Principles and Practices of Banking

O.P. Agarwal

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PRINCIPLES AND PRACTICES OF BANKING

(As Per the New Syllabus of S.Y. BAF, 2017-18, Semester III, University of Mumbai)

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Preface to First Edition

The students and professors of the Bachelor of Com., in Accounts and Finance, needed a book on the Principles and Practices of Banking subject as per the revised syllabus applicable from the academic year 2017-18 of the Mumbai University.

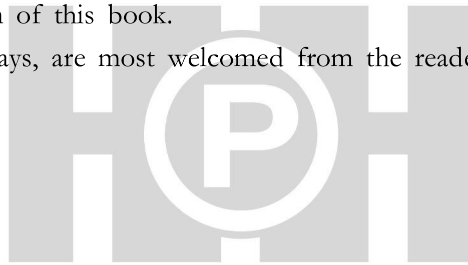
I, as a retired banker, have endeavoured my best to incorporate and describe the various topics *viz.* Banking Regulation Act, 1949, retail banking for individuals along with money market, capital market and debt markets.

There are certain other regulations *viz.,* Consumer Protection Act, Banking Qmbudsman Scheme, Negotiable Instrument Act, 1881, as to payment and collection of cheques.

I have tried to explain the topics in plain language which is understandable and explainable in the examinations, by the students. Information technology is playing a very laudable role in providing banking services to the customers. Marketing of Banking Service is essential as in the commodity markets' product, which cannot be skipped in the banking development.

I need to acknowledge my gratitude to my wife Mrs. Veena Agarwal, M.A. (Eco.) for her support in the completion of this book.

Suggestions, as always, are most welcomed from the readers.



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SYLLABUS

Sr. No.	Modules/Units
1.	**Indian Financial System**
	Indian Financial System – An Overview
	Banking Regulation
	Retail Banking, Wholesale Banking and International Banking
	Role of Money Market, Debt Market, Capital Market, Forex Market and SEBI
50	Mutual Funds and Insurance Companies and IRDA
	Factoring, Forfaiting Services and Off-balance Sheet Items
	Risk Management, Basel Accords
	CIBIL, Fair Practices Code for Debt Collection
2.	**Functions of Banks**
	Banker Customer Relationship
	KYC/AML/CFT Norms
	Bankers Special Relationship
	Consumer Protection – COPRA, Banking Ombudsman Scheme
	Payment and Collection of Cheque and Other Negotiable Instrument
	Opening Accounts of Various Types of Customers
80	Ancillary Services
	Cash Operations
	Principles of Lending, Working Capital Assessment and Credit Monitoring
	Priority Sector Advances
	Agricultural Finance
	Micro, Small and Medium Enterprises – MSMED Act, Policy package
	Government Sponsored Schemes – SGSY; SJSRY; PMRY; SLRS
	Self-help Groups
	Credit Cards, Home Loans, Personal Loans and Consumer Loans
	Documentation
	Different Types of Charging Securities
	Types of Collaterals and their Characteristics
	Non-performing Assets
	Financial Inclusion
3	**Banking Technology**
	Payments System and Electronic Banking
20	Data Communication and EFT Systems
	Role of Technology and Its Impact on Banks
4	**Marketing and Services of Banking**
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20	Consumer Behaviour and Product
	Pricing, Distribution and Channel Management

Note : Relevant Law/Statute/Rule in force and relevant Standards in force on 1st April immediately preceding commencement of Academic Year is applicable for ensuring examination after relevant year.

Paper Pattern

Maximum Marks: 75
Questions to be Set: 05
Duration: 2½ Hours
All questions are compulsory carrying 15 Marks each.

Q. No.	Particulars	Marks
Q.1	Objective Questions* (A) Sub-questions to be asked (10) and to be answered (any 08) (B) Sub-questions to be asked (10) and to be answered (any 07) (*Multiple Choice/True or False/Match the Columns/ Fill in the Blanks)	15
Q.2 Q.2	Full Length Question OR Full Length Question	15 15
Q.3 Q.3	Full Length Question OR Full Length Question	15 15
Q.4 Q.4	Full Length Question OR Full Length Question	15 15
Q.5 Q.5	(A) Theory Questions (B) Theory Questions OR Short Notes To be asked (05) To be answered (03)	08 07 15

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INDIAN FINANCIAL SYSTEM

CHAPTER 1

1.1 AN OVERVIEW OF IFS

The liberalisation of the financial sector in India which formed a key part of the overall liberalisation process, blurred the distinction between various financial intermediaries and promoted greater efficiency and competiveness in the financial markets. With the growth of the debt capital markets and entry of mutual funds, disintermediation have gradually set in.

The 'system' stands for a set of bodily organs like composition or concurring in function, a scheme of **Classification** and a **Method of Organisation.**

'Finance' holds the key to all human activities. Finance is the study of money — its nature, creation, behaviour, regulation and administration. So all these activities dealing in finance are organised in a system, known as the "financial system."

The term financial system is a set of interrelated activities/services, working together to achieve some predeterminad purpose or goal. It includes different markets, institutions, instruments, services and mechanisms, which influence the generation of savings, investment, capital formation and growth.

According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

1.2 EVOLUTION OF INDIAN FINANCIAL SYSTEM

The evolution of the financial system has been interlinked with the growth of macroeconomics. In India, the evolution of the financial systems reflected its political, social and economic needs and aspirations. The government has exerted its influence, over the flow of credit, interest rates, credit control and direction. If is also a big borrower as well as regulator of the financial system. A bulk contributor of the Indian Financial System is the public sector, even though cooperatives and private sectors are there to compete with other institutions.

1.3 CLASSIFICATION OF INDIAN FINANCIAL SYSTEM

The Indian financial system is broadly classified into two groups:

(i) Organised Sector, and

(ii) Unorganised Sector

There are users of the financial services and also providers of financial services. The provides are Reserve Bank of India, commercial banks, financial institutions, money and capital markets and informal financial enterprises.

Organised Sector – The organised sector consists of a network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are provided by the commercial and cooperative banks. About 83% of such banking business are managed by 21 leading public sector banks. In addition to commercial banks, there is a network of cooperative and development, regional rural banks at district, city and block levels. During the last two decades Indian banks have diversified into areas such as merchant banking, mutual funds, learning, factoring, foreign exchange and corporate treasury services.

The financial institutions in India mainly consist of public sector banks (21), private sector banks (22), regional rural banks (56), small finance banks (8), payment banks (11), urban cooperative banks (53), state cooperative banks (31), district central cooperative banks (373), NBFCs (11,769 registered with RBI and 34,754 unregd.) and institutions of mutual funds (42).

Hence the organised financial system comprises the following subsystems:

- Commercial banks (public and private sector)
- Cooperative banks/Cooperative societies
- Development banking (Long-term financial institutions provider)
- Money markets; and
- Financial institutions

Unorganised Financial System

It comprises relatively less controlled in regulated moneylenders, indigenous bankers, lending pawnbrokers, landlords, traders etc. There are other financial companies like Chit Funds and Nidhi Cos. etc., which are also not regulated by RBI or the government.

1.4 Evolution of Commercial Banking

In India, the ancient Hindu scriptures refer to the rnoneylending activities in the Vedic period. During the *Ramayana* and *Mahabharat* eras, banking had become a full fledged business activity and during the *Manu Smriti* period which followed the Vedic period and Epic age, the business of banking was carried on by the members of the Vaishya community.

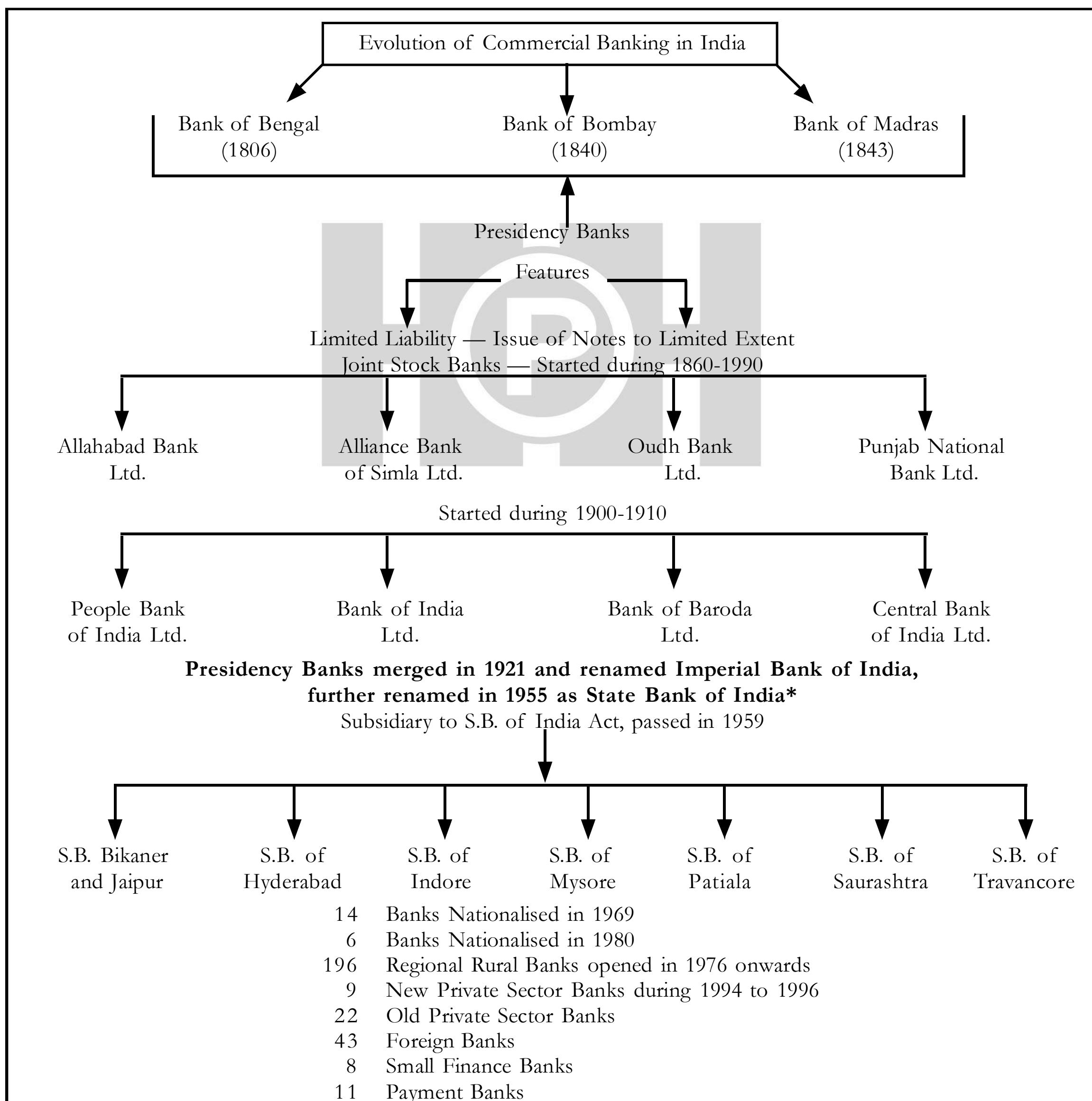
Banking is different from moneylending but the two terms have in practice been taken to convey the same meaning. Banking has two important functions to perform, one of accepting deposits and other of lending monies and/or investment of funds.

During the Moghul period, metallic money was issued and the indigenous bankers added one more line of money changing to their already profitable business. They started exchanging money circulating in one part of the country with the money currently in another part of the country making good margin for themselves. The indigenous bankers could not however, develop to any considerable extent the systems of obtaining deposits from the public, which today is an important function of a banker.

The English traders, who came to India in the 17th century, established some contacts with the indigenous bankers by borrowing funds from them. In 1786, the English Agency Houses had established the Bank of Bengal at Calcutta. With the advent of modern banking conducted on Western lines, the

indigenous bankers lost further importance. The English Agency Houses in Calcutta and Bombay were the bankers to the East India Company and the European merchants in India. They had no capital of their own and depended mainly on deposits from the public for finance. These agency houses failed as they combined banking with trading.

Among the earliest banks established in India were the Banks of Bengal (1806), Bombay (1840) and Madras (1843). These banks were also known as “Presidency banks”. In 1860, the concept of limited liability was introduced in banking. These banks (Presidency banks) were allowed to issue notes to a limited extent, but this right was taken over by the government in 1862. In view of limited liability, several joint stock banks were floated. Some of the important banks that were established during 1860 to 1900, were:



*Merged with S.B. India on 31.3.2017

- Allahabad Bank Ltd.
- The Alliance Bank of Simla Ltd,
- The Oudh Bank Ltd.
- The Punjab National Bank Ltd.

Thus, by the end of the year 1900, there were three classes of bank.,, in India, viz.,

(i) Presidency banks, numbering 3
(ii) Joint stock banks, numbering 9
(iii) Exchange banks or foreign banks, numbering 8

The Swadeshi movement, which started in the early 1900s, gave stimulus to the growth of indigenous joint stock banks. Some of the banks established during the 1900 to 1910 period were:

(i) The Peoples Bank of India Ltd.
(ii) The Bank of India Ltd.
(iii) The Bank of Baroda Ltd.
(iv) The Central Bank of India Ltd.

In 1921, the three presidency banks were merged to form the Imperial Bank of India. On the eve of independence in August 1947, there were 648 commercial banks, comprising 97 scheduled and 551 non scheduled banks. The number of offices of banks stood at 2,987, with total eposits at ₹ 1,000 crore and advances at ₹ 475 crore.

During the 50 years or the period 1900 to 1950, the Indian joint stock banks specialised in providing short term credit, for trade in the form of cash credit and overdraft facilities, foreign exchange business, remained the monopoly of foreign banks. Between 1900 and 1925, many banks failed. The Central Banking Enquiry Committee was constituted in 1929, it gave reasons for the failure of banks as:

(a) Insufficient capital
(b) Poor liquidity of assets
(c) Combination of non banking activities with banking activities
(d) Irrational credit policy, and
(e) Incompetent and inexperienced directors

On the basis of major recommendations of the Central Banking Enquiry Committee, the RBI Act was passed in 1934. While in 1949, the Banking Regulation Act, was passed for regulation and supervision of banks. It gave wide powers to RBI to regulate, supervise and develop the banking systems.

During 1950 to 1969, two important developments took place, first, the All India Rural Credit Survey Committee, which examined the issue of credit availability in the rural areas, recommended the creation of a State partnered/ sponsored bank entrusted with the task of opening branches in the rural areas. Accepting. This recommendation, the State Bank of India Act, 1955, was passed and the Imperial Bank of India was renamed State Bank of India. Later in 1959, the State Bank of India (Subsidiary Bank) Act, was passed enabling SBI, to takeover eight princely state associated banks, as their subsidiaries.

Banks were:

State Bank of Bikaner*

State Bank of Hyderabad

State Bank of Indore**

State Bank of Jaipur*

State Bank of Mysore

State Bank of Patiala

State Bank of Saurashtra**

State Bank of Travancore

These two banks merged into one bank)

(** Merged with State Bank of India in 30.6.2010 and rest 5 on 31.3.2017)

Secondly, the need for wider diffusion of banking facilities and to change the uneven distributive pattern of bank lending was realised. The scheme of social control, over banks, was announced in Parliament in December 1967. The National Credit Control Council was set Lip in 1968, to assesses the demand for bank credit, from various sectors of the economy and to determine their respective priorities in allocation.

At the launch of the First Five Year Plan in 1951, there were 566 commercial banks consisting of 92 scheduled and 474 non-scheduled banks. In 1969, the total number of banks declined to 89 out of which 73 were scheduled and 16 were non scheduled.

1.5 Era of Nationalisation to 1991

The Indian banking scene underwent significant changes during the period 1969 to 1990. The social control measures, of not less than 51% of the directors of the board of a banking company had to consist of persons with special knowledge or practical experiences in respect of accountancy, agriculture, rural economy, banking, cooperation, economics, finance, law and SSIs, were not considered adequate to achieve the desired social and economic objectives. The Government of India, therefore, on 19th July, 1969, nationalised by an ordinance, 14 major Indian commercial banks having deposits of ₹ 50 crores and above. The objectives of nationalisation were:

An institution such as the banking system, which touches and should touch lives of millions, has to be inspired by a larger social purpose and has to subserve national priorities and objectives, such as rapid growth in agriculture, small industry and exports, raising employment levels, encouragement of new entrepreneurs, and the development of backward areas. The acquisition of ownership of banks was, thus, to enable the banks to play more efficiently the role of a catalytic agent for the economic growth by extending banking facilities to the most deserving classes.

Again in 1980, the Government of India had nationalised another six banks, each having deposits of ₹ 200 crores or above. The banks nationalised in 1969 and 1980 were as below:

Banks Nationalised in 1969

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Bank of Baroda
5. United Commercial Bank
6. Canara Bank

7. United Bank of India
8. Dena Bank
9. Syndicate Bank
10. Union Bank of India
11. Allahabad Bank
12. Indian Overseas Bank
13. Indian Bank
14. Bank of Maharashtra

Banks Nationalised in 1980

15. Andhra Bank
16. Corporation Bank
17. Oriental Bank of Commerce
18. Punjab and Sindh Bank
19. Vijaya Bank
20. New Bank of India*

*This bank was merged with PNB in 1990 and a new bank IDBI Ltd., was added in the year 2003.

Another important structural development was the formation of' the Regional Rural Banks (RRBs), which were started in 1976. Their ownership vests with the sponsoring commercial bank, the Central Government and the State Government of the area. Under this approach, 196 RRBs were set Lip.

Major developments in banking during 1970 to 1991 were:

1973-74	–	Setting targets for priority sector lending.
1974-75	–	Prescription of norms for lending and working capital limits by Tandon Committee.
1982-83	–	Prof. Chakrabarty's report on monitoring system in India.
		Establishment of National Bank for Agriculture and Rural Development (NABARD)
1985-86	–	Introduction of MICR Technology
		Introduction of Health Code system for bank loans
1985-86	–	Permission to banks to float mutual funds.
1988-89	–	Vaghul Working Group on Money market.
	–	Establishment of Discount and Finance House of India (DFHI) and the National Housing Bank (NHB)
	–	Adoption of Service Area Approach.
1989-90	–	Enhancement of access to call money market, in terms of number of participants.
	–	Establishment of the Small Industries Development Bank of India (SIDBI)

During nationalisation and thereafter, there was wide branch expansion in rural and semi urban areas, backward regions and under banked states so that interregional disparities could be reduced. The details of the programme of' branch network were as follows:

Year branches	Total branches	Rural branches	Semi urban
1969	8262	1833	3342
1980	32419	15105	8122
1991	60220	35206	11344

Source: Bank Quest, Oct-Dec., 2002 of IIBF

The total number of bank branches increased eight fold between 1961) and 1991 and the bulk of the increase was on account of rural branches, which increased from less than 1,900 in 1961) to over 35 thousand in 1991.

One of the objectives of branch expansion was to mop up national savings, both actual and potential and to channel them into investments according to Five Year Plan priorities.

₹ in Crores

Year	Deposits Total	Term Deposits	Saving Deposits
1969	5173	3280	1524
1980	37988	19253	10937
1991	230758	128768	56902

The RBI's credit policy over the years, laid increasing emphasis on channeling of bank credit to preferred sectors and borrowers of small means. The credit operations of banks were:

₹ in Crores

	1969	1980	1991
Bank Credit	3729	25371	125592
Priority Sector	659	8501	45425
%age of which	18	33	36
Agriculture	258	3584	18157
%	39	42	42
SSI Sector	347	3229	18150
%	52	37	42

Note. Figures are in percentages to vertical totals.

1.6 Era of Economic Reforms (1992-2003)

The period, 1992-2003, may be regarded as the present or the current phase in the evolution of Indian Banking. Like the phase of 1969-1991 began with a bang, *i.e.,* nationalisation of banks, the current phase also began towards market oriented banking, as a result of the introduction of financial reforms, especially banking reforms. India's economic reforms programme began as a response to the macroeconomic crises that developed in early 1991. The crises manifested itself in rising inflation, high level fiscal deficit, low growth and unsustainable current account deficit, and the Gulf War of 1990 precipitated, the "balance of payment" crisis.

The main plank of economic reforms comprised:

(a) Stabilisation of the economy so as to keep under control inflationary and balance of payment pressures.

(b) Deregulation of the real and financial sectors and removal of licence and permit system from all spheres.

(c) Liberalisation of international trade in various sectors to promote competition and efficiency by removing the high degree of protection enjoyed by the domestic industry, and

(d) Integration with world economy to attract capital and modern technology.

The banking reforms have the specific task of achieving:

(i) A suitable modification in the policy framework within which banks operate,

(ii) Improvement in the financial health and competitive capabilities of banks,

(iii) Building financial infrastructure relating to supervision, audit and technology, and

(iv) Upgradation of the level of managerial competence and the quality of human resources.

The basis for banking reforms approved by the Committee on Financial System (Narasimham Committee), which were made recommendations in November, 1991 for transforming highly regulated policy to a more market oriented system.

The various measures were:

(a) Reduction in the pre emption of funds through lowering of the CRR and SLR from 63.5% to 31.5% (CRR 6.5% and SLR 25%) in October 2001.

(b) Redefining and redesigning directed credit programmes.

(c) Dismantling administered interests.

(d) Establishment of Discount and Finance House of India, Securities Trading Corporation of India and Negotiated Payment Settlement System.

(e) Improving financial health of banks through prescription of risk weighted capital adequacy ratios, re-capitalisation and restructuring of weak banks.

(f) Amendment to the bank branch licensing policy to deal effectively with the loss making branches.

(g) Withdrawing the concept of MPBF and increasing the share of loan segment in banks credit.

(h) Setting up of special Debt Recovery Tribunals (DRTs) for improving recovery of bank loans.

(i) Norms for floating new private sector banks.

(j) Deregulation of interest rates all loans over ₹ 2 lakh.

Various measures were taken by RBI and Government for economic reforms, such as:

(i) Introduction of Banking Ombudsman Scheme in 1995.

(ii) Freedom to banks to decide their Prime Lending Rate (PLR).

(iii) Introduction of the concept of Local Area Banks.

(iv) Granting of conditional autonomy to the public sector banks.

(v) Revision of capital adequacy norms in 1998-99.

(vi) Deregulation of interest rates of all term deposits.

(vii) Introduction of Voluntary Retiremen0t Scheme (VRS) in public sector banks resulting in about 11% reduction of employees in 2001.

There has been a growing presence of private sector banks, more so, after the introduction of financial sector reforms from 1992. Six new private sector banks, listed as under, were issued licenses in 1994-95 and four more licences in 1995-96, commenced operations during the same year. Minimum net owned funds of private sector banks was ₹ 300 crores w.*e.f.* July 2006 to 2011.

1. UTI Bank Ltd.
2. Indus Ind. Bank Ltd.
3. ICICI Banking Corporation Ltd.
4. Global Trust Bank Ltd.
5. Centurion Bank Ltd.
6. HDFC Bank Ltd,
7. Times Bank Ltd.
8. Bank Of Punjab Ltd.
9. IDBI Bank Ltd.
10. Kotak Mahindra Bank Ltd.

Out of these above listed banks, following banks merged with and/or acquired by other banks:

(i) Merger of Times Bank with HDFC Bank Ltd., in 1999-2000.

(ii) Bank of Madhura merged with the ICICI Bank in 2000-01.

(iii) Centurion Bank acquired Bank of Punjab Ltd., in October 2005.

(iv) Global Trust Bank Ltd., merged with Oriental Bank of Commerce in 2004.

(v) Bharat Overseas Bank Ltd., merged with Indian Overseas Bank in 2007.

(vi) Sangli Bank Ltd., merged with ICICI Bank Ltd.

(vii) United Western Bank Ltd., merged with Kotak Mahindra Bank Ltd.

(viii) UTI Bank Ltd., converted to AXIS Bank Ltd.

(ix) Centurion Bank of Punjab Ltd., merged with HDFC Bank Ltd., in May 2008.

(x) Bank of Rajasthan Ltd., merged with ICICI Bank Ltd., in July 2010.

Private sector banks have been rapidly increasing their presence in the recent times and offering a variety of newer services to the customers and posing a stiff competition to the group of public sector banks.

The response of the banks to the reforms has been impressive. The following position was of public sector banks at the end of March 2001:

(a) Capital adequacy 9% required, actual was in excess of 10% in March 2001.

(b) Ratio of gross NPAs to gross advances in 1992-93 was 23% reduced to 12.4%.

(c) PSB in 1993-94 had loss of ₹ 4,705 crore which turned into profit of ₹ 2,095 crore in March 2001.

(d) Total branches at the end of March 2001, 65,901.

1.7 From 2004 to Date

India has become $ 2.0767 trillion economy in 2014 end. As per World Bank report, India's GDP stands at $ 2.067 trillion in just 7 years. But still it is in the lower middle income category. India's gross national income per person has risen to $1,610 which converts to ₹ 1,01,430 by present exchange rate (June 2015) (E.T. Newspaper 04 07 2015)

The Indian banking system faces several difficult challenges, *viz.,* high cost of doing business, yearly increases in NPA, low levels of Customer satisfaction, phenomenal growth in the volume of capital inflows, etc. There are several areas of concern, which needs to be addressed.

Indian banks will have to operate in a deregulated competitive financial sector. Competitive pressure is building up on Indian banks, both from within and from outside. Competition is likely to intensify in the coming years within the industry, from NBFCs and from foreign entities. Competition is not just in terms of number of competitors but in terms of proliferation of innovations, specialised markets, cross border trade in financial services and capital flows.

We cannot lag behind other countries and we have to transform the Indian banking system from being a largely domestic to a truly international one, and this should enable India to emerge as all international banking centre. Information and communication technology has reduced costs, increased volumes and has facilitated customised products. It has played all important role in the payments and settlement system. Technology has opened new avenues in banking, for discharging the same functions in a cost effective manner, 24 hour 7 days banking, telebanking, Internet banking, e-banking, home-banking and mobile banking.

Asset liability mismatches expose the banks to various types of risk, *i.e.,* risks of illiquidity and insolvency, risks arising from globalisation and deregulation. Risk management is a continuous process of controlling assets and liabilities in terms of size**,** maturities and yields.

In any banking system, no bank, howsoever owned, can survive unless it continuously strives to transform its organisation as a self-governing, self-correcting and self-adjusting equity. In this millennium, mankind is destined to serve not one but two masters. The first is no longer the **owner,** but the **customer,** who is supreme, regardless of whether he is rich or poor, young or old, domestic or foreign. The second is profits and there is no third thing. And just as "income recognition" and capital adequacy are two sides of the same coin, so also it is with customer satisfaction and profits.

There are two models, emerging in the banking scenario today. One or them is universal banking in which banks are attempting to provide products and services developed by them to the customers. The second one is Customer Relationship Management (CRM). Many retail banks are focusing all new strategies to maximise customer acquisition, cross sell, retain customers, and increase profitability, while increasing customer service and satisfaction levels, reducing product costs and improving distribution. Banks have started selling their customers, online banking and consultation services to add, both value to their services and to satisfy their customers. But, even after selling a series of financial transactions to the customer on the internet, the customer needs a good reason to remain loyal to the bank. As use of the Internet continues to expand, more banks are using the web to offer products and services or otherwise enhance communication with customers. But once a customer is online, it is hard to keep him or her loyal to the bank. For financial inclusion NO FRILL accounts were opened by all banks. The position of all such banks at the end of 31.03.2009 was as under:

	Number of accounts (cumulative figure)
Public Sector banks	2,98,59,178
Private Sector banks	31,24,101
Foreign Banks	41,482
Total	3,30,24,761

The commercial banking sector plays an important role in the mobilisation of deposits and disbursement of credit to various sectors of the economy. Traditional banking has come a long way through from goldsmiths who were tile literal bankers to the virtual banks. Banking is going through a metamorphosis. Technology, deregulation, disintermediation and securitisation are the major forces that are producing ripples in the industry.

Savings banks accounts were opened under Prime Minister Jan Dhan Yojna 2014 in order to have social security to poors with zero balance with accidnt benefit and life cover. Total 28.23 crore accounts were opened till 31.03.2017 with balance of ₹ 63,971.38 crores.

District Central Cooperative Banks: It is a federation of PACs (primary agricultural credit societies) located in a specific area, i.e., district. These organisations are linking points between primary cooperative agricultural credit societies and State Cooperative Banks. District Central Cooperative Banks undertake banking related activities. They also grant credit to customers on the basis of first class gilt securities, gold, etc.

State Cooperative Banks: SCBs occupies a key position in the cooperative credit structure. The RBI reaches to the cultivators through the States Cooperative Banks. Resource of such state level coop. Banks comprises share capital, reserve funds, various type of deposits, loans and overdrafts/borrowings and surplus funds of district Central Cooperative Banks affiliated to the respective banks. These banks lend to affiliated District Central Cooperative Banks. The main functions of State Cooperative Banks are as follows:

(i) Acts as bankers' bank for District Central Cooperative Banks.

(ii) Connects Cooperative Credit Societies or banks with money market in the country.

(iii) Supervises, controls and renders guidance to the District Central Cooperative Banks.

(iv) Performs functions like issuing drafts, cheques and letters of credit, etc.

(v) Assists the state governments in drawing up cooperative development related plans for the State.

There were 31 (in 2017) state cooperative banks in India, with total aggregate deposits of ₹ 71,315 crore and ₹ 21,582 crore advances at the end of 2008-09. NABARD gives loans to RRBs at 4.5%, while the interest rate for cooperative banks is around 4%. In the year 2010-11, government had used ₹ 5,000 crore fund for meeting short-term financial needs of cooperatives and RRBs for farm sector.

Among non agricultural credit, which is provided by the urban cooperative banks and employees cooperative credit societies are the main institutions under the cooperative sector. Urban cooperative banks are also known as "Common man's banks" play an important role in the life of urban people. Urban cooperative banks having deposits of ₹ 100 crore and above are given the status of scheduled bank under RBI Act, 1934, subject to minimum demand and time liabilities of ₹ 250 crores.

The position of UCB as on 31st March 2017 were as below:

No. of Scheduled UCBs	— 53 (March 2016)
No. of banks	— 1,561 (March 2016)
	— (including 119 fully ladies branches)
Owned funds	— ₹ 12,843 crores, 9% CRAR in 95.4% banks
Deposits	— ₹ 3,92,179 crores
Borrowings	— ₹ 2,45,013 crores
Gross NPAs	— 6.55% on 31.3.2016

Most of the urban cooperatives banks are situated in the States of Maharashtra/Gujarat/Karnataka/Andhra Pradesh/Tamil Nadu/Goa and Uttar Pradesh.

As per RBI statistics, there are only nine urban cooperative banks which are having deposits of ₹ 1,000 crores or above, while 60% UCBs are having deposit totals of less than ₹ 25 crores.

Implementation of Vaidyanathan Committee's recommendations had been asked by the RBI to the State Governments. The finance package of ₹ 14,839 crores was to be shared at 53% by the State Government, while cooperative societies had been asked to contribute 16%. [As all cooperative societies had C.A.R. of 7% and after 5 years in 2012, it was raised to 12%.] RBI directed all UCBs to implement CBS system in Dec. 2014.

1.7.1 Regulating Cooperative Banks

In discussions on banking licences, one rather ignored area is that of urban cooperative banks (UCBs). This has remained somewhat below the radar. However, it appears that there might be some action in this space if the Reserve Bank of India (RBI) considers issuing licences for new urban cooperative banks in the near future. A the report submitted by an expert committee of RBI, led by Y.H. Malegam, lays down some of the principles for issuing new licences.

It is, however, important for RBI to recognise the difference in the form of organisation before e banking on opening up the gates for new cooperative banks. Cooperatives are distinct from other forms of organisation, as they are organised on the Principle of Mutuality. RBI needs to recognise the complexity of the cooperative form. This complexity emanates from the principles of cooperation, which treats capital as incidental and not central to business.

In this context we should consider one critical principle of open membership that defines cooperatives. Most UCBs operate in violation of this principle in spirit. The principle is anybody who is willing to use the services of the cooperative, as per the terms of engagement should not be denied membership, unless there are genuine capacity constraints. Open membership permits a member to walk out, when he or she does not want the services. Therefore, the share capital of a cooperative is incidental and is in the nature of a fixed deposit where a member can subscribe to or withdraw from it at any time.

RBI needs to recognise this oxymoron — that there could be no cooperative "banking". Banks seek deposits from public and uses them for lending. If we follow the cooperative principles, there could be no "public" as deposits come from owner members. Thus, from a puritanical view one could argue for a neighbourhood level cooperative society. Federated structures could provide the sophisticated

services to the members by having multiple neighbourhood societies promote the upper tier organization. The European and the North American models are basically neighbourhood credit unions and federated structures. Neighbourhood cooperatives might need to be a bank to be a part of the payments system.

The UCBs (with the notable exceptions like the Sewa Bank), work as neighbourhood banks rather than as cooperatives, It is impossible to break into a DCB's membership club. So, as the expert report rightly recognises, these are borrowerrun organisations with depositors having optional membership. The conflict of interest of a borrower run bank is stark. If RBI were to issue new licences, it should move the control entirely to the depositors (except for institutional deposits) rather than accepting the recommendation that at least 50% of the deposits should be represented by members.

Till now, we had no instances of cooperatives going below the capitalisation requirements because of withdrawal of membership under the open membership route. Most DCB collapses were because of a 'run', an indication that DCBs are a close club where members are too entrenched to withdraw membership; and deposits were held by customers, not members.

A new formula was proposed by the report that the new members should pay a premium to obtain membership to represent the accumulated and indivisible reserves of the DCB appears fair, but has a dangerous flip side. The members withdrawing from membership also get a premium representing indivisible reserves. The implication is significant when considered with the other recommendation that the membership should represent more than 50% of the depositor base. These two together would make a perfect case for a run led by members in case of trouble. While the principle of withdrawing members getting a premium representing their unencashed loyalty and patronage is desirable, it is dangerous in a bank. The cooperative should at least fence the minimum amounts required for capital adequacy as non distributable amounts.

The issue of professionalism in running a UCB was a serious issue and RBI considered the recommendations of the committee to have sliced governance, a board of directors (elected) for strategy formulation and a board of management (appointed/co-opted) who satisfy the fit and proper criteria for governing the operations.

The committee recommended lower capitalisation for UCBs operating in unbanked areas. Granting a licence for starting/running an UCB is a technical issue, and this cannot be treated as a nation building exercise. Cooperatives operate as neighbourhood institutions and it might not be a good idea to grant licences at lower capitalisation. If a cooperative society could morph into a bank at scale, then the unbanked areas Could start with societies than undercapitalised banks. However, the eventual question that RBI should stand upto is, whether the regulator considers these institutions as banks incorporated as cooperatives or as cooperatives wanting to do banking. This makes a world of difference. This might be the one opportunity for RBI to restore cooperation in cooperative banks.

1.7.2 Agricultural and Rural Development Banks

The avenues for borrowing on long-term basis provide only short-term credit requirements and the funds of the commercial banks and cooperative societies could not be blocked for longer periods of time. Against this backdrop only the institution of **Land Development Banks** or Agricultural and Rural Development Banks, came into existence in the form of term finance, for buying equipment like pump sets, tractors, electric motors and other equipment, which are being used by the farming community. These banks provide long term credit against the mortgage of land as security generally for a period of 5 to 20 years.

The first cooperative land development or land mortgage bank was established at Jhind in Punjab in 1920. Subsequently, similar banks were established in other parts of the country, *viz.,* in Madras province in 1929 and in Bombay State. Loans are given to members on the mortgages of their lands usually upto 30 times the land revenue payable in other states of course, after assessing the value of the lands and scrutinising the legal title of the members, duly taking into account their need and their repaying capacity. The other purposes for which the loans are given are for

(i) fencing of land,
(ii) digging wells,
(iii) construction of wells,
(iv) tubewells,
(v) tanks, etc.,
(vi) redemption of old debts, and
(vii) effective permanent improvement in the productivity of land.

Land Development Banks do not have a uniform pattern. However, the structure can be easily described as Under:

(i) Central Land Development Banks at the top, and
(ii) Primary Land Development Banks at the base.

Central Land Development Banks tend to centralise the working of mortgage banking by issuing bonds and debentures for and on behalf of Primary Land Development Banks and making funds available to them. Primary Land Development Banks constitute the base of long term agricultural credit. However, having regard to the vast demands of development credit, one could only say that LDBs had not made a great dent in this area. Also, the follow up and monitoring aspects of their operation are not that intense, so as to avoid the pitfalls of misapplied loans, wrong end usage and improper credit assessment. Percentage share of different banks in total deposit amount as on 1.3.2000 was 3.7% (UCBs) 4. 1% (Land Dev.), 2.7% (RRBs), and 89.5% (Commercial banks).

1.7.3 Regional Rural Banks (RRBs)

The Regional Rural Bank Act, 1976 was passed by Parliament to promote, regulate with a view to developing the rural economy. It was for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal Farmers, agricultural labourers, artisans and small entrepreneurs and for matters connected therewith and incidental thereto.

The authorised capital of each RRB was ₹ 5 crores, divided into five lakh fully paid Lip shares of ₹ 100 each, provided that the Central Government may, after consultation with the NABARD and sponsoring bank, increase or decrease the authorised capital, but it shall not be reduced to below ₹ 25 lakh. file share of RBB capital is divided as 50% by Central Government, 15% by the concerned State Governments and 35% by the sponsoring bank.

In Jan. 2013 there were 56 RRBs in 23 states with 15,475 branches in the country. The total loan outstanding was ₹ 83,562 crores, and deposits were ₹ 1,42,814 crores at the end of March, 2010. As of now, 30 RRBs had accumulated losses to the extent of ₹ 1,808 crores. There was a need of around ₹ 2,200 crores to bring the CAR of RRBs to 9% by tile year 2011-12.

Business of RRBs

(i) The granting of loans and advances, particularly to small and marginal farmers and agricultural labourers, whether individually or in groups, and to cooperative societies, Including agricultural marketing societies and processing societies, cooperative farming societies, primary agriculture credit societies or farmers' service societies for agricultural purposes or agricultural operations or for other purposes connected therewith.

(ii) The granting of loans and advances, particularly to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities, within the notified area in relation to tile RRBs.

Regulation

Besides the RBI, which is the regulatory authority for the RRBs in accordance with the provisions of Banking Regulation Act, 1949, the Banking Regulation Act empowers NABARD, to undertake the inspection of RRBs. A RRB seeking permission of the RBI for opening branches, etc., has to obtain the recommendation of NABARD.

1.7.4 Local Area Banks (LABs)

In August 1996, the RBI issued guidelines for setting up LABs. The starting of such banks was allowed for promoting rural savings as well as for the provision of credit for viable economic activities in the local areas. To cater to the needs of the local people and to provide efficient and competitive financial intermediation services in areas of operation. It was extending over two or three Contiguous districts as also to tapping retail savings where tile branches of commercial banks are insignificant. The RBI gave approval of setting up Local Area Banks, a total of 4, in Maharashtra, Karnataka, Punjab and Andhra Pradesh States. The guidelines of opening of LABs were as below:

(i) LABs should focus on local Customers and lending to agriculture and allied activities, SSI, agro industrial activities, trading and non farm sector.

(ii) LABs will have overall priority sector lending target of 40% of net bank credit and weaker sector lending norm of 10%.

(iii) The bank is to be registered as public limited company under the Companies Act, 1956 or 2013.

(iv) The minimum paid-up capital is ₹ 5 crore (Raised to ₹ 50 crore by March, 2011) and promoters' contribution of at least ₹ 2 crore.

(v) Promoters may be individuals, corporate trusts or societies.

(vi) The area of operation is in a maximum of three Contiguous districts and the registered office should be situated within the area of operation.

(vii) The voting rights of an individual shareholder is governed by the ceiling of 10% of the total voting rights as per aection 12(2) of B.R. Act, 1949.

(viii) Prudential norms and capital adequacy of 10% of risk weighted assets (8% since beginning in 1996) is to be compiled with.

(ix) Out of local area banks numbering four, bank from Punjab is allowed to become Capital Small Finance Bank Ltd. and started working from April 2016 hence present number is three only.

In view of liberalisation of Indian economy, if the fruits are to percolate down to the teeming millions, inhabiting rural India, it would be necessary to provide them easy and timely access to institutional

finance. The freedom to determine their lending rates is given to LABs, like RRBs by RBI.]'his may promote healthy competition in the nonurban areas, resulting in the resources being Put to more efficient and productive areas. The agricultural sector, in view of its recent turnaround and the forthcoming Favourable impact of the formation of the World Trade Organisation (WTO), is heading towards a major boom. LABs are considered complementary to the efforts of the nationalised banks and RRBs, but at the same time take some pressure off the PSBs in their priority sector credit commitments and promote capital formation and higher investment in rural and semi urban areas.

1.8 Development Banks

Another important feature of the structure and organization of the Indian banking systems is the establishment of many financial corporations, which provide finance to the sectors of the economy, to which commercial and cooperative banks do not provide finance.

Medium and long-term finance is provided by these development banks all India status and by State level institutions in their respective states (such states are 29 in number now). Such India financial institutions are –

IDBI, NABARD, Exim Bank, National Housing Bank.

Other investment institutions are Life Insurance Corpn. of India, GIC, Mutual funds, para-banking institutions such as for hire purchase financing and leasing and factoring are undertakens by private sector's non-banking financial companies (NBFCs). State financial corps., also provide finances in their states. Such SFCs are 18 in number.

1.9 Financial Markets

Indian financial markets are broadly categorised into the Money Market, Foreign Exchange Market, Securities Market (Stock exchanges) including equity/bonds and credit markets.

The capital market has evidenced tremendous growth in the last two and half decades in terms of resource mobilisation, listing of shares, and market capitalization. The market capitalization for listed companies at the end of 26.5.2017 was ₹ 1,25,63,952 crores and the BSE-30 index was 31074 points. Activities in the network of 21 stock exchanges listing over seven thousand companies (only in BSE and NSE stock exchanges in Mumbai) are being regulated by Securities and Exchange Board of India (SEBI). The short-term money market comprises

- Call money market
- Interbank money market
- Bills rediscounting market
- Treasury bills (91 days to 364 days)
- Inter corporate funds market

Discount and Finance House of India Ltd. (DFHIL) is the leader of the money market of money overnight for few days to few months.

1.10 Financial Companies

There investment and finance companies are housing finance, chit funds, Nidhi companies etc. which also mobilize and channel savings into investment. They are only partly controlled by RBI under the Companies Act, 2013. Similarly, moneylenders and indigenous bankers are licensed under the state laws and regulated by State agencies.

1.11 QUESTIONS

(A) *(i)* Describe the classification of Indian financial systems and overview of IFS.

(ii) Discuss the evolution of commercial banking.

(iii) Write about the era of nationalisation of bank and after (1969 to 1991) till economic liberalisation.

(iv) Explain the present banking from the year 2004 to date.

(B) Write short notes in not exceeding 15 lines

(i) State cooperative banks

(ii) Land development banks

(iii) Regional Rural Banks

(iv) Financial Markets

(v) Development Banks

(C) State which of the following statements are true or false ?

(i) The important goal of the financial services is to mobilize and allocate savings.

(ii) Term lending institutions are non-fund based market intermediarier.

(iii) Banking companies earn a major part of their income through fee-based activities.

(iv) A forward contract is a derivative of a spot contract ?

[Answer : *(i)* True, *(ii)* False, *(iii)* False, *(iv)* True]

(D) Fill in the banks

(i) Finance is the study of …………… its nature, creation behaviour administration.

(ii) The organized sector consist of a network of ……….. other financial and investment institutions.

(iii) Banking is ………………… from moneylending but the two terms have in past been taken to convey the same meaning.

(iv) The total number of bank braches increased ………… fold between 1969 and 1991.

(v) District Central Cooperative bank is a ……….. of PACs located in specified area, i.e., district.

[Answer : *(i)* money, *(ii)* banks, *(iii)* different, *(iv)* eight, *(v)* Federation]

(E) Match the following

(i)	RBI reaches to the cultivators	*(a)*	in the life of urban people
(ii)	Urban Cooperative banks play an important role	*(b)*	for development of agriculture, trade, commerce, industry activities in rural area
(iii)	The RRBs were prmoted	*(c)*	rural savings as well as for provision of credit for viable economic activities in the local areas
(iv)	Local Area Banks were started for promoting	*(d)*	development banks
(v)	Medium and long-term finance is provided by	*(e)*	money market, foreign exchange market, securities market
(vi)	Indian financial markets are broadly categorized into the	*(f)*	through state cooperative banks

[Answer : ***(i) (d), (ii) (a), (iii) (b), (iv) (c), (v) (e), (vi) (f)]***