

Unit. I

Introduction to Banking

Indian Banking System ^{phases} and Development

The word 'bank' is said to have derived from the French word 'Banco' or 'Banca' or 'Banque' which mean a bench.

The early jews in Lombardy transacted their banking business by sitting on benches.

Banking history traces back to ancient civilizations with merchants providing loans and temples acting as early depositories. In the 14th century, Italian cities like Florence and Venice established the first modern banks, and by the mid-20th century, the introduction of ATMs and online banking revolutionized the industry.

Ancient Roots of Banking:

Early Lending:

Merchants in ancient Assyria, India and Sumer provided grain loans to farmers and traders around 2000 BC.

Temples as Banks:

Temples in ancient Greece and Rome began offering loans, accepting deposits and exchanging currency.

Early Banks in India:

The Bank of Hindustan was established in India in 1770, followed by the General Bank of India in 1786.

The Journey of Indian Banking system divided into three distinct phases.

phase 1: The early phase of Indian Banks (1786 to 1969)

phase 2: Nationalisation of Banks and Banking sector Reform (1969-1991)

phase 3: New phase of Indian Banking system (1991 till)

phase 1:

The first bank, Bank of Hindustan was established in 1770, followed by the General Bank of India in 1786. The East India company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called the presidency Banks.

These three banks were amalgamated in 1920 and the Imperial Bank of India, a bank of private shareholder mostly ~~too~~ Europeans) was established.

In 1866, Allahabad bank was established exclusively by Indians and another public sector bank (punjab National Bank) was welcomed by Indian citizens in 1894.

Between 1906 and 1913 Bank of India, central Bank of India, Bank of Baroda, canara Bank, bank of mysore were set up. And at last the Bank of All Banks the Reserve Bank of India has been established in 1935.

phase a:

The Govt of India has taken major steps to reform Indian Banking sector after independence. The reform has started with nationalization of Imperial Bank of India and started banking facility to rural and semi urban areas.

The government ~~const~~ constituted the state bank of India to act

as the principal agent of RBI and to handle banking transaction of the union government and state government all over the country. In 1969, 14 commercial banks in the ~~country~~ country were nationalized.

In the second phase of banking sector reform, seven more banks were nationalized in 1980. With this 80% of the banking sector in India came under the government ownership.

Phase 3:

This phase has introduced many more products and facilities in the banking sector as part of the reform process. In 1991, under the chairmanship of M. Narasimham, a committee was set up which worked for the liberalization of banking practices.

Bank - Definition:

According to H.L. Hart a banker is "one" who in the ordinary course of his business honours cheques drawn upon him by person from and for whom he receives money on current accounts.

Indian Banking History :

The concept of banking has existed for thousands of years evolving alongside human civilization. It began with the basic idea of storing wealth and facilitating trade, and has grown into a complex system that powers the global economy.

In ancient times, banking was carried out by temples and palaces in Mesopotamia (around 8000 BCE), where priests safeguarded goods like grains and silver. These early "bankers" issued loans and kept records on clay tablets. In Ancient Egypt, Greece and Rome, moneylenders operated in market places, accepting deposits and issuing credit.

The Roman bankers, called *argentarii*, offered various services similar to modern banks.

During the medieval period:

Banking developed further in both the Islamic world and Europe. Islamic ethical principles in banking, banking interest and promoting profit sharing system. Tools like cheques and money transfer made trade easier. In

Europe, especially in Italy. Merchant families like the medici became influential bankers. They used bills of exchange, which were easily form of international money transfer.

In the early modern era:

The banks became more structured. The bank of Amsterdam (1609) and the bank of England (1694) were pioneers in modern, central banking. In England goldsmiths who stored previous metals started issuing paper receipts. These later evolved into banknotes. This era also saw banks supporting colonial expansion by financing long distance trade.

By the 19th and early 20th centuries the banking system became essential to industrial economic. Banks funded railways, factories and infrastructure.

modern era, banking went global. After world war II institutions like the International Monetary Fund (IMF) and World Bank were created to stabilize economies. The rise of digital technology brought online banking, ATM and mobile payments.

Banking Regulation Act 1949 - provisions:

A bill was introduced in march 1948 and was passed in the parliament in feb 1949. It came into force from 16th march 1949.

The act was originally called the banking companies act, 1949 and now it is renamed as the Banking Regulation act, 1949.

The important provision of the Act have been discussed under the following heads:

1. Definition of Banking
2. Business of Banking company and prohibited Business.
3. Capital Requirements
4. Management
5. Maintenance of liquid assets
6. Licensing of Banks
7. Opening of new branches
8. provisions ~~of~~ Regarding loans and advances.
9. Inspection of Banks
10. power of RBI
11. Returns to be submitted
12. Acquisition of business
13. winding up of Banking companies
14. Amalgamation of Banking companies

15. Miscellaneous - penalties

16. Application of the Act to co-operative Banks.

Definition of Banking:

See 5(b) "Accepting for the purpose of lending or investment of deposit of money, from the public repayable on demand or otherwise and withdrawable by cheques, order or otherwise."

See 5(c) defines a "Banking company" as "any company which transacts the business of banking in India".

Business of Banking company:

Kinds of business that can be done
core Banking Activities:

Borrowing, Raising or Taking up money.

Lending or Advancing money

Drawing, making, Accepting, Discounting and managing Bills of Exchange promissory notes etc.

Other permitted Activities:

Agency Business (Acting as agents for clients)

Guarantee and Indemnity Business

(like insurance and underwritings)

Buying and Selling foreign Exchange

Dealings with stocks, funds, shares,

Debtenture, Bonds etc.

Kinds of Business that cannot be done:

Section 8 prohibits a bank from carrying on trading activities which are not incidental to banking business.

Section 19 → prohibits a banking company from entering into trading activities by acquiring a control in non-banking companies.

Capital Requirements:

For a bank incorporated outside India the minimum capital requirement is Rs 15 lakhs; including 20 lakhs if it has a place of Business in Bombay or Calcutta.

Aggregate of paid up capital and Reserve to Banking companies situated in India.

I (a) For a banking company having place of Business in more than one State.

(b) If it has a place of business in more than one State and if any such place is situated in Mumbai, Kolkata or both

-10,00,000

ii For a banking company having office in only one state but none in Mumbai or Kolkata.

a) For the principal place of business plus - 1,00,000

b) For each of the place in the same district plus - 10,000

c) For each of the place in other district - 25,000

Subject to an overall limit of 5,00,000

iii For a banking company having only one place of business and also no branch in Mumbai or Kolkata.

- 50,000

iv For a banking company having offices in only one state, one or more of which is or are situated in Bombay or Kolkata plus - 5,00,000

for each place of business outside the city - 25,000

Subject to an overall limit of - 10,00,000

Reserve Fund:

Sec 17. Every banking company must before ~~declaring~~ declaring dividend transfer a sum not less than 20% of its net profit to a Reserve Fund until the amount of the Reserve Fund is equal to the paid-up capital of the company.

Management:

Board of Director

Sec 10 (A) provides that at least 51% of the Board of Director of a banking company must consist of persons who have special knowledge in

- (i) Agricultural & rural economy
- (ii) Banking
- (iii) Economics
- (iv) Law etc.

whole time chairman:

Every banking company shall have a chairman who will be a professional banker. He shall be entrusted with the management of the affairs of banking company.

Sec 10 - Insolvent criminals

persons having commission as remuneration share in profit of company.

(whose remuneration is excessive according to RBI)

should not be chairman.

Maintenance of liquid Assets:

Sec 18 - every bank should maintain 3% of the total time and demand liabilities in the form of cash reserve with RBI or SBP or any other notified banks. RBI can increase the Reserve upto 15%.

Sec 19 - requires banking company do not hold share in other companies more than 30%.

Sec 20 - prohibited from making any loans or advances on the security of its own shares.

Prohibited from granting unsecured loans to directors.

Sec 14 - n - prohibited from creating a floating charge to any of its property without obtaining certificate from RBI

prevent speculative dealings:

prevent overtrading at the expenses of liquidity.

prevent banks from India to their countries.

Sec 9 - Prohibits banks not to hold as the owners of the pledge, immovable properties

more than 7 years.

Licensing of Banks:

Sec- 22 of the Act says that every bank should license from RBI before commencing business.

Opening of new Branches:

Sec 23 provides provisions to open and relocating branches. Every banks should get prior approval from RBI before opening new branches.

Loans & Advances:

Sec 77 - No banks shall grant any loans or advances on the security of its own shares.

Powers of RBI:

- powers to issue license for new banks and grant permission for starting new branches.

- powers to determine the audit policy to be followed by banks.

- powers of inspection

- power to control management,

- power to advise banks.

- power to assist in proposals for returns

- power to grant moratorium,

- power to appoint

Additional powers:

power to give advice to the central government.

Returns to be Submitted:

Sec 23(3) Return of liquid asset & liabilities

Sec 26 Return unclaimed deposits.

Sec 27 monthly return

Sec 31 Return of Annual Records.

Additional Information:

The amendment ordinance empowers RBI.

Acquisition of Business:

Section 36 AE to 36 AJ provide for the acquisition of banking companies by the central government on the recommendation of the RBI.

Winding up of Banking companies:

A banking company can be wound up like any other company, compulsorily or voluntarily or subject to supervision of the court.

Amalgamation of Banking companies:

Sec 44 (a) of the Act deals with amalgamation of banking companies.

Miscellaneous provisions:

Part IV of the Act deals with miscellaneous provision. and Sec 46 deals with penalties.

Application of the act cooperative Banks:

cooperative banks were brought under the purview of Banking Regulation Act by passing an amendment to it in 1965 called the Banking Laws (Application co-operative Societies) Act 1965.

Banking structure In India:

payment Banks and Small Banks:

Small Finance Banks (SFBs) and payment Banks are both specialised banking institutions in India, but they differ in their scope of operations and target clientele.

SFBs provides a wider range of banking services, including loans and credit while payment banks focus on facilitating payments, remittances and basic banking services.

Small Finance Banks:

Small finance Banks provide Banking service and financial inclusion to underserved and unbanked segments, including small business owners, farmers, and low income household.

Services:

They offer deposit accounts loans and credit facilities.

Regulation :

licensed and regulated by RBI.

Eg: AU Small finance bank, Capital Small finance bank, Equitas Small finance banks.

Payment Banks :

A payment bank is a financial institution set up to operate on a small scale with minimal credit risk. It was introduced based on the recommendations of the Nachiket more committee to promote financial inclusion providing banking service to the unbanked and unbanked populations.

It is registered under companies act 2013.

Governed by

Banking Regulation Act 1949

Foreign Exchange management Act 1999

Payment & Settlement System Act 2007

Main objectives :

Serve migrant workers, low income households, and small entrepreneurs.

offer essential banking service such as deposits, payment & remittances.

facilitate the digital banking
eco system in India.

Minimum paid up capital - Rs 100 crore.

Advantages :

Expand Rural Banking & financial inclusion
Boasts digital & formal financial System.

Alternative to commercial banks.

Safe & Secure.

Limitations :

Lack of Awareness

Low incentives for Agents

Infrastructure limitations

Technological Barriers

Commercial Banking :

A commercial bank is a kind of financial institution that carries all the operation related to deposit and withdrawal of money for the general public, providing loans for investment and other such activities.

These banks are profit-making institutions and do business only to make a profit. Two primary characteristics of a commercial bank are lending and borrowing.

Function of commercial Bank:

primary function

Accepting Deposits

providing loan &

Advances

credit cash

Secondary

functions

Discounting of

bill of Exchange

overdraft facilities

broker facilities

paying & sutthering

the credit

Types of commercial Bank

- Scheduled

Public Sector Bank

Private Sector Bank

Regional Rural Bank

Foreign Bank

public Sector Bank:

Public banks are a type of commercial Banks in India that are known to be safe and reliable they are co-owned by the central government.

Functions:

To help people build wealth through savings and interest earned.

To offer msme & sme loans for small businesses and entrepreneurs.

To finance agricultural ventures & other small scale industries.

To create credit service that promote uninterrupted economic growth.

Encourage capital formation in slow economic area through deposits & loans.

SBI, Bank of Baroda, central Bank

Private Sector Banks:

Private Sector banks are financial institutions that are owned and operated by private individual or corporation. These banks operate with the objective of making profit for their shareholders.

Functions:

Accepting deposits from individual and business.

Providing variety of loans to individual and business.

Facilitating payments through various channels, including ATM, online banking, mobile banking, debit & credit cards.

Private banks provide various investment opportunities to customers. (bonds, shares, other fin instruments)

They offer wealth management service, including ~~pro~~ personalized portfolio management.

Electronic banking such as mobile banking, online banking, internet banking.

Regional Rural Banks:

Regional Rural Banks (RRB) are aimed at providing banking service in rural areas, particularly to small farmers, artisans, rural entrepreneurs and weaker section of society.

Established under the Regional Rural Banks Act of 1976, on the recommendation of the Narasimham Committee on Rural Credit.

Regulated by the RBI and supervised by NABARD.

Ownership Structure:

Central Government -	50%
State	15%
Spons or bank	35%

First RRB of India - pratham Gramin Bank. It was established on Oct 2, 1975

Functions:

- Accepting deposits
- Credit facilities
- Agricultural & Rural Development
- Financial Inclusion
- co-operative Banking Activity.

Foreign Banks:

Foreign banks are essentially branches of a larger bank that is headquartered in a different country. They operate under the regulation of both their home country and the host country. They often cater to multinational corporations, with operations across borders.

Function:

Financial Service

Supporting global trade and Investment

Facilitating International Business

Promoting financial inclusion

Competing with domestic banks.

Scheduled commercial Banks:

These are commercial banks that are listed in the Second Schedule of the RBI Act 1934.

Non Scheduled Commercial Banks:

There are commercial banks that are not listed in the Second Schedule of the RBI Act.

Commercial Banking Functions:

Accepting Deposits

Advancing loans

Investing funds

Promoting Banking Habit

Agency Service

General utility service

Credit creation

Realisation of socio-Economic objectives

Accepting Deposits:

The banks accept deposits

a) Fixed deposit account

b) current deposit account

c) Savings deposit account

Fixed deposit account:

Accept money for a fixed period time.

This is also called time deposit or 'term deposits'. It cannot be withdrawn before the expiry a certain fixed period of time.

current deposit account:

The depositor can withdraw the money from his current account whenever the need for it arises. It is a following deposit account, no interest is paid by the banker. This type of account is preferred by businessman who may ^{have} to withdraw money several time a day. Also known as demand

deposit or chequing deposits.

Savings bank account:

Depositor can make deposits of money any number, of time a day. But there are restrictions for number of withdrawals.

Advancing loans:

Out of the deposits collected from the public, bank earmark certain portion as cash reserves. The balance of cash available with them is lent out to the needy customers.

Types of loan:

Demand loan - Specified sum of money against some collateral security.

Cash credit - allow the borrower to withdraw money from time to time up to certain limit based on value of stocks of borrower's godown.

Overdraft - Banker allow borrower to overdraw his account through cheques.

Discounting of bill:

Bankers provides financial accommodation by discounting eligible first class commercial bill of exchange.

Investing funds:

Banks makes an investment of its surplus funds in Govt securities, bonds & stock etc and earn interest on them.

Promoting Banking Habit:

Promotes banking habits among customers through advertising ~~compersing~~ campegting of new account opening, deposit acceptance etc.

Agency Services:

- fund transfer
- fund collection
- portfolio management
- collecting dividends
- premium payments etc

General utility services:

- Safe custody service
- issue of traveller's cheques
- credit information
- Business information
- underwriting services
- acceptance services.

Credit creation:

loans and advances granted by the banker are credited to a separate account in the name of the borrower - customer.

Realization of socio-economic objectives:

To support various policies and programme of govt with adequate & timely findings.
funding.

Universal Banking :

Banks that are engaged in diverse kinds of banking Business, which are generally handled by different types of banking entities are known as universal banks. Banking that includes investment services related to Savings and loans are known as universal banking they are financial conglomerates, which function as part of financial markets.

It was originated in Germany in 1850s. In India it is new arisin.

Types :

1) fully engaged universal banks :

Function as a single institutions entity offering a complete range of banking and financial products & services.

2) Partly integrated financial conglomerates

They provide service such as mortgage banking, leasing & insurance.

3) Banking subsidiary Structure :

offer function such as investment banking, & insurance in addition to commercial banking functions.

4) Bank holding ~~company~~ structure :

Banking and financial products are offered.

Central Banking :

Central Bank is a bank which constitutes the apex of a monetary and banking structure of its country and which performs as best as it can in the national economic interest.

Need for central Banking :

1) control of credit :

To regulate and control the volume of credit created by commercial banking.

creates stability and sustainability in monetary economy.

2) Issue of paper currency :

To issue paper currency so as to keep the economy in a monetized state.

Note issue by central bank satisfied the requirement of elasticity.

3) Supporting commercial banks :

To support and help the commercial banks to tide over economic crisis by providing them with financial assistance.

4) Implementation of monetary policy :

central bank exercises full control over the banking and financial system of a country.

Implement the financial monetary policies.

Principles of central Banking:

1) National welfare:

central bank should work for exclusively in the interest of public welfare.

2) Monetary Stability:

Helps to maintain monetary and financial stability in the country to promote economic stability.

3) No political interference:

central bank is free from all political influences in all matters of its nations.

4) Co-operation with central Government:

Helps proper formulation and efficient implementation of policies relating to monetary management of the country.

5) co-operation with member banks:

central bank should co-operate with its member banks in receiving deposits and providing deposits to needy people.

Functions of central bank:

Function of note issue.

Function of banker, agent & adviser

Function of Bankers Bank

Function of lender of last resort

Function of central clearance, settlement & transfer.

Function of custodian of gold and forex reserves.

Function of information dissemination

Function of control of credit

1) Function of Note issue:

Note is the monopolistic function of central bank. It is not possible of being undertaken by the commercial banks and Government.

popular system of note issue.

Proportional Reserve system

Minimum Reserve System

Proportional Reserve System:

Only a proportion of note issued will be backed by gold or silver reserves and the rest by government securities & approved commercial paper. It was adopted in India until 1956.

Minimum Reserve System:

The law prescribe a minimum reserve to be maintained against note issue in gold coin and foreign securities. RBI currently adopting this system of note-issue.

2) Function of Banker, agent and adviser:

conducting the banking accounts of government departments and enterprises

Advancing short term loans to the Government.

Making extraordinary advances during war, famine, depression.

Providing to the government foreign exchange resources.

3) Function of Banker's Bank:

Keeping in its custody, either by law or by custom a certain portion of deposits called cash reserves, received from the public by commercial banks to be drawn during busy season.

Rediscounting the bills of commercial banks.

Providing dominant & good leadership to commercial banks.

4) Function of lender of the last resort:

It assumes the responsibility of meeting all reasonable demand for financial accommodation from the commercial banks, discount houses and certain institutions.

Central bank helps the commercial banks by extending financial accommodations when they have exhausted all the source of funds.

5) Functions of central clearance, settlement and Transfer:

It holds the cash reserve of the commercial banks, it becomes easier and more convenient for it to act as the clearing-house of the country.

6) Function of the custodian of Gold and Foreign Reserves:

The central banks are supposed to keep both gold as well as foreign currency as reserves against note issue.

7) Function of Information dissemination:

To disseminate information pertaining to the economic development of the country.

8) Function of control of credit:

It means regulation and control of bank advances. Through this function all the other functions are united.

Central Banking Vs Commercial Banking:

Features	central Banking	commercial Banking
1) Bank status	Apex bank in the banking system	constituent bank in the banking system
2) ownership	owned by the central Government	private or public owned.
3) primary motive	Stimulating economic growth of the country	profit making
4) Dealing with public	Do not directly deal with public	Directly with public
5) competitions	No competition with commercial banks	competitions among commercial banks in common.
6) control	control over functioning of commercial banks.	No control over central banks.
7) Note issue	Note-issue is the monopoly function of central banking.	No authority in note issue
8) custodian	custodian of foreign exchange reserve	custodian of valuable of customers.

9)	Banker	Banker to government	Banker to public
10)	Cash reserve ratio	Not required to maintain CRR	Required to maintain CRR with central bank.
11)	Lender of last resort	Grants credit to help commercial banks.	Help central bank in availing credit
12)	clearing house	Act as clearing house of information for commercial banks.	No such function is performed.
13)	Regulation	controls & Regulates monetary and banking system.	No such responsibility.

Indian Banking system - structure:

The structure of banking system in India consists of two parts

un-organised sector

organised sector

Un-organised Sector:

money lender

Indigenous Banker

Organised Sector:

Commercial Banks

(i) scheduled banks

(ii) non-schedule banks

co-operative banks

regional rural banks

unorganised Sector:

This sector operates outside RBI regulation and is often informal or semi formal.

main components:

Money lender

chit funds

Indigenous banker

pub
b
pri
for

pawn brokers

Finance companies. not regulated by RBI

microfinance through informal groups.

Organised Sector:

This sector is regulated by the reserve banks of India and follow formal rules & regulations.

Main components:

Commercial banks

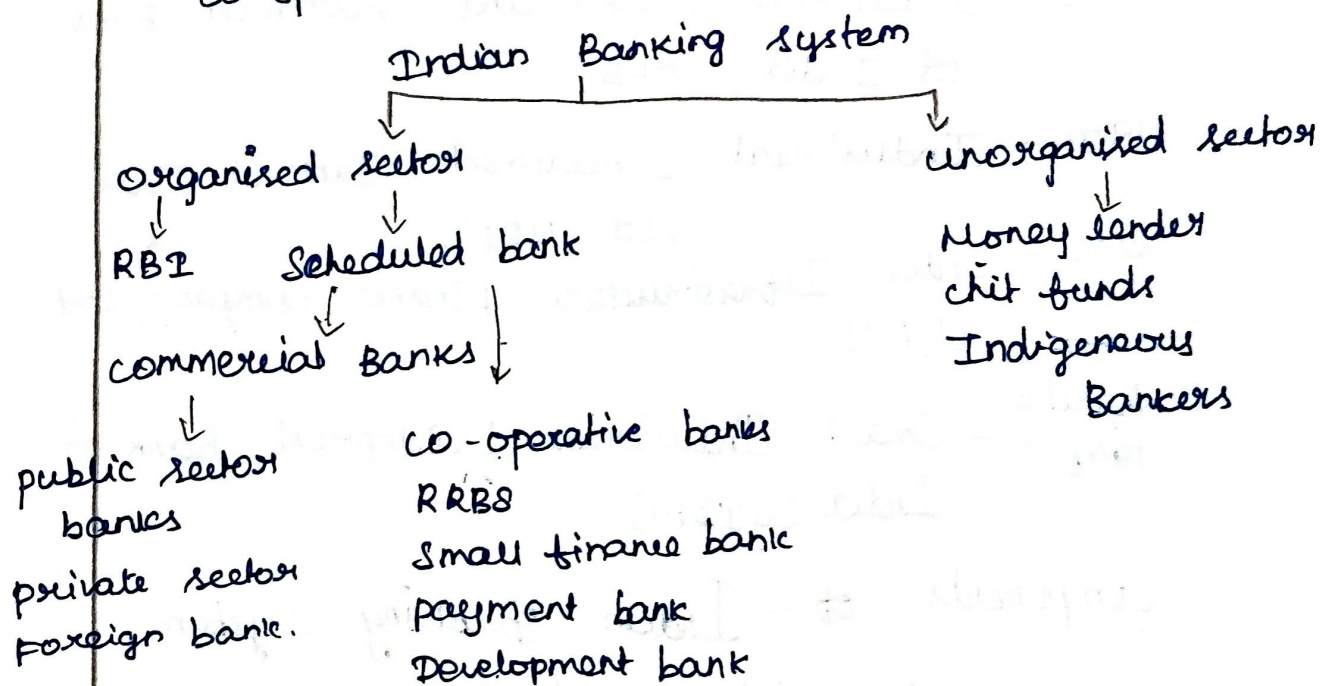
Regional rural banks

Small finance banks

payment banks

Development bank (NABARD, SIDBI)

co-operative banks.



Indigenous Bankers:

Indigenous bankers do not have any contract with other sections of the banking world. They combine banking with trading business. They generally deal with agriculturists and small traders. They charge higher interest rates.

Development Banks :

It is a multipurpose institution which provides medium and long term credit to industrial undertakings discover investment projects, undertake the preparation of project report provide technical advice and managerial services and ~~audit~~ assist the management of industrial units.

1948 - Industrial Finance corporations of India
IFCI

1951 - State financial corporation (SFCs)

1964 - Industrial development Bank of India

1955 - Industrial credit and Investment Bank of India, 1955.

1971 - Industrial Investment Bank of India
Ltd. (IIBI).

2006 - India Infrastructure Finance company Ltd
(IIFCL)

April 2
1990 - Small Industries Development Bank of India (SIDBI)

Components of Indian Banking System:

1) Financial Institutions

2) Financial markets

3) Financial Instruments / ~~debt~~ / ~~services~~
Securities

4) Financial services

1 Financial Institutions:

They are the intermediaries which facilitates smooth functioning of the banking system by making investors and borrowers meet. They mobilize savings and allocate them in productive activities. They also provide service to entities seeking advice on various issues. They act as middlemen between savers and borrowers as they are called intermediaries.

2) Financial Markets:

It is through financial markets that the banking system of an economy works. The main function of financial markets are facilitating creation and allocation of credit and liquidity, serving as intermediaries for mobilization of savings arising. The process of balanced economic growth, providing financial convenience etc.

3) Financial Instruments:

They represent a claim against the future income and wealth of others.

4) Financial Services:

The term financial services can be is the activities, benefits and satisfaction connected with sale of money, that offers to users and customers, financial related values.

Role of Banks in Economic Development:

Commercial banks role in promoting the economic Development of a country are:

1) Capital formation:

Commercial banks mobilize savings from innumerable house holds. This happens through the network of branches. Banks promote several savings scheme.

2) Financial Industry:

The meet the credit requirements of different sectors of an economy. Short term loans are provided to meet working capital needs of industries.

3) Financial Trade:

Banks provides loan to retailers and wholesalers against stock of goods dealt with them. They facilitate movement of goods from one place to another with the help of discounting and accepting bill of exchange, overdraft learning drafts etc.

4) Financing Agriculture:

Banks assist in agriculture development more over they provide loans to traders in agricultural commodities and also for the marketing of products.

5) Consumer financing:

They provide housing loans, vehicles loan, personal loan, loans for white goods, educational loan etc.

6) Financing Employment:

Banks provide loans for pursuing higher studies in engineering, medical, hotel management etc... Loan to young entrepreneurs, Medical & engineering graduates for establishing business.

7) Supporting monetary policy:

Monetary policy is formulated by central banks. It is essential to provide direction for the economic development.