banks included:

1. Global Trust Bank
2. ICICI Bank
3. HDFC Bank
4. Axis Bank
5. Bank of Punjab
6. IndusInd Bank
7. Centurion Bank
8. IDBI Bank
9. Times Bank
10. Development Credit Bank

BANKING REGULATION ACT-1949

The **Banking Regulation Act, 1949** is a legislation in India that regulates all banking firms in India.[1] Passed as the Banking Companies Act 1949, it came into force from 16 March 1949 and changed to Banking Regulation Act 1949 from 1 March 1966. It is applicable in jammu and Kashmir from 1956. Initially, the law was applicable only to banking companies. But, 1965 it was amended to make it applicable to cooperative banks and to introduce other changes.

The Act provides a framework under which commercial banking in India is supervised and regulated. The Act supplements the Companies Act, 1956.[3] Primary Agricultural Credit Societyand cooperative land mortgage banks are excluded from the Act.

The Act gives the Reserve Bank of India (RBI) the power to license banks, have regulation over shareholding and voting rights of shareholders; supervise the appointment of the boards and management; regulate the operations of banks; lay down instructions for audits; control moratorium, mergers and liquidation; issue directives in the interests of public good and on banking policy, and impose penalties.

In 1965, the Act was amended to include cooperative banks under its purview by adding the Section 56. Cooperative banks, which operate only in one state, are formed and run by the state government. But, RBI controls the licensing and regulates the business operations. The Banking Act was a supplement to the previous acts related to banking.

Objectives of banking regulation act

1. The company act 1913 proved to be inadequate for regulating the banking sector of the country
2. Many banks were failing as they did not have the required capital for a smooth functioning. It was necessary to pass rules regarding maintaining a minimum capital
3. To reduce unhealthy competition in the banking sector
4. Ta safeguard the rights of shareholders and the public
5. Proper mechanism for appointing the bank officials
6. To ensure new branches are licensed
7. Help banks liquidate when they are unable to operate
8. Impose restrictions on Indian investors
9. Take necessary steps to strengthen the banking sector of the country

Role of Banks in the Economic Development of a Country

• The banking system plays an important role in the modern economic world. Banks collect the savings of the individuals and lend them out to business- people and manufacturers. Bank loans facilitate commerce.

• Manufacturers borrow from banks the money needed for the purchase of raw materials and to meet other requirements such as working capital. It is safe to keep money in banks. Interest is also earned thereby. Thus, the desire to save is stimu¬lated and the volume of savings increases. The savings can be utilised to produce new capital assets.

• Thus, the banks play an important role in the creation of new capital (or capital formation) in a country and thus help the growth process.

• Banks arrange for the sale of shares and debentures. Thus, business houses and manufacturers can get fixed capital with the aid of banks. There are banks known as industrial banks, which assist the formation of new com¬panies and new industrial enterprises and give long-term loans to manu-facturers.

• The banking system can create money. When business expands, more money is needed for exchange transactions. The legal tender money of a country cannot usually be expanded quickly. Bank money can be increased quickly and used when there is need of more money. In a developing economy (like that of India) banks play an important part as supplier of money.

• The banking system facilitates internal and international trade. A large part of trade is done on credit. Banks provide references and guarantees, on behalf of their customers, on the basis of which sellers can supply goods on credit. This is particularly important in international trade when the parties reside in different countries and are very often unknown to one another.

• Trade is also assisted by the grant of loans by discounting bills of exchange and in other ways. Foreign exchange transactions (the exchange of one currency for another) are also done through banks.

• Finally, banks act as advisers, counsellors and agents of business and indus¬trialorganisations. They help the development of trade and industry.

Conclusion:

There are special types of banks which provide facilities to different kinds of economic activities. Now-a-days in every country there is a central bank which controls the activities of all other banks, endeavours to keep the price level steady, and controls the rates of foreign exchange.

CENTRAL BANK OF INDIA

A central bank plays an important role in monetary and banking system of a country. It is responsible for maintaining financial sovereignty and economic stability of a country, especially in underdeveloped countries.

“A Central Bank is the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country”-Bank of International Settlement. It issues currency, regulates money supply, and controls different interest rates in a country. Apart from this, the central bank controls and regulates the activities of all commercial banks in a country.

According to Samuelson, "Every Central Bank has one function. It operates to control economy, supply of money and credit."

According to Vera Smith, "The primary definition of Central Bank is the banking system in which a single bank has either a complete or residuary monopoly of note issue."

According to Kent, "Central Bank may be defined as an institution which is charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of general public welfare."

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Bank of England was the world's first effective central bank that was established in 1694. As per the resolution passed in Brussels Financial Conference, 1920, all the countries should establish a central bank for interest of world cooperation. Thus, since 1920, central banks are formed in almost every country of the world. In India, RBI operates as a central bank.

Functions of Central Bank:

The different functions of a central bank

(i) Bank of issue:

Possesses an exclusive right to issue notes (currency) in every country of the world. In the initial years of banking, every bank enjoyed the right of issuing notes. However, this led to a number of problems, such as notes were over-issued and the currency system became disorganized. Therefore, the governments of different countries authorized central banks to issue notes. The issue of notes by one bank has led to uniformity in note circulation and balance in money supply.

(ii) Government's banker, agent, and advisor:

As a banker, the central bank performs banking functions for the government as commercial banks performs for the public by accepting the government deposits and granting loans to the government. As an agent, the central bank manages the public debt, undertakes the payment of interest on this debt, and provides all other services related to the debt.

As an advisor, the central bank gives advice to the government regarding economic policy matters, money market, capital market, and government loans. Apart from this, the central bank formulates and implements fiscal and monetary policies to regulate the supply of money in the market and control inflation.

(iii) Custodian of cash reserves of commercial banks:

Commercial banks are required to keep certain amount of public deposits as cash reserve, with the central bank, and other part is kept with commercial banks themselves.

The percentage of cash reserves is deeded by the central bank! A certain part of these reserves is kept with the central bank for the purpose of granting loans to commercial banks Therefore, the central bank is also called banker's bank.

(iv) Custodian of international currency:

The main aim of this reserve is to meet emergency requirements of foreign exchange and overcome adverse requirements of deficit in balance of payments

(v) Bank of rediscount:.

Rediscounting implies discounting a bill of exchange that was previously discounted. When owners of bill of exchange are in need of cash they approach the commercial bank to discount these bills. If commercial banks are themselves in need of cash they approach the central bank to rediscount the bills.

(vi) Lender of last resort:

Instead of rediscounting of bills, the central bank provides loans against treasury bills, government securities, and bills of exchange.

(vii) Controller of Credit:

The credit creation depends upon the amount of deposits, cash reserves, and rate of interest given by commercial banks. All these are directly or indirectly controlled by the central bank. For instance, the central bank can influence the deposits of commercial banks by performing open market operations and making changes in CRR to control various economic conditions.

RBI and its functions

The Reserve Bank of India is the central bank of the country. Central banks are a relatively recent innovation and most central banks, as we know them today, were established around the early twentieth century.

The Reserve Bank of India was set up on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank, which commenced operations on April 1, 1935.

The Bank was constituted to
* Regulate the issue of banknotes
* Maintain reserves with a view to securing monetary stability and
* To operate the credit and currency system of the country to its advantage.

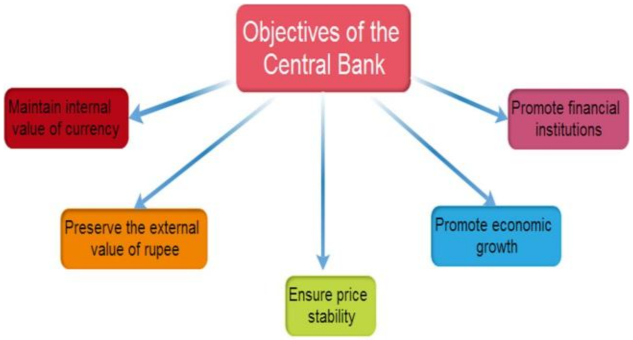
The Bank began its operations by taking over from the Government the functions so far being performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department. Offices of the Banking Department were established in Calcutta, Bombay, Madras, Delhi and Rangoon.

What are the main functions of Reserve Bank of India?

Reserve Bank of India (RBI) is the Central Bank of India. RBI was established on 1 April 1935 by the RBI Act 1934. Key functions of RBI are, banker's bank, the custodian of foreign reserve, controller of credit and to manage printing and supply of currency notes in the country.

Reserve Bank of India (RBI) is the central bank of the country. RBI is a statutory body. It is responsible for the printing of currency notes and managing the supply of money in the Indian economy.

Initially, the ownership of almost all the share capital was in the hands of non-government shareholders. So in order to prevent the centralisation of the shares in few hands, the **RBI was nationalised on January 1, 1949.**



Functions of Reserve Bank

1. Issue of Notes —The Reserve Bank has a monopoly for printing the currency notesin the country. It has the sole right to issue currency notes of various denominations except one rupee note (which is issued by the Ministry of Finance).
The Reserve Bank has adopted the **Minimum Reserve System** for issuing/printing the currency notes. *Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 Cr. of which at least Rs. 115 cr. should be in gold and remaining in the foreign currencies.*

2. Banker to the Government–The second important function of the Reserve Bank is to act as the Banker, Agent and Adviser to the Government of India and states. It performs all the banking functions of the State and Central Government and it also tenders useful advice to the government on matters related to economic and monetary policy. It also manages the public debt of the government.

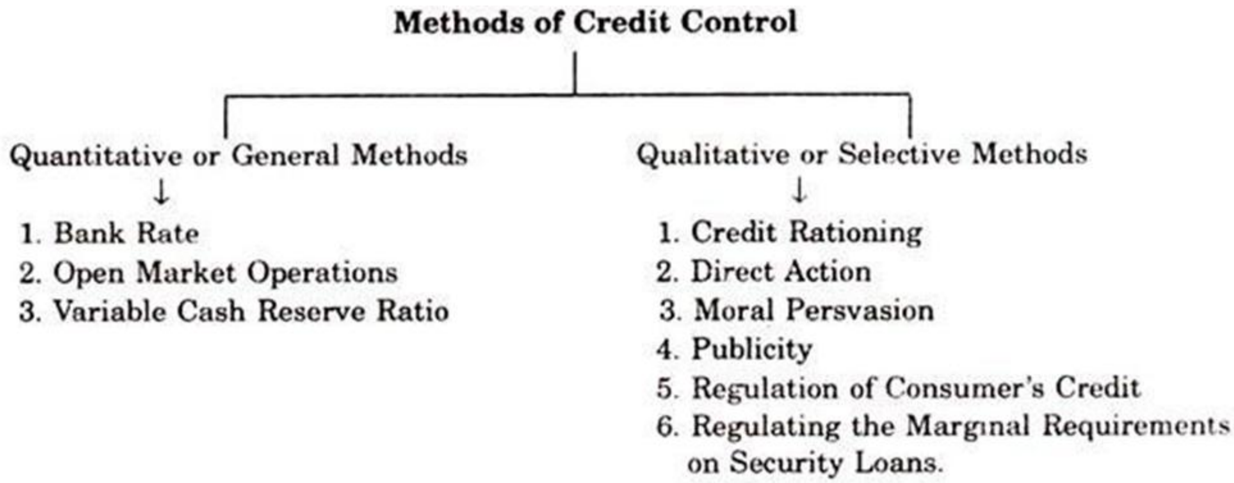
3. Banker's Bank:- The Reserve Bank performs the same functions for the other commercial banks as the other banks ordinarily perform for their customers. RBI lends money to all the commercial banks of the country.

4. Controller of the Credit:- The RBI undertakes the responsibility of controlling credit created by commercial banks. RBI uses two methods to control the extra flow of money in the economy. These methods are quantitative and qualitative techniques to control and regulate the credit flow in the country.
5. Custodian of Foreign Reserves:-For the purpose of keeping the foreign exchange rates stable, the Reserve Bank buys and sells foreign currencies and also protects the country's foreign exchange funds. RBI sells the foreign currency in the foreign exchange market when its supply decreases in the economy and vice-versa.

Methods of Credit Control used by Central Bank

The two categories are:

I. Quantitative or General Methods
II. Qualitative or Selective Methods.



Quantitative or General Methods:

1. Bank Rate Policy:

The bank rate is the rate at which the Central Bank of a country is prepared to re-discount the first class securities.It means the bank is prepared to advance loans on approved securities to its member banks.As the Central Bank is only the lender of the last resort the bank rate is normally higher than the market rate.If the Central Bank wants to control credit, it will raise the bank rate. As a result, the market rate and other lending rates in the money-market will go up. Borrowing will be discouraged. The raising of bank rate will lead to contraction of credit.

Similarly, a fall in bank rate mil lowers the lending rates in the money market which in turn will stimulate commercial and industrial activity, for which more credit will be required from the banks. Thus, there will be expansion of the volume of bank Credit.

2. Open Market Operations:

This method of credit control is used in two senses:

(i) In the narrow sense, and

(ii) In broad sense.

In narrow sense—the Central Bank starts the purchase and sale of Government securities in the money market. But in the Broad Sense—the Central Bank purchases and sale not only Government securities but also of other proper and eligible securities like bills and securities of private concerns. When the banks and the private individuals purchase these securities they have to make payments for these securities to the Central Bank.This gives result in the fall in the cash reserves of the Commercial Banks, which in turn reduces the ability of create credit. Through this way of working the Central Bank is able to exercise a check on the expansion of credit.

Further, if there is deflationary situation and the Commercial Banks are not creating as much credit as is desirable in the interest of the economy. Then in such situation the Central Bank will start purchasing securities in the open market from Commercial Banks and private individuals.

With this activity the cash will now move from the Central Bank to the Commercial Banks. With this increased cash reserves the Commercial Banks will be in a position to create more credit with the result that the volume of bank credit will expand in the economy.

3. Variable Cash Reserve Ratio:

Under this system the Central Bank controls credit by changing the Cash Reserves Ratio. For example—If the Commercial Banks have excessive cash reserves on the basis of which they are creating too much of credit which is harmful for the larger interest of the economy. So it will raise the cash reserve ratio which the Commercial Banks are required to maintain with the Central Bank.

This activity of the Central Bank will force the Commercial Banks to curtail the creation of credit in the economy. In this way by raising the cash reserve ratio of the Commercial Banks the Central Bank will be able to put an effective check on the inflationary expansion of credit in the economy.

Similarly, when the Central Bank desires that the Commercial Banks should increase the volume of credit in order to bring about an economic revival in the country. The Central Bank will lower down the Cash Reserve ratio with a view to expand the cash reserves of the Commercial Banks.

Qualitative or Selective Method of Credit Control:

The qualitative or the selective methods are directed towards the diversion of credit into particular uses or channels in the economy. Their objective is mainly to control and regulate the flow of credit into particular industries or businesses.

The following are the important methods of credit control under selective method:

1. Rationing of Credit.

2. Direct Action.

3. Moral Persuasion.

4. Method of Publicity.

5. Regulation of Consumer’s Credit.

6. Regulating the Marginal Requirements on Security Loans.

1. Rationing of Credit:

Under this method the credit is rationed by limiting the amount available to each applicant. The Central Bank puts restrictions on demands for accommodations made upon it during times of monetary stringency.

In this the Central Bank discourages the granting of loans to stock exchanges by refusing to re-discount the papers of the bank which have extended liberal loans to the speculators. This is an important method of credit control and this policy has been adopted by a number of countries like Russia and Germany.

2. Direct Action:

Under this method if the Commercial Banks do not follow the policy of the Central Bank, then the Central Bank has the only recourse to direct action. This method can be used to enforce both quantitatively and qualitatively credit controls by the Central Banks. This method is not used in isolation; it is used as a supplement to other methods of credit control.

Direct action may take the form either of a refusal on the part of the Central Bank to re-discount for banks whose credit policy is regarded as being inconsistent with the maintenance of sound credit conditions. Even then the Commercial Banks do not fall in line, the Central Bank has the constitutional power to order for their closure.

This method can be successful only when the Central Bank is powerful enough and has cordial relations with the Commercial Banks. Mostly such circumstances are rare when the Central Bank is forced to resist to such measures.

3. Moral Persuasion:

This method is frequently adopted by the Central Bank to exercise control over the Commercial Banks. Under this method Central Bank gives advice, then request and persuasion to the Commercial Banks to co-operate with the Central Bank is implementing its credit policies.

If the Commercial Banks do not follow or do not abide by the advice or request of the Central Bank no gross action is taken against them. The Central Bank merely was its moral influence and pressure with the Commercial Banks to prevail upon them to accept and follow the policies.

4. Method of Publicity:

In modern times, Central Bank in order to make their policies successful, take the course of the medium of publicity. A policy can be effectively successful only when an effective public opinion is created in its favor.

Its officials through news-papers, journals, conferences and seminar's present a correct picture of the economic conditions of the country before the public and give a prospective economic policies. In developed countries Commercial Banks automatically change their credit creation policy. But in developing countries Commercial Banks being lured by regional gains. Even the Reserve Bank of India follows this policy.

5. Regulation of Consumer's Credit:

Under this method consumers are given credit in a little quantity and this period is fixed for 18 months; consequently credit creation expanded within the limit. This method was originally adopted by the U.S.A. as a protective and defensive measure, there after it has been used and adopted by various other countries.

6.Regulating the Marginal Requirements on Security Loans:

This system is mostly followed in U.S.A. Under this system, the Board of Governors of the Federal Reserve System has been given the power to prescribe margin requirements for the purpose of preventing an excessive use of credit for stock exchange speculation.

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