Summary Sheet

Banking and Financial System

Important Note:

This chapter has very high-level information on various areas of banking. It would not be justice to create a further summary out of the same. So we are sharing the content sheet here as an attachment in place of summary sheet.

1 Evolution of Banking In India

The evolution of The formal Banking system in India can be divided into 2 phases:

1. Pre-Independence.
2. Post-Independence.

1.1 Pre-Independence Evolution

1.1.1 Establishment of the First Banks In India

- Banking in India has its **origin in Vedic times**, i.e., 2000 to 1400 BC.
- **Indigenous bankers and money lenders** have played a vital role for centuries.
- **Modern banking** in India emerged between the eighteenth and the beginning of the nineteenth centuries when European agency houses erected a structure of European controlled banks with limited liability.
- In **1683, the first bank was set up in Madras** by the officers of East India Company.
- The **first joint stock bank was Bank of Bombay**, established in 1720 in Bombay, followed by Bank of Hindustan in Calcutta, which was established in 1770 by an agency house.
- The **first 'Presidency bank'—the Bank of Bengal**—was established in Calcutta on June 2, 1806 with a capital of Rs. 50 lakh to cater to the requirement for modern banking services, uniform currency to finance foreign trade and remittances by British army personnel and civil servants.
- The Government subscribed to 20 per cent of its share capital.
- The **Bank of Bombay** was the second Presidency bank set up in 1840 followed by the Bank of Madras in July 1843.

Note: What is a Presidency Bank:

As these banks were set up in the three Presidencies that were the units of administrative jurisdiction in the country for the East India Company, they were known as Presidency banks and were governed by Royal Charters.

1.1.2 Imperial Bank Of India:

- **Three presidency banks**—the Bank of Bombay, the Bank of Madras, and the Bank of Bengal—which were set up between 1809 and 1843, **were amalgamated into the Imperial Bank of India in 1921.**
- The **role of the Imperial bank** was that of a commercial bank, a banker's bank and a banker to the government.
- The Imperial Bank of India **eventually became the State Bank of India.**

1.1.3 Cooperative Banking Movement:

- The cooperative banking movement had already evolved in India in the last decade of the nineteenth Century.
- **Vithal L Kavthekar** pioneered the urban cooperative credit movement in the year 1889 in the then princely State of Baroda.
- The second urban cooperative bank was the **Peoples' Cooperative Society in 1905** in Bangalore city in the princely State of Mysore.
- These banks catered to the requirements of urban lower income group population.

1.1.4 Banks with Indian Ownership:

- The **first Indian owned bank** was the Allahabad Bank set up in Allahabad in 1865 followed by Punjab National Bank which was set up in 1895 in Lahore.
- Between 1906 and 1913, many Indian owned banks such as Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up.
- The **major function of these banks** was to finance foreign trade while domestic trade was largely handled by the Multani shroffs and moneylenders.

1.1.5 Impact of The Great economic Depression:

- Between **1928 to 1934, the period of Great Depression**, a large number of small banks failed due to their loans going bad.
- To check the bank failures and to cater to the requirements of agriculture, **the Reserve Bank of India Act, 1934** was enacted and the Reserve Bank of India was set up in 1935.
- There was an increase in the number of reporting banks with low capital base, after the Reserve Bank was set up.
- However, the Reserve Bank did not have adequate powers of control or regulation.
- **Commercial banks were governed by the Company Law** and the permission of the Reserve Bank was not required even for setting up of a new bank.

1.2 Post Independence Evolution:

- At the time of Independence **banks were under private ownership** of the maharajas, or kings, of the princely states of India.
- These banks used to serve rich families and industrial houses and this narrowed the growth of banking system.
- To overcome these limitations, the government, in consultation with the RBI, enacted the **Banking Companies Act in 1949 (later renamed as the Banking Regulation Act).**

1.2.1 Bank Consolidations:

- The RBI accelerated the task of consolidation in the first 15 years of independence, when the scope of the Banking Companies Act was widened.
- Between **1954 and 1966, 217 weak banks were either amalgamated or liquidated** or their liabilities and assets transferred to other banks.
- In order to enlarge the reach of banking services, the **Government nationalised the Imperial Bank of India** by converting it into the State Bank of India in 1955.
- The objective of nationalisation was ‘extension of banking facilities on a large scale, more particularly in the rural and semi-urban areas, and for diverse other public purposes’.
- The ownership of SBI was vested with the Reserve Bank which has now been transferred to the Government of India.
- In **1969, 14 banks were nationalised** to promote macro-economic objectives such as economic growth, better regional balance of economic activities, and the diffusion of economic power.
- The nationalisation was effected by an ordinance, which was later replaced by an act of parliament known as the **Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.**
- Another six, viz, Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank, with deposit liabilities of Rs. 200 crore and above in 1980.

- The policy makers imposed a strict credit rationing approach, prescribed formula-based lending and high-directed credit obligations.

1.2.2 Disadvantages of Nationalisation:

- With the increase in nationalized banks and their branches the Government had easy access and control over public funds.
- As banks were merely tools in the hands of the government, banks had **no incentive to make profits and improve the financial health.**
- **Nationalisation killed competition** and stifled innovations in banking.
- Trade unions became strong in banks with political patronage and they resisted any form of change in the banking system.

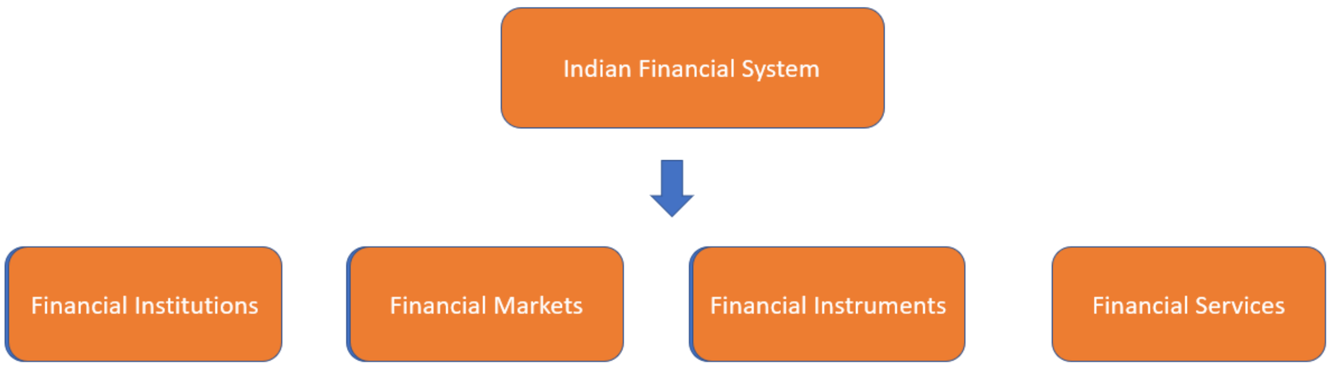
1.2.3 Banking Reforms:

- Although a series of reforms were undertaken from 1985 onwards, the first phase of comprehensive reforms in the banking sector was undertaken in June 1992 by implementing the **recommendations of the Narasimham Committee I (1991) on the financial system.**
- The recommendations of the committee were a fundamental departure from the then existing banking sector regulations.
- The major objective of the reforms was to create a viable and efficient banking system, which would thereby improve the productivity and efficiency of the financial sector.
- The **major policy changes brought about emphasised deregulation and liberalisation.**
- The first phase of reforms **focused on cleaning up bank balance sheets** and bringing about greater disclosure and transparency in accounting.
- The RBI laid down clear policies for asset classification, income recognition, loan-loss provisioning, and investment valuation with mandatory **compliance of the Bank for International Settlements (BIS) capital adequacy standards.**
- The **initial years of these reforms were very painful for banks.** Twelve of the 27 public sector banks reported losses. To overcome the crisis, the financially weak New Bank of India was merged with the large profitable Punjab National Bank in the early nineties.
- Two public sector banks, the State Bank of India and the Oriental Bank of Commerce, came out with their maiden initial public offerings (IPOs) which led to a dilution of government ownership in banks for the first time.
- Competition was infused in the banking system for the first time in 1993 when the RBI granted permission to set up private sector banks and foreign banks were allowed to open branches .
- Despite competition, banks were in a position to post higher profits due to volume expansion and fewer poor quality loans.

2 Introduction to Financial System

A financial system plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilizes and usefully allocates scarce resources of a country. A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.

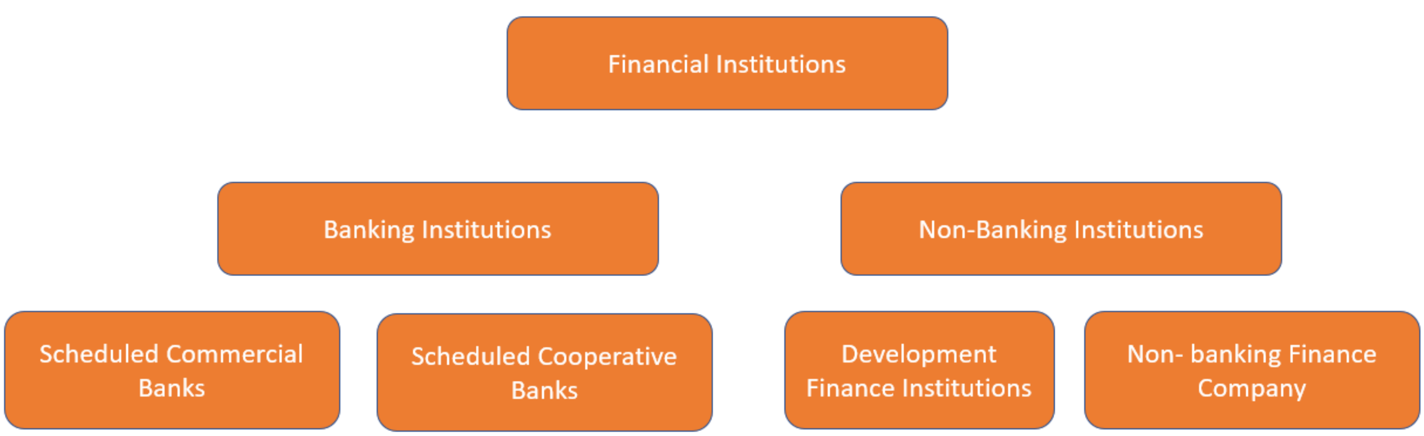
Components of Indian Financial System



1. **Financial Markets:** Financial Markets consist of Capital Markets and Money Markets. We have already studied the same in the Chapter on Debt Markets and Equity Markets.
2. **Financial Instruments:** Financial Instruments consist of Equity, Preference Shares, Bonds, etc. This also has been discussed in the respective chapters
3. **Financial Services:** Financial Services consist of Depositories, Custodians, Factoring, Forfeiting, Leasing, Underwriting**.** This also has been discussed in the respective chapter
4. **Financial Institutions:** Financial Institutions comprises of Banking and Non-Banking Institutions which we will discuss in this chapter

So, we have already discussed the major part in our previous chapters. Financial Markets, Financial Instruments and Financial Services have been discussed. Only Financial Institutions part has been left behind

3 Financial Institutions



3.1 Scheduled Commercial Banks

Scheduled commercial banks are those included in the second schedule of the Reserve Bank of India Act, 1934. Banks not under this Schedule are called **Non-Scheduled Banks**.

In terms of ownership and function, commercial banks can be classified into four categories**: public sector banks, private sector banks, foreign banks in India, and regional rural banks**.

Every Scheduled bank enjoys two types of principal facilities: it becomes eligible for debts/loans at the bank rate from the **RBI**; and, it automatically acquires the membership of **clearing house**.

3.1.1 Public Sector Banks

Public sector banks are banks in which the government has a major holding. These can be classified into two groups:

1. **The State Bank of India and its Associates**: State Bank of India The State Bank of India was initially known as the Imperial Bank. Imperial Bank was formed in 1921 by the amalgamation of three presidency banks—the Bank of Bengal, the Bank of Bombay, and the Bank of Madras. These presidency banks were created as a charter to deal in bills of exchange payable in India and were an integral part of the Indian treasury. They were taken over by the Imperial Bank of India as going concerns under a special legislation in 1920. The Imperial Bank acted as a banker to the government until the establishment of the RBI in 1935. Later, it was authorized to act as the sole agent of the RBI in places where the latter did not have its own branches. The Imperial Bank was nationalized under the State Bank of India Act, 1955, which was passed on May 8, 1955. Over the time, various other banks have been merged with SBI and they are basically called associated of SBI

2. **Nationalized banks**: In 1969, fourteen big Indian joint stock banks in the private sector were nationalized. The nationalization was affected by an ordinance which was later replaced by an act of parliament, known as the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970. This was the second phase of nationalization. Six commercial banks in the private sector with deposits over `200 crore was nationalized on August 15, 1980—the third phase of nationalization. In all, 28 banks were nationalized from 1955–1980.

3.1.2 Private Sector Banks

For over two decades, after the nationalization of 14 larger banks in 1969, no banks could be set up in the private sector. In the pre-reforms period, there were only 24 banks in the private sector. The Narasimham Committee, in its first report, recommended the freedom of entry into the financial system. It stated that the RBI should permit the establishment of new banks in the private sector provided they conform to the minimum start-up capital and other requirements. The committee also recommended that there should not be any difference in treatment between the public sector and private sector and any restrictions in operation in this regard should be removed. The RBI considered the above recommendations and allowed banks to be set up in the private sector. The banks which have been setup in the 1990s taking into consideration the guidelines of the Narasimha Committee are referred to as new private sector banks. Examples of Private banks would be ICICI, HDFC bank etc.

3.1.3 Foreign Banks in India

Banks from foreign countries are called foreign banks. Foreign banks have been operating in India since decades. A few foreign banks have been operating in India for over a century. ANZ Grindlays had been in India for more than hundred years, while Standard Chartered Bank has been around since 1858. Many foreign banks from different countries set up their branches in India during the 1990s—the liberalization period. A total of 27 new foreign banks opened branches in India following the reforms of 1991, in addition to the 18 which were already operating in India.

3.1.4 Regional Rural Banks

Regional Rural Banks are **local level banking organizations** operating in different States of India. They have been created with a view to serve primarily the rural areas of India with basic banking and financial services. However, RRBs may have branches set up for urban operations and their area of operation may include urban areas too.

The area of operation of RRBs is limited to the area as notified by Government of India covering one or more districts in the State. RRBs also perform a variety of distinct functions. RRBs perform various functions in following heads:

- Providing banking facilities to rural and semi-urban areas.
- Carrying out government operations like disbursement of wages of MGNREGA workers, distribution of pensions etc.
- Providing Para-Banking facilities like locker facilities, debit and credit cards.

3.2 Scheduled Cooperative Banks

Cooperative Banks in India have become an integral part of the success of Indian Financial Inclusion story. They have achieved many landmarks since their creation and have helped a normal rural Indian to feel empowered and secure

The structure of cooperative network in India can be divided into 2 broad segments-

1. Urban Cooperative Banks
2. Rural Cooperatives

Urban Cooperatives can be further divided into scheduled and non-scheduled. Both the categories are further divided into multi-state and single-state. Majority of these banks fall in the non-scheduled and single-state category.

- Banking activities of Urban Cooperative Banks are monitored by RBI.
- Registration and Management activities are managed by Registrar of Cooperative Societies (RCS).

The rural cooperatives are further divided into short-term and long-term structures. The short-term cooperative banks are three-tiered operating in different states. These are

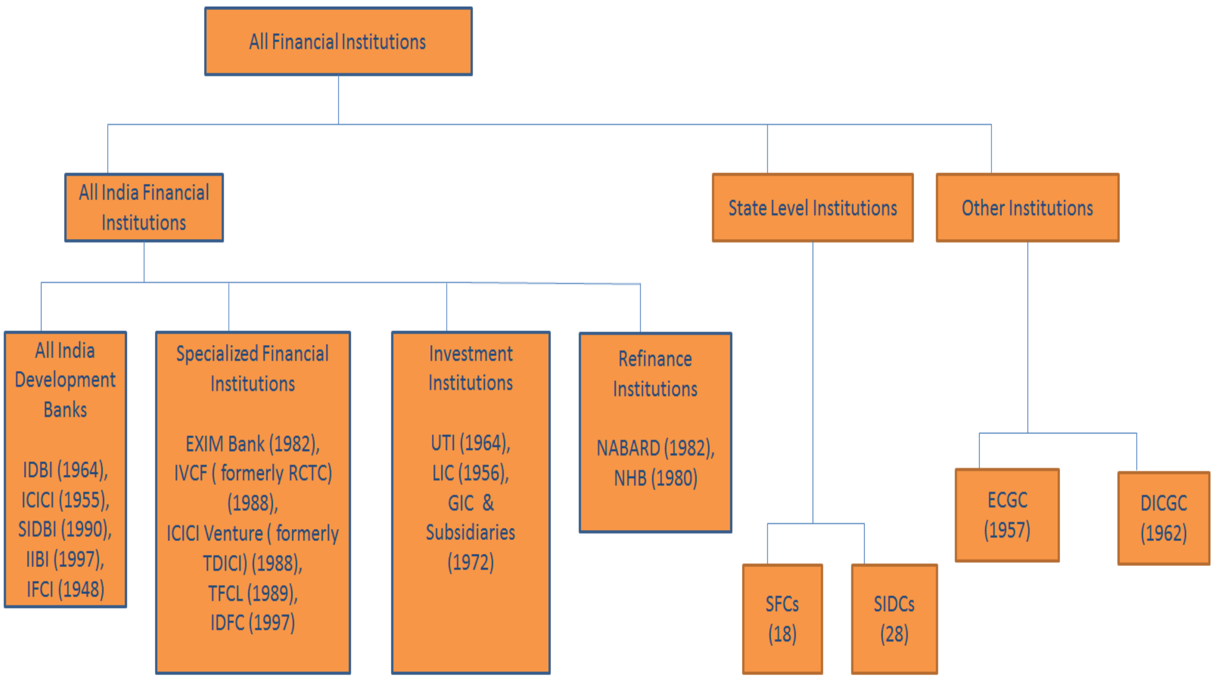
1. **State Cooperative Banks**- They operate at the apex level in states
2. **District Central Cooperative Banks**-They operate at the district levels
3. **Primary Agricultural Credit Societies**-They operate at the village or grass-root level.

Likewise, the long-term structures are further divided into –

1. **State Cooperative Agriculture and Rural Development Banks (SCARDS)-** These operate at state-level.
2. **Primary Cooperative Agriculture and Rural Development Banks (PCARDBS)**-They operate at district/block level.

3.3 Development Finance Institutions

Development Finance will be discussed in a separate unit as it is a separate unit in the syllabus. In this separate unit we will cover SIDBI, NABARD, EXIM Bank etc.



3.4 Non- Banking Finance Company

Non-banking financial companies (NBFCs) constitute an important segment of the financial system. NBFCs are financial intermediaries engaged primarily in the business of accepting deposits and delivering credit. They play a key role in channelizing the scarce financial resources to capital formation. NBFCs supplement the role of the banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers. But they differ from banks in many ways. An NBFC can accept deposit but not demand deposits and hence, they cannot raise low cost funds through savings or current accounts. Moreover, it is not a part of the payment and settlement system, cannot issue cheques drawn on itself and cannot borrow from the RBI.

NBFCs can be classified into different segments depending on the type of activities they undertake.

1. Asset Finance Company (AFC)
2. Investment Company (IC)

3. Loan Company (LC)
4. Factors (During 2012–13, a new category of NBFCs-Factors was created.)
5. NBFC has also been created with a category named as NBFC-P2P (Peer to peer lending)

NBFCs provide a range of services such as **hire purchase finance, equipment lease finance, loans, and investments**. Due to the rapid growth of NBFCs and a wide variety of services provided by them, there has been a **gradual blurring of distinction between banks and NBFCs except that commercial banks have the exclusive privilege in the issuance of cheques**.

4 Types of account

There are mainly **three types of Banking accounts** in India which are usually offered by most banks in India.

1. Demand Deposits
2. Term Deposits
3. Non Resident Deposits

4.1 Demand Deposits:

Demand Deposit, as the name suggests are types of accounts that offer **money accessibility on demand.** They are usually easier to access but offer a **lower interest rate** as they are more uses for day to day business and expenses. There is **no penalty or advanced notice required** to withdraw money from the demand deposit accounts.

Demand Deposits are of 2 types:

4.1.1 Saving account Deposit:

Savings Account is the **most common and basic type of bank account in India.** It allows you to deposit money and withdraw funds at your convenience. The interest earned on the savings account is generally low. Types of Saving Bank Account:

4.1.1.1 Basic Savings Bank Deposit Accounts (BSBDA):

- There is no requirement of minimum balance.
- There is an upper limit to the monetary balance.
- Especially available for the economically weaker sections.
- only one BSBDA account in one bank is permitted.
- No limitations on age and income criteria of the customer.
- Jan Dhan accounts under PMJDY comes under this category.

4.1.1.2 Basic Saving Bank Deposit Accounts Small scheme:

- They have provisions of **relaxed KYC and self-attested required documents.**
- The upper limit on credit is one lakh rupees in a year
- The upper monetary limit on deposit is Rs.50000/-
- One can open the account for only 12 months if further extension is required the applicant must submit the required documents.

4.1.1.3 Normal saving Bank account

- Minimum balance provisions vary from bank to bank.
- Mostly help be salaried individuals, students, etc.

4.1.2 Current account:

- Current accounts are the types of bank accounts that are designed to **facilitate frequent transactions** for business owners.
- It is **also known as a financial account.**
- Such bank accounts allow the individual to carry out an **unlimited number of transactions** regularly.
- No restriction on the number of transactions in a day.
- Overdraft facility at an agreed limit.
- Flexible and high liquidity options.
- Higher minimum balance as compared to saving account.
- KYC guidelines are to be followed.

4.2 Term Deposits

Term deposit accounts are like **investments for a fixed-term**. It allows depositing of the money in the bank account **for an agreed time and at a fixed interest rate.** They generally range from one month to a few years. The interest rate on Term deposit accounts is generally more than demand deposit accounts. Term Deposits can be of two types:

4.2.1 Fixed Deposits:

In this type of deposits, banks accept deposits **varying from 7 days to a maximum of 10 years.** The **interest rate varies from bank to bank.** At the end of the agreed term, you receive the deposited amount with interest.

4.2.2 Recurring Deposits:

In this type of accounts, banks accept a fixed amount from a customer in fixed instalment at a regular interval of time. The deposit period varies from six months to ten years.

4.3 Non-Resident Accounts

These are for Non-Resident Indians. These are mainly of three types

1. NRO Account
2. NRE Account
3. FCNR (B) Account

Let us discuss these briefly

4.3.1 Non-Resident Ordinary Rupee Account (NRO Account)

- NRO accounts may be opened / maintained in the form of current, savings, recurring or fixed deposit accounts. Interest rates offered by banks on NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.
- Account should be denominated in Indian Rupees.
- NRI/PIO may remit from the balances held in NRO account an amount not exceeding USD one million per fiscal year, subject to payment of applicable taxes.
- The limit of USD 1 million per fiscal year includes sale proceeds of immovable properties held by NRIs/PIOs.

4.3.2 Non-**Resident (External) Rupee Account (NRE Account)**

- NRE account may be in the form of savings, current, recurring or fixed deposit accounts.
- Account will be maintained in Indian Rupees.
- Accrued interest income & balances held in NRE accounts are exempt from Income tax.
- Authorised dealers/authorised banks may at their discretion allow for a period of not more than two weeks, overdrawing's in NRE savings bank accounts, up to a limit of Rs. 50,000.
- Loans up to Rs.100 lakh can be extended against security of funds held in NRE Account either to the depositors or third parties.

4.3.3 **Foreign Currency Non-Resident (Bank) Account – FCNR (B) Account**

- FCNR (B) accounts are only in the form of term deposits of 1 to 5 years
- Account can be in any freely convertible currency.
- Loans up to Rs.100 lakh can be extended against security of funds held in FCNR (B) deposit either to the depositors or third parties.
- The interest rates are stipulated by the Department of Banking Operations & Development, Reserve Bank of India.

4.4 Additional Type of Accounts

Apart from what we have discussed earlier, there are some additional type of accounts that are important for us to know

4.4.1 Nostro Account

Italian word 'nostro' means 'ours'. Hence, Nostro account points at - "Our account with you"

Nostro accounts are generally held in a foreign country (with a foreign bank), by a domestic bank (from our perspective, our bank). It obviates that account is maintained in that foreign currency.

4.4.2 Vostro Account

Italian word 'Vostro' means 'yours'. Hence, Vostro account points at - "Your account with us"

Vostro accounts are generally held by a foreign bank in our country (with a domestic bank). It generally maintained in Indian Rupee (if we consider India)

For example, HSBC account is held with SBI in India.

4.4.3 LORO Account

Again, Italian word 'loro' means 'theirs'. Therefore, it points at - "Their account with them"

Loro accounts are generally held by a 3rd party bank, other than the account maintaining bank or with whom account is maintained.

For example, BOI wants to transact with HSBC, but doesn't have any account, while SBI maintains an account with HSBC in U.K. Then BOI could use SBI account.

4.4.4 Mirror account

While a bank maintains Nostro account with a foreign bank, it must keep an account of the same in its books. This is more or less a reflection or a shadow of the nostro account. The entries in the mirror account are used for reconciliation of entries in the nostro account. The mirror account is maintained in two currencies, one of which is the foreign currency and the other one is the home currency.

5 Banking and Regulation

Different Banks are regulated by different Acts. There are huge number of acts related to Banking but the ones which are important form exam point of view are listed below

1. Negotiable Instruments Act, 1881
2. RBI Act, 1934
3. Banking Regulation Act, 1949
4. SARFAESI Act, 2002
5. Payment & Settlement Systems Act, 2007

We will cover Negotiable Instrument Act, 1881 and RBI Act, 1934 here. The rest shall be discussed separately in other chapters

5.1 Negotiable Instruments Act, 1881

Negotiable instrument is a document which guarantees the payment of a specific amount of money, either on demand, or at a set time, with the payer named on the document. A negotiable instrument can be transferred from one person to another. Negotiable Instruments Act, 1881 was passed in 1882. There are **147 different sections** in the act. The important ones are:

I. **Section 4 - Promissory note:** A "promissory note" is an instrument in writing (not being a bank-note or a currency-note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

II. **Section 5 - Bill of exchange:** A "bill of exchange" is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

III. **Section 6 – Cheque:** A cheque is bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form

   a. ***a cheque in the electronic*** form means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system

   b. ***a truncated cheque*** means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing

IV. **Section 13 - Negotiable Instruments:** A Negotiable Instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer.

V. **Section 123 - Cheque Crossed Generally:** Where a cheque bears across its face an addition of the words and company or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words, not negotiable, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally.

VI. **Section 124 - Cheque crossed specially:** Where a cheque bears across its face an addition of the name of a banker, either with or without the words not negotiable, that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be crossed to that banker.

VII. **Section 126 Cheque crossed specially:** Payment of cheque crossed specially. - Where a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed, or his agent, for collection.

VIII. **Section 130 Cheque bearing Not Negotiable:** A person taking a cheque crossed generally or specially, bearing in either case the words not negotiable, shall not have, and shall not be capable of giving, a better title to the cheque than that which the person from whom he took it had.

5.2 Reserve Bank of India Act, 1934

The Reserve Bank of India Act 1934 is an Act to constitute a Reserve Bank of India (RBI) and **provide the central bank (RBI) with various powers to act as the central bank of India**. There are **total 61 Sections in the RBI Act 1934**. Below we have mentioned important sections of the Act:

I. The **first schedule** of the RBI Act 1934 defines the 4 areas under which the Indian states should come. The 4 areas are Western Area, Eastern Area, Northern Area, Southern Area

II. **2nd Schedule of the Act:** Comprises the **definition and classification of scheduled commercial banks** which includes nationalised banks, State Bank of India and its associates, Regional Rural Banks (RRBs) and private banks and a few co-operative banks that fulfil certain criteria.

III. **Sections 3 to 19** are related to **RBI's incorporation, capital, management and business. Few of them are:**

- ✓ **Section 3:** Pertains to the establishment and incorporation of Reserve Bank
- ✓ **Section 4:** Mentions Capital of the Bank. The **capital of the Bank (RBI) shall be 5 crores of rupees**
- ✓ **Section 6:** Permits RBI for establishment of offices, branches and agencies in India
- ✓ **Section 7:** Describes Management operations to be carried out in RBI through central board of directors and government's right to issue directions in consultation with governor of RBI in public interest
- ✓ **Section 8:** Describes composition of the Central Board, and term of office of Directors. The Central Board shall consist of the following Directors, namely: -
    - i. **a Governor and [not more than four] Deputy Governors** to be appointed by the Central Government;
    - ii. **4 Directors to be nominated by the Central Government**, 1 from each of the four Local Boards as constituted
    - iii. **10 Directors to be nominated by the Central Government** and
    - iv. **2 Government officials** to be nominated by the Central Government
- ✓ **Section 17:** Outlines the **basic business functions** of the RBI. It accepts deposits of and extends advances to the Central and State governments, purchases foreign exchange from banks and sells it to them, provides loans to banks and state financial corporation's

(SFCs), purchases and sells government securities, purchase and discounts bills of exchange, to deal in derivatives namely, repo or reverse repo, among other functions

- ✓ **Section 18: Power of direct discount:** In **emergency situations**, RBI has the right to lend loans to banks, purchase or discount for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture

IV. **Sections 20 to 45** are related to **Central Banking Functions. Few of them are;**

- ✓ **Section 20:** Obligates of RBI to transact Government business
- ✓ **Section 21:** Gives RBI the right to transact Government business in India
- ✓ **Section 21 A:** Allows RBI to transact Government business of States on agreement
- ✓ **Section 22:** RBI alone has the **right to issue bank notes**
- ✓ **Section 23:** Issue Department will issue bank notes against gold coins, bullion, foreign securities
- ✓ **Section 24: Denomination of Notes:** Bank notes shall be of the denominational values of two rupees, five rupees, ten rupees, twenty rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees, five thousand rupees and ten thousand rupees or of such other denominational values, as the Central Government may, on the recommendation of the Central Board, specify in this behalf **not exceeding ten thousand rupees**
- ✓ **Section 25:** Design, form and material of bank notes shall be such as may be approved by the Central Government after recommendations from central board
- ✓ **Section 26 (1): Defines legal tender of notes**
- ✓ **Section 26 (2): Gives power for the withdrawal of legal tender of notes**
- ✓ **Section 27: Re-issue of notes.** The RBI shall not re-issue bank notes which are torn, defaced or excessively soiled
- ✓ **Section 28:** Assigns power to RBI to decide rules for the recovery of notes lost, stolen, mutilated or imperfect
- ✓ **Section 30: Gives powers to Central Government to supersede Central Board of RBI**
- ✓ **Section 31: Only RBI or Central Government can issue or accept Promissory Notes payable on demand**
- ✓ **Sections 42 (1): Defines Cash Reserve Ratio:** Every bank is required to maintain with RBI an average daily balance equal to a percentage of the net demand & time liabilities as stipulated by RBI from time to time. This is known as CRR. Further RBI does not pay interest on balance held for CRR purpose
- ✓ **Section 42 (6):** Stipulates requirements by any bank to become SCB i.e. in order to be included into the second schedule of the Act,
    - i. **Minimum Paid up capital** and reserves not less than **Rs 5 Lakhs**
    - ii. Conduct of affairs by the bank in a manner which will not jeopardize interest of depositors
- ✓ **Note: Banks not included in 2nd schedule of the RBI Act, 1934 are called Non-scheduled banks**

V. **Section 45 I (c): Defines Financial Institution as under:**
"Financial Institution" means any non-banking institution which carries on as its business or part of its business any of the following activities, namely: -

- ✓ The financing, whether by way of making loans or advances or otherwise, of any activity other than its own
- ✓ the acquisition of shares, stock, bonds, debentures or securities issued by a government or local authority or other marketable securities of a like nature
- ✓ Letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972
- ✓ The carrying on of any class of insurance business

- ✓ Managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto
- ✓ collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person

But does not include any institution, which carries on as its principal business, -

- ✓ agricultural operations
- ✓ industrial activity
- ✓ the purchase or sale of any goods (other than securities) or the providing of any services the purchase, construction or sale, of immovable property, so however, that no portion of the income of the institution is derive from the financing of purchases, constructions or sales of immovable property by other persons

VI. **Section 45 I (f): Defines Non-Banking Financial Company**

- ✓ a financial institution which is a company
- ✓ a non-banking institution which is a company, and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner
- ✓ Such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify

VII. **Section 45 U: Defines repo, reverse repo, derivative, money market instruments and securities**

VIII. **Sections 45 Z to 45 ZO are related to Monetary Policy.** Few of them are:

- ✓ **Section 45 ZA: Setting Inflation Target:** The Central Government will determine the inflation target in terms of the CPI, once in every 5 years and inform the same through Official Gazette
- ✓ **Section 45 ZB: Describes Monetary Policy Committee composition**

IX. **Section 47: Allocation of Surplus profits to Central Government**

X. **Section 49: Declaration of Bank rate:** RBI shall declare bank rate from time to time which is the rate at which it buys or rediscount bills of exchange or other commercial paper eligible for purchase under this act