Summary Sheet - Banking System in India (Structure and Developments)

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1 Introduction to Banking System

According to section 5B of the Banking Regulation Act 1949, "**banking"** means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise. However, India's banking sector has gone **through a paradigm shift in the** last few decades.

We will first start this chapter with the understanding of history of banking around the world.

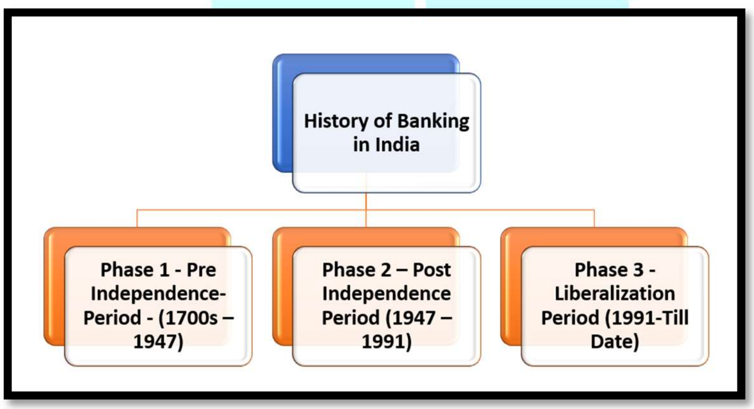
2 History of Banking around the world

Earlier Barter system was used to trade and it was the Britishers who started organized banking system in India to fulfill their business objectives and they established many Banking houses but later its area grew considerably, and it served many purposes like lending, receiving interest, securing money. And the work of providing funds for development also started. Banking was practiced prior to the arrival of Britishers as well.

Now let us understand how the concept of banking evolved in India.

2.1 History of Banking in India

The History of Banking in India dates to the time when India got independence in 1947. **The banking sector development can be divided into three phases** given below –



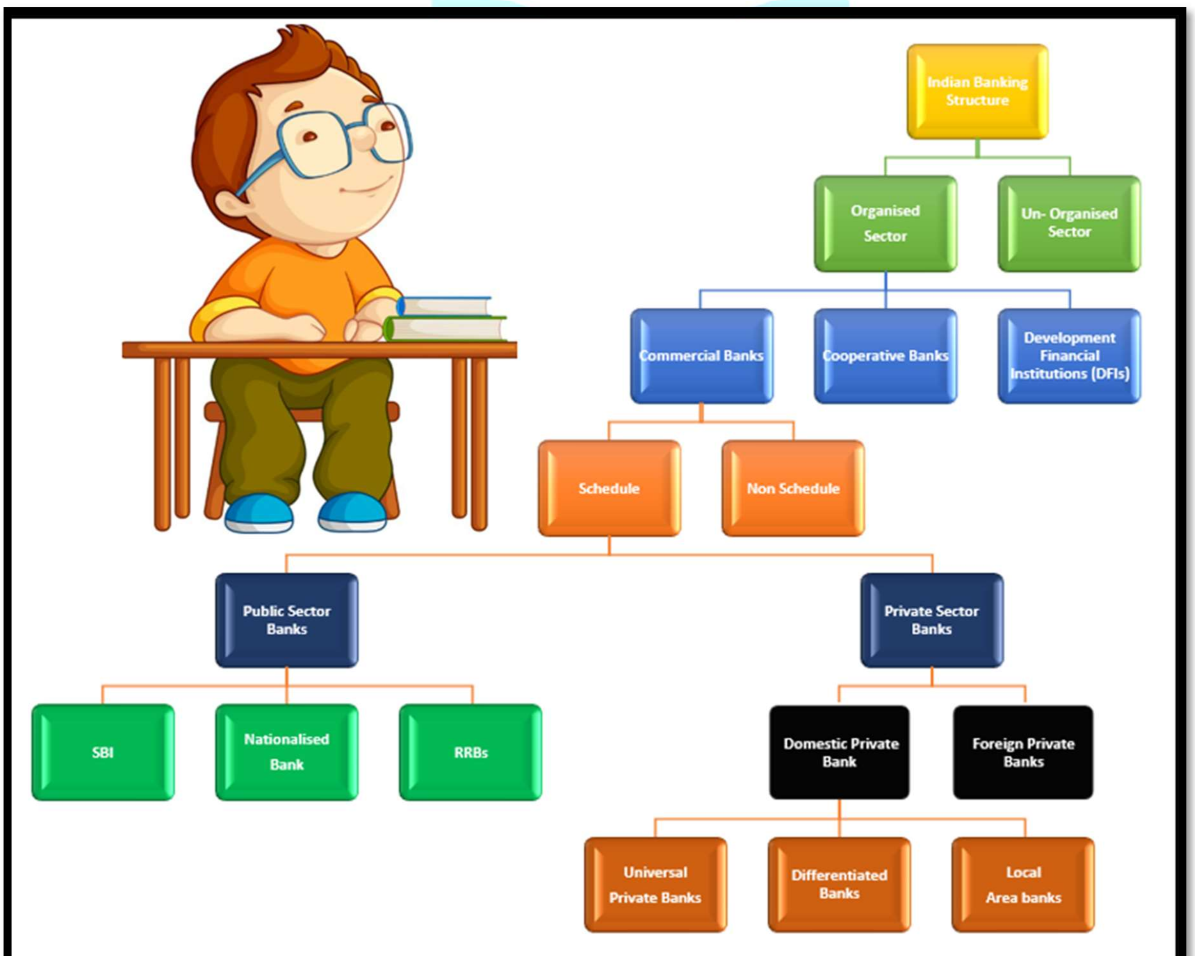
- **Phase 1 - Pre Independence-Period - (1700s – 1947) – Bank of Hindustan** was the first Bank to be established in the year 1770 but it eventually failed to work and was closed in the year 1832. On the same lines many banks **like The General Bank of India (1786-1791), Oudh Commercial Bank (1881-1958), Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) were formed.** The East India Company called the Bank of Bengal, Bank of Bombay and Bank of Madras as **Presidential Bank**. These three Presidential Banks were

merged in 1921 to form the Imperial Bank of India. In 1955 the Imperial Bank was Nationalized to form the State Bank of India.

- **Phase 2 – Post Independence Period (1947 – 1991) –** Post Independence, major banks were controlled by private entity. Looking at this situation, Indra Gandhi decided to **Nationalize the banks in India under The Banking Regulation Act of 1949.** Following the Nationalization of SBI in 1955, **14 banks were Nationalized in 1969**. **In 1980 again 6 banks were Nationalized** marking the second phase of Nationalization.

- **Phase 3 - Liberalization Period (1991-Till Date)** - Once the banks were established in the country, regular monitoring and regulations were needed 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 hugely significant role. Liberalization in Indian banking sector was begun since 1991, **following the Narsimha Committee Report (December 1991).**

3 Current Banking Structure in India



The Reserve Bank of India regulates the organized banking sector, while the unorganized sector, dominated by money lenders, operates without strict oversight. This informal sector lacks regulation and can involve traditional financial practices**.**

3.1 Commercial Banks

Commercial banks accept deposits and provide loans to earn profits, facilitating economic activity and financial stability. They are classified as scheduled and non-scheduled.

- **Scheduled Commercial Banks**: Listed in the Second Schedule of the RBI Act, 1934, they enjoy privileges and oversight by the RBI. They maintain higher reputations and adhere to specific regulations. Minimum paid-up capital and raised funds of Rs 5 lakh are required.
- **Non-Scheduled Commercial Banks**: Not listed in the Second Schedule of the RBI Act, 1934, they lack the privileges of scheduled banks and may not have direct access to certain central banking services. Regulatory requirements are relatively less stringent.

In India's banking system, banks are classified as scheduled or non-scheduled by the central bank, a significant distinction. Scheduled commercial banks, the majority, are vital in the formal banking sector. They are further categorized into public-sector and private-sector banks.

3.1.1 Public Sector Banks

Public sector banks are government-owned banks like Bank of Baroda, State Bank of India (SBI), Dena Bank, Corporation Bank, and Punjab National Bank. These can be further classified as follows –

A. **SBI –** SBI, formed in 1955 from the nationalization of the Imperial Bank of India, became the largest public sector bank in India after merging with five associate banks and Bhartiya Mahila Bank on April 1, 2017. The associate banks included the State Bank of Bikaner and Jaipur, the State Bank of Mysore, the State Bank of Travancore, the State Bank of Hyderabad, and the State Bank of Patiala.

   Currently, SBI is the largest Public Sector Bank in India.

B. **RRB -** RRBs, established in 1975 under the Regional Rural Banks Act, 1976, aim to provide sufficient credit for agriculture and rural sectors. M. Swaminathan is often credited as the father of RRBs.

C. **Nationalized Bank** - Nationalized banks are the **banks owned by the Government of India**. Examples – Punjab National Bank, Bank of India, Canara Bank, etc.

3.1.2 Private Sector Banks

It is a type of commercial bank **where private individuals and businesses own most of the share capital**. They can be further classified into **Domestic Private Banks** and **Foreign Private Banks**.

3.1.2.1 Domestic Private Banks

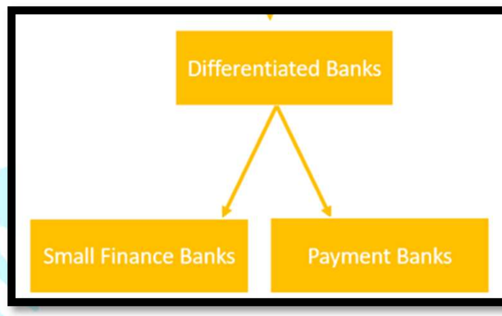
Domestic private banks, operating within the country's boundaries, include HDFC Bank, ICICI Bank, Axis Bank, Yes Bank, etc. They are further classified into three types: Universal Private Banks, Differentiated Banks, and Local Area Banks.

3.1.2.1.1 Universal Private Bank

A Universal Private Bank offers wholesale, retail, and investment banking services all in one place. Examples include BNP Paribas and Deutsche Bank.

3.1.2.1.2 Differentiated Banks

Differentiated Banks, introduced in 2014 following a recommendation by the Nachiket Mor Committee, cater to specific demographic segments to enhance financial inclusion. These banks include Payment Banks and Small Finance Banks.



3.1.2.1.2.1 Payment banks.

Payment banks were established to bolster financial inclusion by offering small savings accounts and facilitating payments and remittances for migrant laborers, low-income households, small businesses, and other unorganized sector entities. Unlike traditional banks, they do not lend to customers but instead invest their funds in government securities and bank deposits. In August 2016, RBI granted licenses to 11 entities to operate as Payment banks.

Additional Information - Scope of activities and other conditions of a Payment Banks

- Restricted deposit limit: Up to Rs 2 Lakhs.
- Services: It can issue ATM/debit cards, however, it cannot issue credit cards, and payment banks cannot extend loans too.
- Payments banks will be permitted to handle cross border remittance transactions and the payments bank may undertake utility bill payments etc. on behalf of its customers and general public
- Investment requirement: 75% of deposits in government securities; maximum 25% in deposits with scheduled commercial banks.

3.1.2.1.2.2 Small finance banks

Small finance banks cater to specific demographic segments, promoting financial inclusion by offering savings options and providing credit to small businesses, farmers, and the unorganized sector. They operate with high-tech, low-cost methods and can offer services like forex, mutual funds, insurance, and pensions. While they can evolve into full-fledged banks, they're restricted from granting large loans or establishing non-banking financial service subsidiaries.

Additional Information - Scope of activities and other conditions of a Small Finance Banks

Key conditions and activities of small finance banks include:

- Incorporating the term "small finance bank" in their name.
- Offering credit and debit cards, operating ATMs, and issuing passbooks.
- Channeling 75% of their credit towards priority sectors such as agriculture, small enterprises, and low-income earners.
- Ensuring that 50% of their loan portfolio comprises advances up to Rs. 25 lakh, distinguishing between advances (short-term lending) and loans (long-term lending), with no interest charged on advances.
- Meeting an initial paid-up voting equity share capital/net worth requirement of Rs. 200 crore to establish operations.

3.1.2.1.3 Local Area Banks

They operate within district towns, limited to a maximum of three districts or towns. Currently, India has two such banks: Coastal Local Area Bank Ltd and Krishna Bhima Samruddhi Ltd.

3.1.2.2 Foreign Private Bank

Foreign Private Banks, headquartered in other countries but with a presence in India, include Standard Chartered Bank of London, Royal Bank of Scotland, and Bank of America.

3.1.3 Co-operative Banks

A Co-operative bank is a financial entity which **belongs to its members**, **who are at the same time the owners and the customers of their bank**. They were established with the **aim of funding agriculture and allied activities and financing village and cottage industries.**

The Reserve Bank acts in close co-ordination with other **regulators, such as, Registrar of Co-operative Societies and Central Registrar of Co-operative Societies**. The Reserve Bank enters into Memorandum of **Understanding (MoU) with Central Government and all State Governments which have presence of UCB**s to ensure greater convergence of policies on regulation and supervision. Starting with signing **first MoU with the State of Andhra Pradesh on June 27, 2005** and the last with **the State of Telangana on December 30, 2014, today, all the UCBs in the country are covered under MoU.**

3.1.4 Development Financial Institutions

They are government or charity-owned organizations providing funds for low-capital projects or borrowers unable to access commercial loans. DFIs act as intermediaries between public aid and private investment, facilitating international capital flows. India hosts five DFIs: NABARD, SIDBI, NHB, EXIM, and NaBFID.

4 Basic Terminologies used in Banking

Section 5 (B) of Banking Regulation Act, 1949 defines bank as: "A financial institution which can accept deposit of money from the public, lend to the public and repayable to the public on demand and withdrawal by cheque, draft, order". Now let us discuss the basic concepts involved in the banking sector one by one.

4.1 Types of Banking

Banks come in all shapes and sizes and provide a wide range of services. The key to finding the right bank for your money is to know how various banks are organized and how they serve the community. On the same lines let us understand the different types of banking activities.

- **Unit Banking - Unit banking is a system of banking under which a single banking organization provides banking services.**

- **Branch Banking - Branch Banking** refers to a system in which a bank provides **banking services through a wide network of branch offices**.

- **Correspondent Banking** - A **correspondent bank** is a financial institution that **acts as a middleman to accomplish transactions on behalf of another financial institution**.

- **Group Banking - Group Banking** is the system in which **two or more independently incorporated banks are brought under the control of a holding company**.

- **Pure Banking** – Under Pure Banking the commercial banks give only short-term loans to industry, trade, and commerce.

- **Narrow Bank** – This type of **restricted minimum banking** activity is referred to as 'Narrow Banking'.

- **Relationship Banking** – Relationship banking is strategy used by banks to offer a variety of different products, **strengthen customer loyalty, and generate additional revenue.** Small, mid-sized, and large banks all use relationship banking strategies.

- **Universal Banking** - Universal banking can be defined as a banking system that offers a wide range of banking and financial services.

- **Wholesale Banking** – Wholesale banking refers to banking services that are **offered just to other institutional customers, huge companies with strong balance sheets, government agencies, local governments, and pension funds and not to common people.**

- **Private Banking**- These banks **provide banking services to rich people instead of banking with corporate clients**.

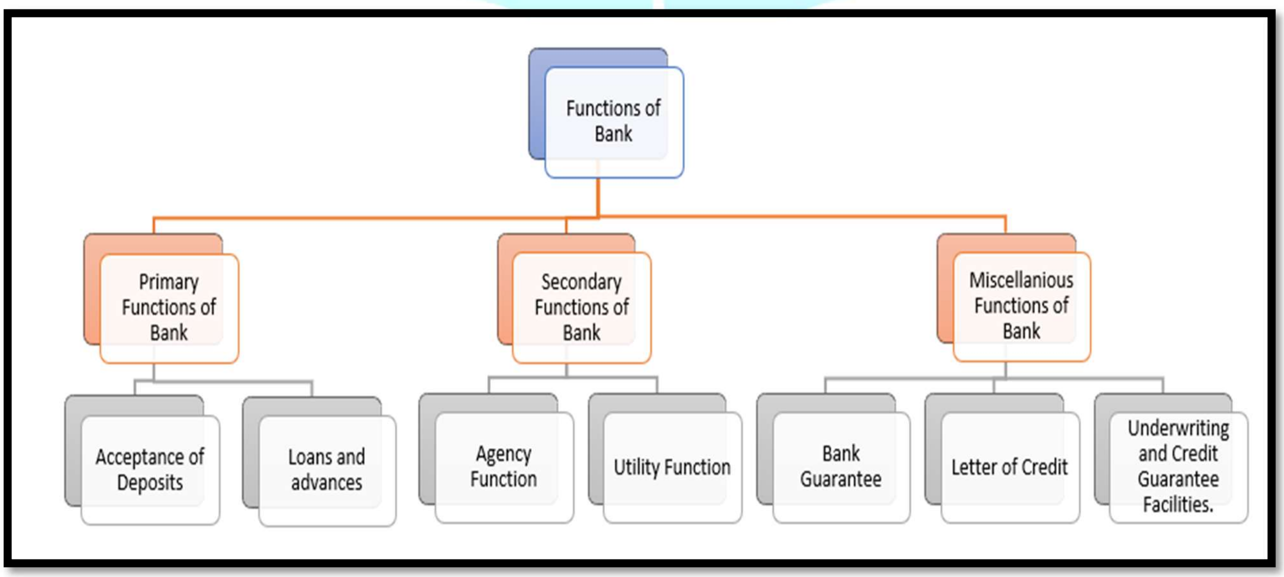
- **Retail Banking / Consumer banking/ Personal Banking** – Under Retail Bank service, banking **service is provided to masses or public** instead of big companies or corporates.

- **CORE Banking –** Centralized Online Real Time Exchange is anywhere banking with the same bank. Core Banking Solution (CBS) is networking of branches, which enables Customers to operate their accounts, and **avail banking services from any branch of the Bank on CBS network, regardless of where he maintains his account**.

4.2 Functions of Banks

Banks established a bridge between the community of surplus and deficit funds so that money could be utilized by the community who require it and at the same time, people having surplus funds would earn some interest over their savings.

On the same lines let us understand the various functions carried out by a bank as summarized in the diagram below.



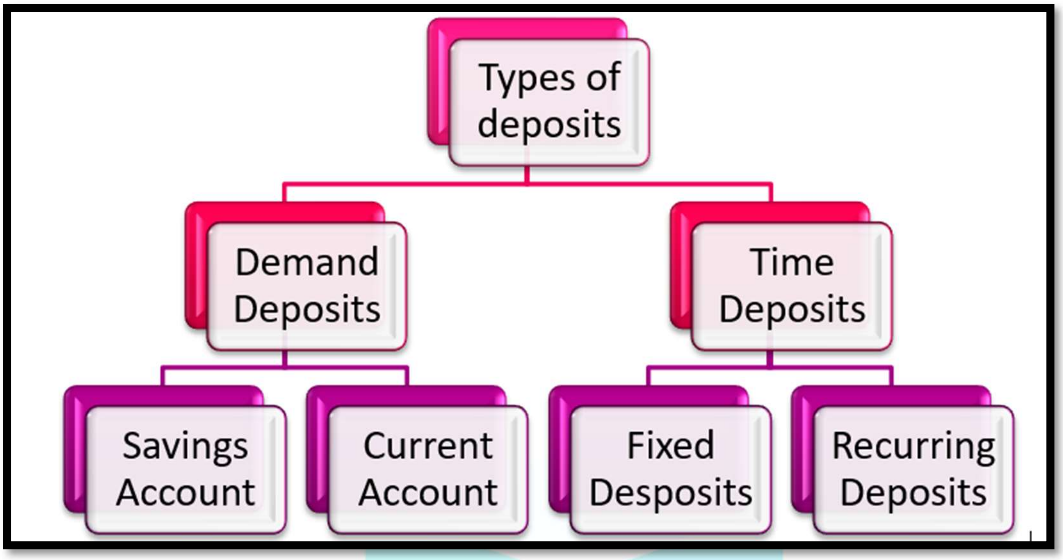
4.2.1 Primary Functions of the bank

All banks must perform two major primary functions namely:

- Accepting of deposits
- Granting of loans and advances

4.2.1.1 Accepting of Deposits

. Bank accepts different types of deposits, which can be seen in the Following image –



Demand Deposits - -Here deposits can be withdrawn anytime, without any advance notice to the bank. They can be of two types of demand deposits.

- **Saving Deposits** encourages saving habits among the public. It is suitable for salary and wage earners**. It is a type of demand deposit**. The **rate of interest received is low**. There is **no restriction on the number of withdrawals**. The account for saving deposits **can be opened in a single name or in joint names**.
- **Current Deposits**: They are **opened by businessmen**. The account holders **get an overdraft facility on this account**. These deposits act as a short-term loan to meet urgent needs.

Time Deposits – Here Deposits cannot be withdrawn anytime; it can only be withdrawn after a fixed maturity. Again, there are two types of it.

- **Fixed Deposits:** Also known as **Term Deposits**. Money is deposited for a **fixed tenure**. No withdrawal of money during this period is allowed. In case depositors withdraw before maturity, banks levy a **penalty for premature withdrawal**.
- **Recurring Deposits:** In recurring deposit certain sum of money is **deposited in the bank at a regular interval**. Money can be **withdrawn only after the expiry of a certain period**. A higher rate of interest is paid on recurring deposits as it provides a benefit of compounded rate of interest and enables depositors to collect a big sum of money**.**

Above mentioned accounts are generally used by the Indian citizens, however for the **Non – Residential Indians**, who wanted to have a convenient mode of money transfer, flexibility in repatriation of funds, earn better interest rates, we have following types of accounts.

- **Non-Resident Indian (NRI) Accounts** – To fulfil the bank requirements of a Non-Residential Indian or a Person of India Origin, the option of NRI account is available. The NRI Accounts are further divided into three types:

  A. **NRE (Non-Resident External Rupees) Account:** An NRE account is a rupee-denominated bank account (Savings or Term deposits) opened in India in the name of an NRI, to park his foreign earnings. It is repatriable back to foreign currency. The interest you earn on the NRE account is tax free.

  B. **NRO (Non-Resident Ordinary Rupees) Account:** These are Rupee accounts opened for the purpose of depositing income earned in India. One can repatriate the interest amount, the principal amount can be repatriated within the set limits of up to USD 1 million in a financial year. Rent, dividends, and other sources of income are all possibilities. These accounts are taxed for income tax purposes.

  C. **FCNR (Foreign Currency Non-Resident) Account –** This type of account can be opened to manage an international currency. It can only be in the form of a Term deposit and can be withdrawn after the maturity period only.

Additionally, to help people transact in international currency, promote global trade, support the increasing interest of global trade community in Indian National Rupee (INR) etc., government planned to have an additional payment option, using the following types of accounts- **NOSTRO, VOSTRO and LORO accounts as given below.**

- **Nostro Accounts –** Such 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. For example, **SBI account with HSBC in U.K.**

- **Vostro Accounts –** Such 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**.

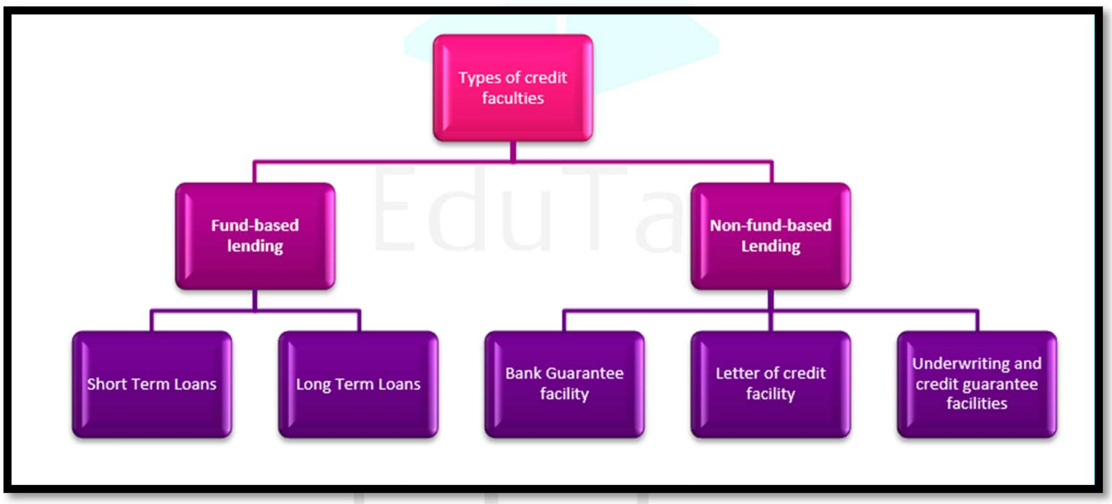
- **Loro Accounts** – If a domestic bank who possess a bank account in foreign bank clear the due of foreign trade on the behalf of third-party banks, then this is called Loro account transactions. Obviously, the third-party bank doesn't have the Nostro account and hence, in this case, domestic bank functions as an intermediary.

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. In this case, for SBI this account is known as Nostro account and for BOI it is known as Loro Account

Banks use the money in deposit accounts to make loans to other people or businesses. In return, the bank receives interest payments on those loans from borrowers. **Part of that interest is then returned to the original deposit account holder in the form of interest. On the same lines let us understand the different type of loans and advances.**

4.2.1.2 Granting of Loans & Advances

Lending of money is a very basic function for banks. Bank offers the following types of credit faculties (Loan and advances facilities)



First, let's cover fund-based lending facilities –

Fund based facilities– Here there is an outflow of funds, which means that real money of the banker is lent to the customer of the bank. Here, direct lending takes place. Actual transfer of funds is done in such activities.

Examples of Fund based lending facilities – Short term loans and Long Term Loans

1. <u>Short term Loans</u>

- **Bank Overdraft**: This facility is **for current account holders**. It allows holders to **withdraw money anytime more than the amount available in bank balance but up to the provided**

limit. The interest in overdraft is paid only on the borrowed amount for the period for which the loan is taken.

2. **Long Term Loans**

- **Term Loan** means a specified amount of money given for a fixed period usually **between one to ten years and to be paid back with interest agreed**. Typically, it features on floating interest rate for a specified amount of money, matures normally in between one to ten years and requires a specified repayment schedule. Loan featured beyond one year, normally repaid from the future cash flow of the borrower.

Now, let's cover Non-Fund based credit facilities–

In such activities, there is no transfer of funds. Non fund credit facilities can be defined as the services that are provided by the bank or other financial institutions, wherein there is no flow of funds from banks. Here, transfer of real cash doesn't take place at all.

Types of Non-fund-based credit facilities

- Bank Guarantee facility
- Letter of credit facility
- Underwriting and credit guarantee facilities.

For holistic coverage for non-fund-based lending facilities**, we will cover all the major non-fund-based lending activities in the later part of this document.**

Now, let's cover the Agency function of the bank.

4.2.2 Secondary Functions of Bank

Like Primary Functions of Bank, the secondary functions are also classified into two parts:

- **Agency functions**
- **Utility Functions**

4.2.2.1 Agency Functions of Bank

Banks are the agents for their customers; hence it must perform various agency functions as mentioned below:

- **Transfer of Funds**: Transferring of funds from one branch/place to another.
- **Periodic Collections**: Collecting dividend, salary, pension, and similar periodic collections on the clients' behalf.

- **Periodic Payments**: Making periodic payments of rents, electricity bills, etc. on behalf of the client.
- **Collection of Cheques**: Like collecting money from the bills of exchanges, the bank collects the money of the cheques through the clearing section of its customers.
- **Portfolio Management**: Banks manage the portfolio of their clients. It undertakes the activity to purchase and sell the shares and debentures of the clients and debits or credits the account.
- **Other Agency Functions**: Under this bank act as a representative of its clients for other institutions. It acts as an executor, trustee, administrators, advisers, etc. of the client

4.2.2.2 Utility Functions of Bank

Utility function measures ‘consumers preferences’ for a set of goods and services and here bank offer some add-on facilities. These functions include the following –

- Issuing letters of credit, traveler’s cheque, etc.
- Undertaking safe custody of valuables, important documents, and securities by providing safe deposit vaults or lockers.
- Providing customers with facilities of foreign exchange dealings
- Underwriting of shares and debentures
- Dealing in foreign exchanges
- Social Welfare programmes
- Project reports
- Standing guarantee on behalf of its customers, etc.

Now, we will discuss regarding two very generally used utility functions, **which are ATMs and Cheques.**

<u>Issuing Cheques</u>

A **cheque** is a document you can issue to your bank, **directing it to pay the specified sum mentioned in digits as well as words to the person whose name is borne on the cheque**.. **There are different types of Cheques are given below**.

A. **Bearer Cheque** - The bearer cheque is a type of cheque in which the **bearer is authorized to get the cheque uncashed.**

B. **Order Cheque** - This type of cheque **cannot be endorsed, i.e., only the payee, whose name has been mentioned in the cheque is liable to get cash for that amount**. The drawer needs to strike the "**OR BEARER**" mark as mentioned on the cheque so that the cheque can only be encased to payee.

C. **Crossed Cheque** - In this type of cheque, **no cash withdrawal can be done**. The amount can only be transferred from the drawer's account to the payee's account. Any third party can visit the bank to submit the cheque. In case of a crossed cheque, **the drawer must draw two lines at the left top corner**

D. **Account Payee Cheque** – In this type of cheque **no third-party involvement is required**. The amount shall be **transferred directly to the payee's account number**. To ensure that it is an account payee cheque**, two lines are made on the left top corner of the cheque, labelling it for "A/C PAYEE".**

E. **Stale Cheque** - In India, any cheque is **valid only until 3 months from the date of issue**. So, if a payee moves to the bank to get withdrawal for a cheque which was signed 3 months ago, the cheque shall be declared a stale cheque

F. **Post Dated Cheque** - If a drawer wants the payee to apply **for withdrawal or transfer of money after the present date, then he/she can fill a postdated cheque**.

G. **Ante Dated Cheque** - If the drawer mentions a date prior to the current date on the cheque, it is called ante dated cheque.

<u>ATM and its type</u>

ATM is the abbreviation of **Automated Teller Machine**. The different types of ATM's existing are as follows –

- **White Label ATMs** - Automated Teller Machines (ATMs) set up, owned and operated by non-bank entities are called "**White Label ATMs"** (WLAs).
- **Brown Label ATMs** - Brown Label ATMs are owned by the bank, but operation and maintenance are done by a third party (Also known as service provider)
- **Green Label ATMs** - Green Label ATMs are used for agriculture transactions.
- **Orange Label ATMs** - Orange Label ATMs are used for share transactions
- **Yellow Label ATMs -** Yellow Label ATMs are used for e – commerce
- **Pink Label ATMs -** Pink Label ATMs are used for women banking
- **Onsite ATM** - Onsite ATM are inside the bank compound and hence are known as Onsite ATMs.
- **Offsite ATMs** - Offsite ATMs are in various places except inside the bank premises and thus named as Offsite ATMs.

Now, this brings us to the end of the discussion on the secondary functions of the Bank, now will be covering other miscellaneous functions of the bank.

4.2.3 Miscellaneous Functions of the Bank

Apart from the above activity, the bank also carries out activities which do not involve any fund transfer. Here the transfer of real fund does not take place. They can be further classified as following –

- Bank Guarantee
- Letter of Credit
- Under writing Facilities.

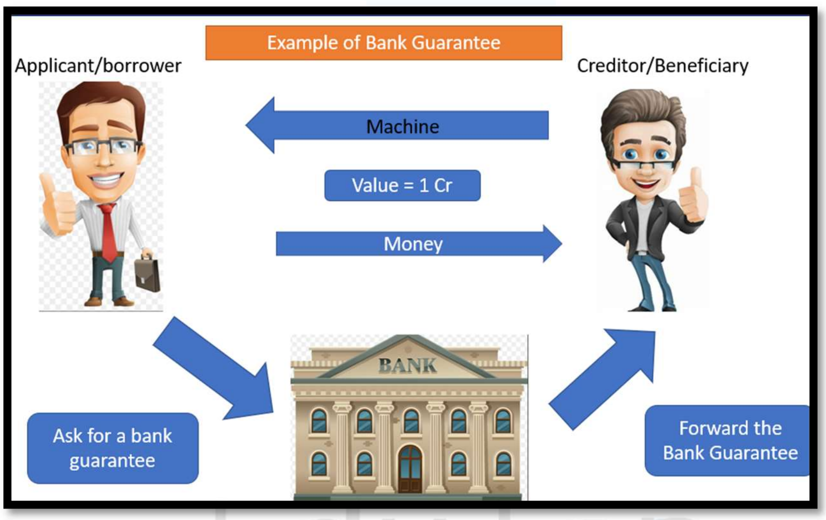
Let us understand each of them in detail.

4.2.3.1 Bank Guarantee

A bank guarantee is a type of promise from a bank that it will cover the loss of one party The bank guarantee serves as a risk management tool for the beneficiary.

Example – Mr. X is Planning to buy a machinery for 1 Crore from Mr. Y and currently Mr. X do not have the ample of cash to pay for the machine ordered and Mr. Y says that, I will not provide you the machine on credit. Therefore, Mr. X will reach to his bank and he will apply for a bank guarantee.

Bank will do a proper study of the credit history of Mr. X and seeing that Mr. X has a very good credit profile, bank will finally issue a bank guarantee to Mr. Y. After receiving bank guarantee, Mr. Y will deliver the machine to the Mr. X and later after some period of time, Mr. X will pay the amount of 1 crore to Mr. Y and the moment Mr. Y receives the full amount from Mr. X, the bank guarantee will nullify and it will be cancelled, because the objective of bank guarantee is fulfilled.



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4.2.3.2 Letter of Credit

A letter of credit (L/C) is a type of **"documentary credit" or a "non-fund-based credit**". It is a **document issued by a bank or financial institution at the request of a buyer** whereby the bank or financial institution **gives assurance of payment to a seller if the terms and conditions specified in the document are fulfilled** like delivery date, product specification etc.

Consider the following example - Mr. X in India want to import certain machinery, which they know is manufactured by Mr. Y in England**.** They enter a contract for purchase of the machinery. Since neither party knows the other, they are not sure whether the other will fulfill his part of the obligation.

Step 1 - In such a situation, **Mr. X will approach Bank of India** and make a request by an **application for opening a letter of credit (LC) in favor of Mr. Y**

Step 2 - Bank of India, after opening a LC in favor of Mr. Y, informs Bank of England, it's a bank with whom Bank of India has a banking arrangement and now, Bank of England will forward the LC to Mr. Y

Step 3 - After verifying, that the LC has been drawn according to the sale contract, Mr. Y ships the machinery to Mr. X

Step 4 - Now Mr. Y will collect, the bills of lading handed over by the shipping Company and now **Mr. Y will present all the important documents to** the **Barclays Bank. The Barclays bank is another bank operating in United Kingdom.**

Step 5 - Barclays Bank, receives the bill and other documents from Mr. Y and checks that they are as per the terms of the LC. On finding them to be in order. **Barclays Bank negotiates the bill and makes payment to Mr. Y**

Step 6 - Barclays Bank thereafter sends the bill and documents to **Bank of India**.

Step 7 - Bank of India on its part verifies the bill and documents **and if found in order sends the bill to Mr. X for payment.** Mr. X on receiving the bills checks the documents or pays the money to Bank of India and **finally bank of India will pay the final amount to the Barclays bank.**

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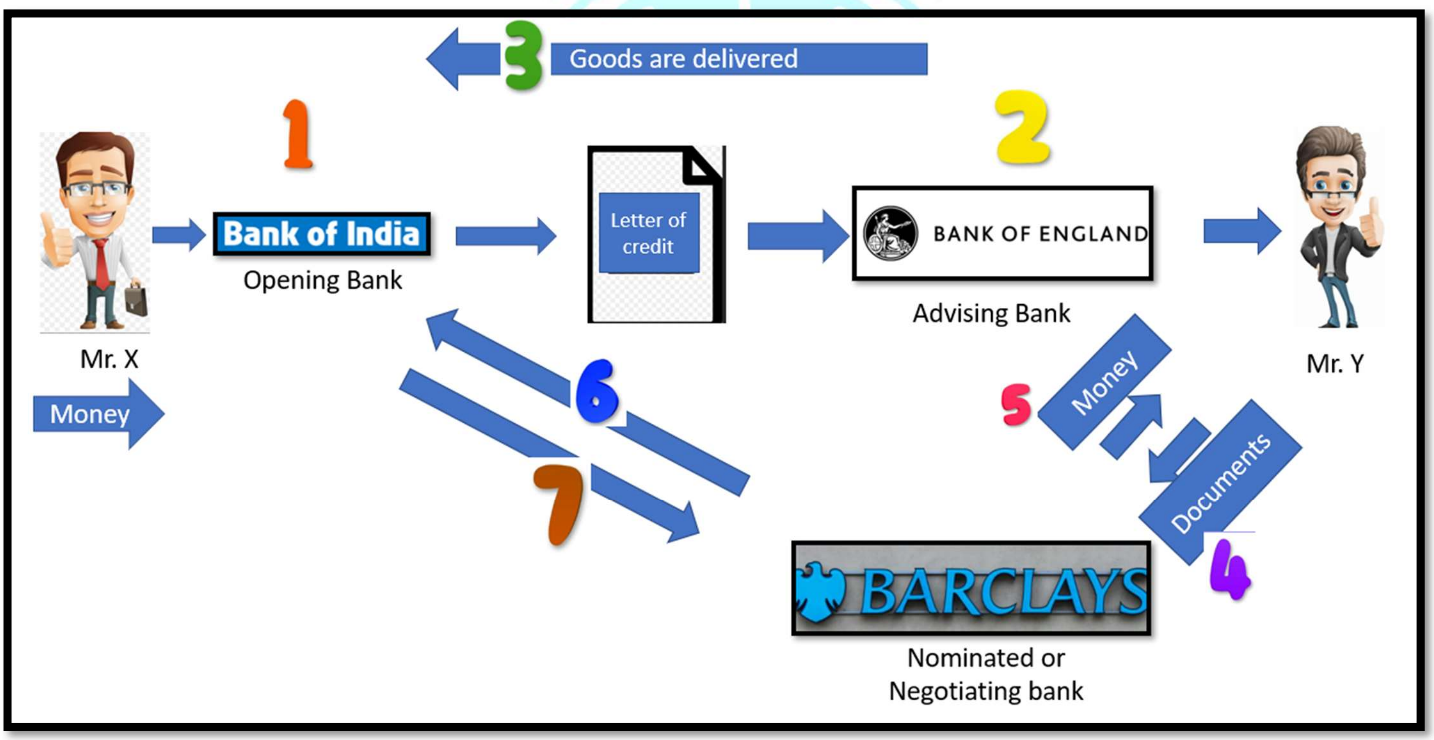
<u>**Parties involved in the Letter of Credit**</u>

Applicant/ Buyer / Importer/ Opener	Person who applies for Letter of Credit to the bank. **Mr. X becomes the buyer in the above example.**
Beneficiary/ exporter/seller	The person entitled to receive Letter of Credit. **Mr. Y becomes the beneficiary.**
Issuing Bank	The bank which opens the LOC on the issue of the buyer. **Bank of India is the issuing bank in the above example.**
Advising Bank	The bank in the beneficiary/exporter's country through which the letter of credit is advised to

	the beneficiary. **Bank of England is the Advising bank in the above example.**
Negotiating Bank	The bank in the beneficiary/exporters country which negotiates the bills that is makes payments on the bill drawn by the seller and accepts the documents. **Barclays Bank is the negotiating bank in this example.**
Confirming Bank	**The advising bank is only required to advise the LC to the beneficiary.** If the seller is not conversant with the issuing bank or not satisfied with its financial position, he may ask for an **additional assurance/guarantee** from another bank located in his country/place and the second guarantee is called confirming the LC.
Reimbursing Bank	Bank appointed by issuing bank to make the **reimbursing** to the negotiating, paying or conforming bank.



Now we will cover the **third miscellaneous function of a bank**

4.2.3.3 Underwriting and Credit Guarantee

Underwriting is a process banks use to **minimize liability and ensure a certain return on investment**.

For example - Mr. Ram and his bank get into an under-writing agreement, wherein Mr. Ram is planning to raise Rs. 100 crores from the market in form of equity shares and Mr. Ram's bank will provide the underwriting support. Now for instance what if Mr. Ram is only able to raise Rs. 90 crores? Under this scenario, bank of **Mr. Ram will fulfill the rest amount that is bank will provide Rs. 10 crores to Mr. Ram.**

Thus, in underwriting **agreement, one party agrees to fulfill the deficient amount for another party.**

Credit Guarantee - A credit guarantee is a form of insurance that helps to protect the interests of a seller from the chance of non-payment by a buyer. A bank guarantee is a promise by a financial institution to meet the liabilities of a business or individual if they don't fulfill their obligations in a contractual transaction

And as we all know that banks are always keen to reduce their risk while giving loans. Therefore, every bank asks for certain types of securities. These securities will help the bank to cover their losses, if any. These **securities are also known as collateral in general language.**

Now let's cover all the topics related to the securities.

5 Securities of the Bank

Securities are **financial instruments that represent some amount of financial value**. Security in the banking sector provide some **safety or guarantee to the bank** in the form of property

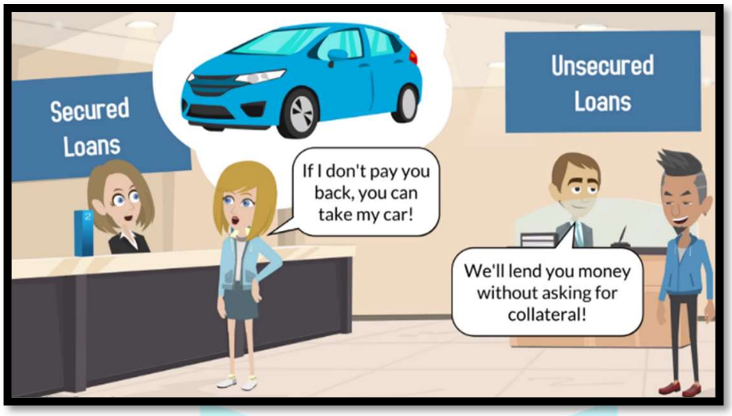
Example – Ravi borrows Rs 50,00,000 from the bank and he gives his land as a security. In case Ravi fails to make the required payment then the bank can sell the land and get their money back.

Before understanding the types of securities, we must understand what the difference between secured and unsecured loans.

- **Un-Secured loan** – An unsecured loan is one for which the banker must rely upon the **personal integrity of the borrower**, and no security is asked by the bank.

- **Secured loan** – In such type of loans bank will ask for the security.

Example – Riya wants Rs 80,00,000 and she approaches a bank for getting the loan. The **bank asks her to provide them with a collateral and she decides to give her BMW car as a collateral.** As the loan amount is large the **collateral provided by Riya would reduce the risk exposure of the bank. In case Riya fails to meet the obligation, the bank would use the BMW Car to compensate for the amount.**



Thus, Banks tend to safeguard their **advances by taking different kinds of securities**. The main purpose of taking a security is to fall back on it in case the loan is defaulted. Bank take movable properties immovable properties or a debt as securities for a loan. **The method of creating charge over a property depends upon the nature of property and nature of charge.**

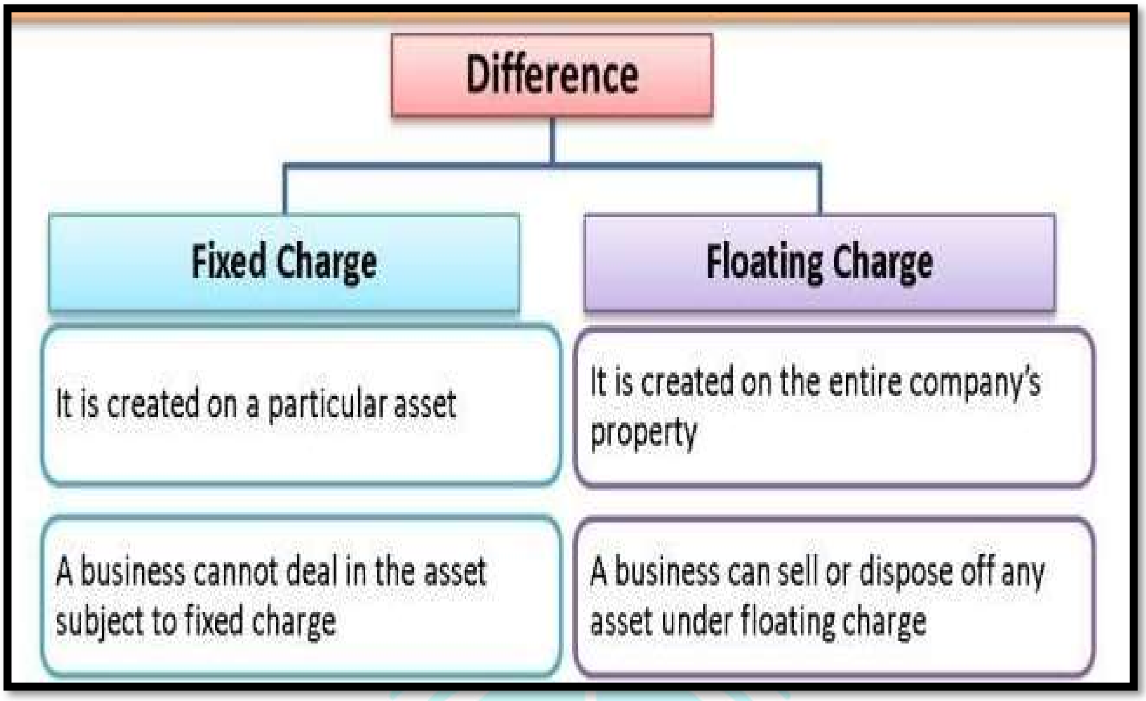
For example, when a bank gives a loan against the security of gold ornaments, it takes the possession of the ornaments whereas when it advances against the security of a vehicle or a house property, the does not take physical possession. **On the same lines let us understand the different types of bank charges.**

6 Modes of Charges

In banking, a charge is a way for a lender to secure a loan against the borrower's property. An asset becomes collateral security when a lender registers a charge over it, either by using a fixed or a floating charge. Any form of **security for debt is called Charge**. There are two types of charges –

- **Fixed charges or Specific charges –** It is a charge which is created on a **particular asset** of a company. **Example - A building is provided as a collateral security for the loan issued**.
- **Floating charge** - It is a charge that is general and not specific.It **does not fasten on or attach to any particular or specific property**.It is **an equitable charge** which covers the whole of the company's property whether it is or is not subject to fixed charge**. For example – All the**

assets which are held up in the name of borrower, can be used to get the loan amount of the bank.



Now let us discuss **the modes of charges** given below in detail

6.1 Assignment

In banking practice, a borrower may assign the book debt, money due from Government department, and life insurance policies as security for an advance. **It is done as per section 130 of transfer of property Act of 1930**

For example, if Ravi gave his LIC policy as a security to the bank to receive advances instead of his land then the bank will use his policy to recover the cost if he fails to meet the obligation. Also, a notice must be sent to LIC that Ravi would be giving his insurance policy in the form of assignment to the bank.

6.2 Mortgage

When **land/building (immovable property)** is offered as a security, it is charged to the bank by a mortgage. The law, relating to the mortgages is deal with the transfer **of the property act,1882. and SARFAESI ACT 2002.**

In standard definition, mortgage can be defined as an agreement between you and a lender that gives the lender the right to take your property if you fail to repay the money you've borrowed.

Example – **Mr. X provides his house (immovable property) to the bank as a collateral, that is a case of mortgage.** The transferor is called the **'mortgagor'** and the transferee a **'mortgagee'.** The principal money and interest of which payment is secured is called **'mortgage money'** and the instrument by which the transfer is affected is called **'mortgage deed'.**

<u>Types of Mortgages</u>

Simple Mortgage	Following points are the features of Simple Mortgage • **Delivery position** of Mortgaged property **does not take place**. Ownership and the possession remain with the borrower only. • **Example** – Ravi takes 50 Lakhs from the bank and gives his 3 BKH Apartment as security to the bank. He signs an agreement with the bank that in case he is not able to repay the loan then the bank can sell his apartment to a third party to get back the amount.
Mortgage by Condition Sale	Following points are the features of **Mortgage by Condition Sale** • On default of payment of **the mortgage money on a certain date**, the sale shall become absolute (It means, when

	mortgagor defaults, the lender can sell the property) • Or by on such payment being made the **sale shall become void**; (It means, if when **mortgagor do not defaults, the lender cannot sell the property)** • **For example**- Ravi takes a bank loan, and he mortgages his house. Now he must sign an agreement with the bank **that if he fails to pay the installments** on the given date then the bank would use his asset to get back the amount.
Usufructuary Mortgage	Following points are the features of **Usufructuary Mortgage** • This type of Mortgage gives **legal but not the physical position.** • Example – Let's say Ravi gives his house as collateral to the bank. In case of Usufructuary mortgage the **bank has the ownership right over the due course of the loan period and it can use it for renting purpose or generate other source of income, but the ultimate rights are still with Ravi.**
English Mortgage	Following points are the features of English **Mortgage** • It is a transaction in which, the mortgagor binds himself 'to **repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee**, but subject to the provision that he will retransfer it to the mortgagor upon payment of the mortgage money as agreed'. • For example – Ravi takes a loan from the bank and mortgages his house, in case of English mortgage, **Ravi would transfer the**

	property in the name of the bank while taking the money itself with the promise that the bank would transfer his property back once he pays the loan amount.
Mortgage by deposits of Title Deeds	• It is also known as an **equitable mortgage.** • When person delivers to creditor documents of title to immovable property, with intent to create a security thereon, **the transaction is called a mortgage by deposit of title deeds**. • For example – Ravi takes a loan from the bank, and he mortgages his apartment with the bank. In case of Mortgage by deposit of title deeds then the **bank would have beneficial interest in the title but not the legal title.**

6.3 Pledge

Pledge is said to be a **bailment of goods** as security for payment of a debt or performance of a promise. **Pledged** is the borrower who pledges the property and **pledgee** is the person with whom the property in pledged. Two important features of pledge are **delivery of goods and return of goods.**

Ownership of goods is not given and only possession over the goods is given when goods are pledged

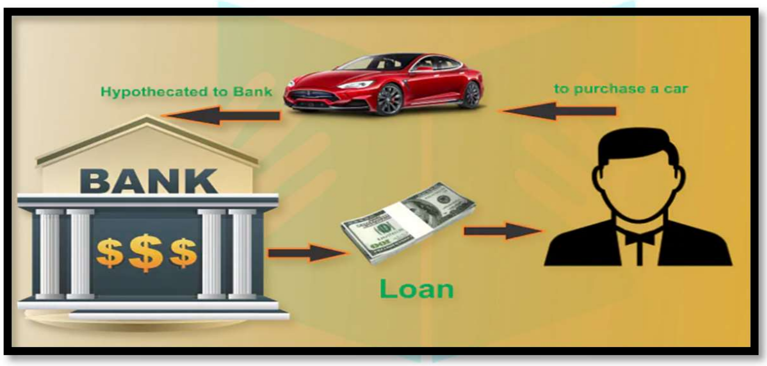
6.4 Hypothecation

The term Hypothecation' means **a charge in or upon any moveable property**, **existing or future, created by a borrower in favour of a secured creditor, without delivery of possession of the moveable property** to such creditor, as a security for financial assistance.The **mortgage of moveable** property is called ‘hypothecation’.

Hypothecation differs from pledge because goods remain in the possession of the borrower. **Hypothecation differs from mortgage in two respects**. Firstly, mortgage related to immoveable property whereas hypothecation relates to movable. **Secondly, in a mortgage, there is transfer of interest in the property to the creditor but in hypothecation there is only obligation to repay money and no transfer of interest.**

Vehicle loans (Auto/bike Loans) are the best example to understand the hypothecation. If an individual wish to purchase a car and doesn't have sufficient funds to buy, then he will surely approach **the bank to get the vehicle loan**. The bank will hypothecate the vehicle which is to be purchased and approve the loan.

That means the bank will create a charge (hypothecation) over the car till the repayment of the loan. In this case, **both possessions, as well as the ownership, retain with the borrower**. The borrower enjoys the benefits of property and gradually repay the loan to the bank or finance company.



6.5 Banker's Lien

Lien is the right of the banker to retain possession of the goods and securities owned by the debtor until the debt due from the latter is paid.

The Banker's lien is an **implied pledge For example** – Ravi takes loan from the bank and gives his apartment to the bank to use as bankers Lien. The bank has the right to retain the apartment until Ravi pays the bank's dues. The bank can sell the apartment after giving due notice to Ravi as per the laws if he fails to meet the obligation.

6.6 Set – Off

Set off means **total or partial merging of a claim of one person against another in a counter claim by the latter against the former**. **For example** – Mr. C has a saving bank account with XYZ bank and Mr. C has taken a loan also from the same bank. So, bank will pay certain some of money to Mr. C as interest on saving bank account and in return Mr. C will pay a certain sum of money to bank as well for the interest on loan amount. **Now let's assume, XYZ will pay Rs. 10 to Mr. C and in return Mr. C will pay Rs. 20. So now bank will set-off the entire transaction by taking Rs. 10 only from Mr. C.**

Now that we have discussed the various terminologies, services, securities, and modes of charges provided by banks, let us discuss the Banking regulation Acts in detail.

7 Regulations of the Bank

Banks are heavily regulated because they're central to the economy and all other businesses, and because one large bank failure could result in apocalypse, as we saw with the financial crisis.

Moreover, Banking is defined in **Section 5(b) of the Banking Regulation Act** as the acceptance of deposits of money from the public for the purpose of lending or investment. Such deposits may be repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

7.1 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 is **total 61 Sections in the RBI Act 1934**. Below we have mentioned important sections of the Act:

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.

Section	What does it convey
Section 3	Establishment and incorporation of Reserve Bank of India
Section 4	Deals with the Capital of the bank
Section 5	Increase and Reduction of Share Capital
Section 6	Permits RBI to open offices, Branches, and agencies in India
Section 7	The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest.

Section 8	Deals with the composition of Central Board and term of office of Directors.
Section 17	Describes the Basic Business Functions of RBI
Section 18	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.
Section 20	Obligations of RBI to deal with Government Business
Section 21	Gives RBI the right to transact the business of GOI in India
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	Speaks about Denomination of Notes
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 27	Re – issue of notes – It says that RBI cannot re-issue notes which are torn, defaced or excessively soiled
Section 42 (1)	Defines Cash Reserve Ratio (CRR)
Section 42 (6)	States the requirements of a bank to become a scheduled Commercial Bank. It further says that the bank should have a paid-up capital of not less than 5 Lakhs and Conduct of affairs by the bank in a manner which will not jeopardize interest of depositors.
Section 45-I	Defines NBFCs
Section 45-ZA	Inflation Target
Section 45 – ZB	Constitution of MPC

7.2 Banking Regulation Act, 1949

It extends to entire India. There are a total of 56 sections in this act. The important regulations of the act are given in the below table –

Section	What it conveys
Section 7	Use of words "bank", "banker", "banking" or "banking company". Every banking company must use the name bank
Section 10BB	power of Reserve Bank to appoint chairman of the Board of directors appointed on a whole-time basis or a managing director of a banking company.
Section 11	Requirement as to minimum paid-up capital and reserves
Section 22	Licensing of banking companies.
Section 24	Statutory Liquidity Ratio
Section 26	Return of unclaimed deposits
Section 35A	Power of the Reserve Bank to give directions.
Section 36AA	Power of Reserve Bank to remove managerial and other persons from office.
Section 47A	Power of Reserve Bank to impose penalty

8 Challenges in the Indian Banking System

Banks in India are the lifeline of the economy. They play a catalytic role in activating and sustaining economic growth. As per KPGM-CII report, India's banking sector is expanding rapidly and has the potential to become third largest by 2025. Amidst the signs of progress, the Indian banking sector has been facing multiple challenges in recent times.

Few of them are given below.

- **Nonperforming assets (NPAs) - Nonperforming assets are recorded on a bank's balance sheet after a prolonged period of non-payment by the borrower**.
- **Issue of Monetary Transmission -** Changes in the key policy rate are not reflected in lending
- **Cyber Threats** - One of the emerging threats in the banking sector is Cyber threat as most of the transaction are made through digital channels, which are not 100% secure.

- **Less awareness of technology** - Many senior bank workers are still not familiar with the use of technologies in bank and young and inexperienced are replacing them.

- **Corruption - Scams** in the erstwhile **Global Trust Bank (GBT) and the Bank of Baroda** show how few officials misuse the freedom they granted under the guise of liberalization for their personal benefit. These scams have badly damaged the image of these banks and consequently their profitability.

  Thus, to tackle the above issues, the government and RBI came up with various solutions as given below.

Steps taken by Government and RBI

- **Mission Indra Dhanush -** In the backdrop of **P J Nayak Committee** report on "Governance of the Boards of Banks in India" and the increasing economic compulsions to augment asset quality of banks, Mission Indra Dhanush was launched by Ministry of Finance. The mission aims at revamping the public sector banks so that they can compete with the private sector banks.
- **Creation of Bad Banks -** Technically, a **bad bank is an Asset Reconstruction Company (ARC)** or an Asset Management Company (AMC) that **takes over the bad loans of commercial banks, manages them and finally recovers the money** over a period of time. The bad bank is not involved in lending and taking deposits, but **helps commercial banks clean up their balance sheets and resolve bad loans.** The **takeover of bad loans is normally below the book value** of the loan and the bad bank tries to recover as much as possible subsequently.
- **Stringent NPA recovery rules:** The government has over the years enacted and tweaked stringent rules to recover assets of defaulters. **The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002** was amended in 2016 as it took banks years to recover the assets.
- **Introduction of Bankruptcy Code** -
- **Disinvestment of Public Sector Banks** - **During Union Budget 2020-21 presentation, the government announced a new** policy **for** strategic disinvestment **of public sector enterprises.**.
- **Creation of National Bank for Financing Infrastructure and Development (NaBFID)**

Thus, Present scenario calls for a paradigm shift in the banking sector to improve its resilience and maintain financial stability. Banks are at the core of any economic system whether developed or developing. Essentially, a technologically advanced, transparent, and efficient banking system is the need of the hour for the growing economy like India