PFRDA

Assistant Manager

Phase - II

Volume - 3

Finance

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1 CHAPTER Financial System

Financial System

The financial system is a structured network of financial institutions, financial markets, financial instruments, and financial services that facilitates the efficient mobilization and allocation of financial resources in an economy. It acts as a crucial intermediary between savers and investors, enabling the flow of funds from surplus units to deficit units. By promoting capital formation, ensuring liquidity, facilitating risk management, and supporting economic growth, a well-developed financial system plays a pivotal role in maintaining financial stability and fostering sustainable development. In India, the Reserve Bank of India serves as the apex regulator, ensuring the soundness and efficiency of the financial system.

Financial Institutions: Structure

1. **Meaning of Financial Institutions:** Financial institutions are organizations that act as intermediaries between savers and borrowers by mobilizing savings and allocating them to productive investments. They form the institutional pillar of the financial system, ensuring smooth flow of funds, financial stability, and economic development.
2. **Structure of Financial Institutions in India:** The Indian financial institutional framework is broadly classified into:
   - ✓ **Regulatory and Apex Institutions:** These institutions regulate, supervise, and ensure stability of the financial system.
     - **Reserve Bank of India (RBI):** The Reserve Bank of India is the apex monetary authority of India, responsible for regulating the banking system and NBFCs, while also acting as the custodian of foreign exchange and the manager of public debt.
     - **Other Regulators**
       - ☞ **SEBI –** Securities and Exchange Board of India regulates capital markets and mutual funds to protect investors and ensure orderly market development.
       - ☞ **IRDAI –** Insurance Regulatory and Development Authority of India oversees the insurance sector to ensure policyholder protection and promote insurance penetration.
       - ☞ **PFRDA –** Pension Fund Regulatory and Development Authority regulates the pension system to ensure secure and sustainable retirement income.
       - ☞ **IFSCA –** International Financial Services Centres Authority regulates financial institutions operating in IFSCs like GIFT City to promote global financial services.
   - ✓ **Banking Institutions**
     - **Commercial Banks:** Financial institutions that accept deposits and provide credit to support trade, industry, and economic activity.
       - ☞ **Public Sector Banks:** Government-owned banks that promote financial inclusion and support priority sector lending.
       - ☞ **Private Sector Banks:** Privately owned banks that offer efficient and technology-driven banking services.
       - ☞ **Foreign Banks:** Banks incorporated outside India that facilitate international trade and cross-border banking services.
       - ☞ **Small Finance Banks:** Banks established to provide basic banking and credit services to underserved and unbanked sections.
       - ☞ **Payments Banks:** Banks focused on deposits and payments services without engaging in credit creation.

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- **Co-operative Banks:** Member-owned financial institutions that provide credit and banking services based on the principle of mutual assistance.
  - **Urban Co-operative Banks (UCBs):** Co-operative banks operating in urban and semi-urban areas to meet the credit needs of small borrowers and businesses.
  - **Rural Co-operatives (SCBs, DCCBs, PACS):** A three-tier structure that provides short-term agricultural credit and supports rural development at state, district, and village levels.
- **Development Financial Institutions (DFIs):** Established to provide long-term finance for infrastructure and industrial development. Examples include:
  - **NABARD:** National Bank for Agriculture and Rural Development provides credit, development, and supervisory support for agriculture and rural development.
  - **SIDBI:** Small Industries Development Bank of India promotes, finances, and develops the MSME sector
  - **EXIM Bank:** Export-Import Bank of India facilitates foreign trade by providing financial assistance and advisory services.
  - **NaBFID:** National Bank for Financing Infrastructure and Development provides long-term finance for infrastructure projects.
- **Non-Banking Financial Companies (NBFCs):** NBFCs supplement banks by providing specialized financial services**.** Types include:
  - **Loan Companies:** NBFCs primarily engaged in providing loans and advances to individuals and businesses.
  - **Investment Companies:** NBFCs that deal in acquisition of securities and capital market investments.
  - **Infrastructure Finance Companies:** NBFCs that provide long-term finance to infrastructure projects such as roads, power, and telecom.
  - **Housing Finance Companies:** NBFCs specializing in providing finance for housing and real estate development.
  - **Microfinance Institutions:** NBFCs that provide small-value loans and financial services to low-income and underserved populations.
- **Insurance Institutions:** Financial institutions that provide risk protection and mobilize long-term savings through insurance products.
  - **Life Insurance Corporation (LIC):** India's largest life insurer providing life insurance coverage and long-term savings instruments.
  - **General Insurance Companies:** Institutions offering non-life insurance products such as health, motor, crop, and property insurance.
- **Pension and Provident Funds:** Institutions that mobilize long-term savings to provide income security after retirement.
  - **EPFO:** Employees' Provident Fund Organisation manages provident fund, pension, and insurance schemes for salaried employees.
  - **NPS (regulated by PFRDA):** National Pension System is a market-linked pension scheme providing retirement savings under PFRDA regulation.

Functions of Financial Institutions

1. Mobilization of Savings

- ✓ Financial institutions collect savings from households, businesses, and government entities.
- ✓ They convert idle savings into productive investments, ensuring efficient use of funds.
- ✓ Example: Banks accept deposits, while insurance companies mobilize long-term savings through premium collections.
- ✓ This process enhances capital formation and supports economic development.

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2. **Allocation of Credit**
   - ✓ Financial institutions channel funds to sectors that need them most, ensuring balanced development.
   - ✓ **Priority sectors include:**
     - **Agriculture:** Credit for farmers and allied activities
     - **MSMEs**: Loans for small and medium enterprises to promote entrepreneurship
     - **Infrastructure:** Long-term finance for roads, power, and telecom
   - ✓ They also help promote regional equity by supporting underdeveloped regions.
3. **Financial Intermediation**
   - ✓ Act as intermediaries between savers and borrowers, reducing the transaction costs of lending and borrowing.
   - ✓ Address information asymmetry by evaluating creditworthiness and mitigating default risks.
   - ✓ Manage maturity and risk transformation by converting short-term deposits into long-term loans or investments.
   - ✓ Example: Banks transform short-term deposits into long-term home or infrastructure loans.
4. **Promotion of Capital Formation**
   - ✓ Provide long-term finance for industrial and infrastructure projects.
   - ✓ Help mobilize domestic savings and channel them into productive investments, increasing the economy's capital stock.
   - ✓ **Example:** Development Financial Institutions (DFIs) like SIDBI or NABARD support MSMEs and agriculture, boosting industrial and rural development.
5. **Risk Management: Financial institutions provide mechanisms to manage various risks:**
   - ✓ Insurance products: Life, health, property, and crop insurance
   - ✓ Credit appraisal and diversification: Reduce the risk of loan defaults
   - ✓ Hedging products: Protect against interest rate or currency fluctuations. During economic shocks, these institutions stabilize the financial system and protect investors.
6. **Support to Monetary Policy Transmission:** Serve as conduits for RBI's monetary policy. Transmission occurs through:
   - ✓ Lending and deposit rate adjustments
   - ✓ Credit supply to different sectors
   - ✓ Example: When RBI changes the repo rate, banks adjust interest rates for loans and deposits, affecting borrowing and spending.
7. **Financial Inclusion:**
   - ✓ Expand access to banking and credit, especially for rural and underbanked populations.
   - ✓ Promote digital payments (UPI, mobile wallets) and microfinance for low-income groups.
   - ✓ Support government initiatives like: PMJDY (Pradhan Mantri Jan Dhan Yojana), DBT (Direct Benefit Transfer)
   - ✓ Encourage savings and participation in the formal financial system.
8. **Economic Growth and Stability**
   - ✓ Maintain liquidity in the financial system to support smooth functioning of markets.
   - ✓ Ensure financial stability by managing systemic risks and supervising institutions.
   - ✓ Prevent crises by monitoring non-performing assets, capital adequacy, and market conduct.
   - ✓ **Example:** RBI's regulation of banks and NBFCs ensures stability and trust in the financial system.

The financial system mobilizes savings, allocates credit, manages risks, and supports economic growth. Through banks, NBFCs, insurance, pension funds, and regulators like the RBI, it ensures financial inclusion, capital formation, stability, and efficient monetary policy transmission, fostering sustainable development and investor confidence.

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2 CHAPTER Reserve Bank of India

Reserve Bank of India

The Reserve Bank of India is the central bank of India and the apex monetary authority responsible for managing the country's financial system. Established under the Reserve Bank of India Act, 1934, the RBI plays a critical role in maintaining monetary and financial stability while supporting economic growth. It controls the supply of money, credit, and currency circulation in the economy, and regulates the banking sector through the formulation and implementation of monetary and lending policies. Acting as the Banker's Bank, the RBI provides liquidity to commercial banks in times of need and oversees the interbank clearing and settlement systems.

Establishment

- **Established:** 1 April 1935
- **Act:** Reserve Bank of India Act, 1934
- **Location:** Initially headquartered in Calcutta in 1935; permanently shifted to Mumbai in 1937 to centralize operations and facilitate better access to the financial hub.
- **Ownership:** Originally privately owned at the time of formation; nationalized in 1949 and is now fully owned by the Government of India, ensuring greater public accountability and alignment with national economic objectives.
- **Recommendation:** The formation of the RBI was recommended by the Hilton-Young Commission (1926–27), which proposed the establishment of a central bank to regulate currency, credit, and banking in India.
- **First Governor: Sir Osborne Smith** served as the inaugural Governor of RBI from 1935 to 1937, laying the foundation for India's central banking operations.
- **Governor at Nationalization: C.D. Deshmukh** was the Governor when RBI was nationalized in 1949, overseeing the transition to government ownership and the expanded role of the bank in India's post-independence economy.

Objectives of RBI

- **Issue and Control Currency:** The RBI is the only institution authorized to issue Indian currency notes (except ₹1, issued by the government). It ensures an adequate supply of cash in all denominations to meet the needs of the public and the economy. The RBI also monitors the quality of notes in circulation, withdrawing unfit or counterfeit currency, thereby maintaining public confidence in the monetary system.
- **Maintain Monetary Stability:** A key objective of the RBI is to maintain monetary stability by controlling inflation, deflation, and liquidity in the economy. Using tools like the repo rate, reverse repo rate, cash reserve ratio (CRR), and bank rate, RBI influences credit flow and interest rates. Effective monetary management ensures economic growth while keeping price levels stable, supporting both businesses and consumers.
- **Regulate and Supervise the Financial System:** RBI regulates banks, NBFCs, and other financial institutions to ensure a sound and stable financial system. It sets rules on capital adequacy, lending practices, risk management, and priority sector lending. By supervising these institutions, RBI reduces systemic risk, prevents financial crises, and protects depositors' interests, strengthening trust in the banking sector.

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- **Act as Banker to Government and Banks:** RBI acts as a banker to the central and state governments, managing their accounts, public debt, and loans. It also serves as a banker to scheduled banks, maintaining their accounts and offering emergency liquidity through the lender-of-last-resort function. This dual role ensures smooth functioning of government finances and financial stability across the banking sector.
- **Promote Economic Growth and Development:** RBI plays a developmental role by promoting economic growth through finance, credit support, and policy initiatives. It supports agriculture, small and medium enterprises, rural development, and infrastructure projects, while promoting financial inclusion and digital banking. These efforts help mobilize savings, expand access to finance, and strengthen the overall economy.

Functions of RBI

RBI functions can be classified under core, developmental, and regulatory roles:

- **Monetary Authority:** Formulates and implements monetary policy to ensure price stability and growth.
    - ✓ **Tools:**
        - **Repo rate**: rate at which banks borrow from RBI
        - **Reverse repo rate**: rate at which banks park excess funds with RBI
        - **Cash Reserve Ratio (CRR)**: percentage of deposits banks must keep with RBI
        - **Bank rate**: long-term lending rate of RBI to banks
    - ✓ **Objectives**: Control inflation, regulate liquidity, stabilize currency
- **Regulator and Supervisor of Financial System:** Ensures financial stability and soundness of banks and NBFCs. Prescribes rules and guidelines for:
    - ✓ Lending and credit norms
    - ✓ Capital adequacy
    - ✓ Risk management
- **Manager of Foreign Exchange:** Implements Foreign Exchange Management Act (FEMA), 1999. It maintains foreign currency reserves (gold and foreign currency) and stabilizes exchange rates and supports international trade.
- **Issuer of Currency:** Sole authority to issue Indian banknotes (except 1 rupee note, issued by government). Withdraws unfit or damaged currency from circulation and ensures adequate supply of currency in all denominations.
- **Development Role:** Promotes economic growth through institutional support and finance. Supports sectors like, Agriculture, MSMEs, Infrastructure and rural and semi-urban development. It also encourages financial inclusion, digital banking, and microfinance.
- **Banker to Government:** It acts as principal banker to central and state governments. Functions include:
    - ✓ Managing government accounts
    - ✓ Issuing loans to governments
    - ✓ Managing public debt and securities
- **Banker to Banks:** It maintains accounts of all scheduled banks and provides lender-of-last-resort facility during liquidity crises. It also facilitates clearing and settlement of interbank transactions.
- **Other Functions**
    - ✓ **Research and Statistics:** Publishes economic and financial data, reports on monetary policy, inflation, credit, etc.
    - ✓ **Regulation of Payment Systems:** Supervises RTGS, NEFT, UPI, and digital payments infrastructure.

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Central Board of Directors

The Central Board of Directors is the apex governing body of the Reserve Bank of India, established under the RBI Act, 1934. It provides overall guidance, strategic direction, and oversight of the bank's functions, including monetary policy, banking regulation, and financial stability.

- **Appointment and Tenure:**
  - Members are appointed or nominated by the Government of India
  - Tenure of board members is generally four years
  - The board ensures a mix of government, RBI, and sectoral representation to balance public policy and financial expertise.
- **Structure of the Board:**
  - **Governor:** Acts as the **chief executive of RBI**. Responsible for executing policies and decisions of the board. Chairs meetings and provides leadership across monetary, banking, and financial regulation.
  - **Deputy Governors (Maximum 4):** Head key functional areas such as Monetary Policy, Banking Regulation, Financial Markets, Risk Management, etc. Support the Governor in decision-making and execution of policies.
  - **Official Directors:** Representatives of the Government of India and senior RBI officials. Provide inputs on policy, administration, and statutory compliance.
  - **Nominee Directors:** Represent banking, finance, and industry sectors. Bring specialized sectoral expertise and industry perspectives to board deliberations.
- **Functions of the Central Board:**
  - Formulation of monetary and credit policy.
  - Regulation and supervision of banking and financial institutions.
  - Approval of budget, annual accounts, and dividend policies.
  - Oversight of RBI operations, including currency management, foreign exchange reserves, and government borrowing programs.
  - Advising the Government of India on economic and financial matters.

Current Key Members (as an example, subject to change):

- **Governor:** Dr. Shaktikanta Das
- **Deputy Governors:** Shri T. Rabi Sankar, Shri Swaminathan, Dr. Poonam Gupta, and Shri Shirish Chnadra Murmu.

Subsidiaries of RBI

- **Deposit Insurance and Credit Guarantee Corporation (DICGC)**
  - **Purpose:** Provides insurance protection to bank deposits, promoting confidence among depositors.
  - **Deposit Coverage:** Insures deposits up to a specified limit per depositor per bank (currently ₹5 lakh).
  - **Functionality:**
    - Safeguards savings and term deposits in commercial banks, cooperative banks, and certain financial institutions
    - In case of bank failure, DICGC reimburses depositors within the insured limit.
    - Promotes financial stability by preventing bank runs.
  - **Additional Role:** Provides credit guarantee schemes to facilitate lending to priority sectors.
- **Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)**
  - **Purpose:** Responsible for printing Indian currency notes under the authorization of the RBI.
  - **Operations:**
    - Maintains high-quality standards in currency note design, security features, and production.\
    - Works with specialized presses to produce banknotes in various denominations.
  - **Significance:** Ensures adequate supply of authentic currency to meet the economy's demand.
  - **Ownership:** Wholly owned subsidiary of RBI, functioning under its strategic direction and policies.

Key Rates Managed by RBI

Rate	Purpose / Function	Explanation
Repo Rate	Lending rate for banks from RBI (short-term liquidity)	The rate at which commercial banks borrow funds from the RBI for short-term needs by selling government securities with an agreement to repurchase them. It is a key monetary policy tool used to control liquidity, inflation, and credit flow in the economy. An increase in repo rate makes borrowing costlier, reducing liquidity, while a decrease encourages lending and investment.
Reverse Repo Rate	Banks park excess funds with RBI	The reverse repo rate is the rate at which commercial banks deposit their surplus funds with the RBI. It helps the RBI absorb excess liquidity from the banking system and stabilize short-term interest rates. A higher reverse repo rate incentivizes banks to park more funds with RBI, reducing money supply.
Bank Rate	Long-term lending rate of RBI to banks	The bank rate is the rate at which the RBI lends to commercial banks without collateral for long-term credit needs. It serves as a signal for long-term interest rate trends in the economy and influences lending and borrowing rates across the financial system.
Cash Reserve Ratio (CRR)	% of bank deposits to be kept with RBI	CRR is the proportion of a commercial bank's net demand and time liabilities (NDTL) that must be maintained with the RBI in cash. It is a key tool to control money supply and liquidity. A higher CRR reduces funds available for lending, while a lower CRR increases liquidity in the economy.
Statutory Liquidity Ratio (SLR)	% of bank deposits invested in approved government securities	SLR is the minimum percentage of a commercial bank's NDTL that must be maintained in approved liquid assets, mainly government securities, gold, or approved bonds. SLR ensures financial discipline among banks, promotes government borrowing, and indirectly influences credit availability.

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Important Facts about RBI

- **Emblem:** The Reserve Bank of India emblem features a panther and a palm tree, symbolizing strength, agility, and stability in financial operations.
- **First Woman Deputy Governor:** K.J. Udeshi became the first woman Deputy Governor of RBI, marking a significant milestone in gender representation in India's central banking system.
- **Deposits:** RBI does not accept deposits from the general public. It primarily deals with commercial banks, state and central governments, and other financial institutions.
- **Issuance of Currency:** RBI is the sole issuer of banknotes in India, managing currency circulation and ensuring the authenticity and adequacy of supply. It plays a critical role in maintaining monetary stability through currency management.
- **Functions Beyond Monetary Policy:**
  - ✓ RBI promotes economic growth by supporting financial inclusion, development of banking infrastructure, and credit accessibility to priority sectors.
  - ✓ Conducts regulatory and supervisory roles to ensure financial stability, protect depositor interests, and facilitate the smooth functioning of payment and settlement systems.

- **Significance:**
  - ✓ Acts as the lender of last resort to banks.
  - ✓ Controls inflation and liquidity through monetary policy tools.
  - ✓ Serves as an advisor to the government on financial and economic matters, supporting sustainable economic development.

The RBI, India's central bank, ensures monetary and financial stability while supporting economic growth. It regulates banks, manages currency and credit, oversees foreign exchange, and acts as banker to the government and banks. Using tools like repo rate, CRR, and SLR, it controls liquidity, inflation, and credit flow. Through subsidiaries like DICGC and BRBNMPL, it safeguards deposits and ensures currency supply. Beyond regulation, RBI promotes financial inclusion, development of priority sectors, and digital banking. In short, the RBI is the guardian of India's financial system and a key driver of sustainable economic growth.

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3
CHAPTER

Banking Acts in India

Banking Acts in India

Banking Acts refer to the set of legislative frameworks enacted by the Indian Parliament to regulate, supervise, and govern the functioning of banks and financial institutions in India. These laws provide the legal foundation for the operations of banks, the protection of depositors' interests, and the smooth functioning of the financial system. They also empower the RBI and other regulators to maintain monetary stability, control credit, and oversee banking practices.

The major banking-related acts in India include:

- **The Reserve Bank of India Act, 1934:** This Act establishes the Reserve Bank of India as the central bank and defines its powers, functions, and responsibilities, including the issuance of currency, regulation of credit, and control of monetary policy. It also outlines the governance structure, capital requirements, and regulatory mechanisms for RBI.
- **The Banking Regulation Act, 1949:** This Act provides a comprehensive framework for the licensing, operations, management, and supervision of commercial banks in India. It lays down the legal obligations of banking companies regarding reserves, liquidity, statutory compliance, and restrictions on trading. It also empowers RBI to regulate and intervene in bank operations to protect the stability of the financial system.
- **The Negotiable Instruments Act, 1881:** This Act governs the law related to negotiable instruments such as promissory notes, bills of exchange, and cheques. It defines key concepts, prescribes the rights and duties of parties, and provides remedies in case of dishonour or default. It also plays a critical role in ensuring trust and reliability in financial transactions.

Reserve Bank of India Act, 1934

- **Capital and Governance**
  - ✓ **Section 4:** The Reserve Bank of India (RBI) is authorized to have a capital of ₹5 crores.
  - ✓ **Section 7:** The Central Government can issue directions to RBI in the public interest, after consulting the Governor.
  - ✓ **Section 8:** Defines the composition of the Central Board of Directors of RBI.
- **Functions and Powers**
  - ✓ **Section 17:** Specifies the types of business the RBI is allowed to undertake.
  - ✓ **Section 21:** RBI has the right to conduct government business in India.
  - ✓ **Section 21A:** RBI can transact state government business under a formal agreement.
  - ✓ **Section 22:** Grants RBI the exclusive right to issue banknotes.
  - ✓ **Section 24:** Defines denominations of notes, up to ₹10,000.
  - ✓ **Section 26(1):** Defines what constitutes a legal tender.
  - ✓ **Section 26(2):** Provisions for the withdrawal of legal tender notes.
- **Regulatory and Supervisory Function**
  - ✓ **Section 42:** Scheduled banks must maintain cash reserves with RBI (Cash Reserve Ratio or CRR).
  - ✓ **Section 45E:** RBI can prohibit disclosure of certain information.
  - ✓ **Section 45ZB:** Constitution of the Monetary Policy Committee (MPC).

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- ✓ **Section 45U:** Defines key financial instruments, including repo, reverse repo, derivatives, money market instruments, and securities.
- ✓ **Section 49:** RBI must publish the bank rate, the standard rate at which it will buy or re-discount eligible bills of exchange or commercial papers.
- ✓ **Section 58G:** RBI has the authority to impose fines on banks for violations.

- **Schedules**
  - ✓ **First Schedule:** Divides Indian states into four regions, Western, Eastern, Northern, and Southern.
  - ✓ **Second Schedule:** Lists all Scheduled Banks in India.

Banking Regulation Act, 1949

- **Banking Operations and Restrictions**
  - ✓ **Section 6:** Specifies the forms of business banking companies can engage in.
  - ✓ **Section 7:** Regulates the use of the terms "bank," "banker," "banking," or "banking company."
  - ✓ **Section 8:** Prohibits trading activities by banks.
- **Regulatory Requirements**
  - ✓ **Section 18:** Non-scheduled banks must maintain a cash reserve (CRR).
  - ✓ **Section 22:** Licensing requirements for banking companies.
  - ✓ **Section 24:** Banks must maintain a Statutory Liquidity Ratio (SLR), a specified percentage of net demand and time liabilities in approved forms
  - ✓ **Section 35A:** RBI's power to issue directions to banks.
  - ✓ **Section 36ACA:** RBI can supersede a bank's board of directors in certain situations.

Negotiable Instruments Act, 1881

- **Definitions**
  - ✓ **Section 4: Promissory Note:** A written instrument containing an unconditional promise by the maker to pay a fixed sum to a person or bearer.
  - ✓ **Section 5: Bill of Exchange:** A written instrument containing an unconditional order directing a person to pay a specified sum to another person or bearer.
  - ✓ **Section 6: Cheque:** A bill of exchange drawn on a specified banker, payable on demand.
    - **6(a):** Defines cheque in electronic form.
    - **6(b):** Defines truncated cheque.
- **Parties to Instruments**
  - ✓ **Section 7:** Defines drawer (maker of the cheque or bill) and drawee (person directed to pay).
  - ✓ **Section 13:** A negotiable instrument is payable either to order or to bearer.
- **Payment and Maturity**
  - ✓ **Section 18:** If figures and words differ, the amount in words prevails.
  - ✓ **Section 25:** If maturity falls on a holiday, the instrument is payable on the preceding business day.
  - ✓ **Section 138:** Deals with dishonour of cheques due to insufficient funds.
- **Bank Holidays**
  - ✓ Declared by Central or State Governments and Union Territories under the NI Act.

Importance of Banking Acts

- **Protection of Depositors' Interests:**
  - ✓ Safeguards the money deposited by individuals and businesses in banks.
  - ✓ Instills public confidence in the banking system by ensuring security of deposits.
  - ✓ Reduces the risk of bank failures or mismanagement affecting depositors.
- **Ensuring Financial Stability:**
  - ✓ Provides a framework for the regulation and supervision of banks.
  - ✓ Maintains stability in the financial system by monitoring credit, liquidity, and risk exposure.
  - ✓ Prevents systemic risks that can arise due to mismanagement or fraudulent practices.

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- **Regulation of Banking Operations:**
  - ✓ Standardizes operations across all banks, including capital adequacy, liquidity, and lending practices.
  - ✓ Sets limits on risk-taking activities and non-banking investments of banks.
  - ✓ Empowers regulators like RBI to issue directions to ensure sound banking practices.
- **Facilitating Smooth Payment and Settlement Systems:**
  - ✓ Legal backing for the issuance of currency and negotiable instruments.
  - ✓ Ensures reliable systems for electronic and paper-based payments.
  - ✓ Streamlines interbank transactions and government business operations.
- **Provision of Legal Recourse:**
  - ✓ Provides clear mechanisms for resolving disputes involving banks, customers, or third parties.
  - ✓ Defines penalties and legal remedies for dishonoured cheques, fraud, or defaults.
  - ✓ Ensures enforceability of contracts and trust in financial transactions.
- **Promotion of Innovation and Modern Practices:**
  - ✓ Allows regulated introduction of new products, services, and technologies in banking.
  - ✓ Provides legal space for initiatives such as digital payments, FinTech collaborations, and regulatory sandboxes.
  - ✓ Encourages efficiency, transparency, and customer-centric services while mitigating risks.
- **Ensuring Compliance with Statutory Requirements:**
  - ✓ Mandates banks to maintain statutory reserves like CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio).
  - ✓ Requires adherence to anti-money laundering (AML), counter-terrorism financing (CFT), and KYC norms.
  - ✓ Helps maintain ethical and legal standards in banking operations.
- **Supervision of Governance and Management:**
  - ✓ Provides RBI with powers to oversee board composition, managerial appointments, and corporate governance of banks.
  - ✓ Ensures competent leadership and professional conduct in banking operations.
  - ✓ Allows corrective action like supersession of boards in cases of mismanagement.
- **Encouraging Financial Inclusion:**
  - ✓ Supports policies for expanding banking services to underserved areas and populations.
  - ✓ Promotes schemes like Jan Dhan Yojana and digital banking initiatives.
  - ✓ Ensures access to affordable financial services for all segments of society.
- **Enabling Economic Growth:**
  - ✓ By regulating credit flow and banking stability, Banking Acts facilitate investments and lending for businesses and individuals.
  - ✓ Supports the development of sectors like MSMEs, agriculture, housing, and infrastructure.
  - ✓ Enhances overall confidence in the economy and strengthens capital markets.

Banking Acts ensure the stability, security, and efficiency of the banking system by protecting depositors, regulating banks, enabling innovations, and supporting smooth financial operations, thereby fostering public confidence and economic growth.

4 CHAPTER Recent Developments in the Banking Sector

Recent Developments in the Banking Sector

The banking sector is rapidly evolving, driven by digital innovation, fintech integration, and changing customer expectations. Advances in technology, along with updated regulations, are reshaping traditional banking, improving efficiency, and creating new opportunities and challenges for financial institutions.

Nationalisation And Development Of Banking In India

The growth of the banking sector in India is deeply connected with the process of nationalisation. After Independence, banking was largely in private hands and primarily served commercial and industrial interests. Over time, the Government of India intervened to transform banking into an instrument of socio-economic development. The turning point began with the nationalisation of the RBI in 1949. With the central bank under government ownership, the state gained authority to regulate credit and align banking with planned economic development.

- **Reasons For Nationalisation Of Banks:** Before nationalisation, private banks operated mainly for profit and catered to urban elites. The government identified several structural problems:
  - **Limited Outreach:** Banking services were concentrated in metropolitan and commercial centres. Rural populations, small farmers, artisans, and weaker sections had little access to institutional credit.
  - **Need for Social Control of Resources:** Savings mobilised from the public were not necessarily channelled into sectors crucial for national development. The government wanted to ensure that credit flowed to agriculture, small-scale industries, and priority sectors.
  - **Support for Planned Economic Development:** India adopted a planned economic framework. Effective implementation of Five-Year Plans required state control over capital formation and allocation.
  - **Reduction of Economic Inequality:** There was a need to prevent concentration of financial power in a few industrial houses and ensure equitable growth.
- **Phases Of Bank Nationalisation:** Bank nationalisation in India occurred in stages.
  - **Establishment of the State Bank of India (1955):** The first step towards public sector banking was the creation of the **State Bank of India**. Through the State Bank of India Act, 1955, the government partially nationalised the **Imperial Bank of India**, which had 466 branches and operated mainly in the three Presidency towns.
    - The RBI acquired 92% of its shares.
    - It became India's first major public sector commercial bank.
    - Its objective was to expand banking into rural and semi-urban areas.
  - **Creation of SBI Associate Banks (1959):** Under the SBI (Subsidiary Banks) Act, 1959:
    - Eight former princely state banks were brought under SBI as associate banks.
    - RBI acquired 92% shareholding in these banks as well.
    - Later, the State Bank of Bikaner and the State Bank of Jaipur were merged to form the State Bank of Bikaner and Jaipur.
    - The SBI Group eventually consisted of SBI and five associate banks.

- ✓ **First Major Nationalisation (1969):** The landmark phase came under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969. Key Features:
  - 14 major private banks were nationalised in July 1969.
  - These banks had deposits exceeding ₹50 crore.
  - The objective was to prevent concentration of economic power and promote social banking.
  - **Impact:**
    - ☞ Massive branch expansion in rural areas.
    - ☞ Emphasis on priority sector lending.
    - ☞ Promotion of agricultural and small-scale industrial credit.
- ✓ **Second Phase of Nationalisation (1980):** Under the **Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980**:
  - 6 additional private banks were nationalised in April 1980.
  - These banks had deposits exceeding ₹200 crore.
  - With this, the government controlled the majority of India's banking business.
- ✓ **Reduction in Number of Nationalised Banks:** In September 1993, the loss-making New Bank of India was merged with Punjab National Bank. The total number of nationalised banks was reduced from 20 to 19.

Regional Rural Banks

Regional Rural Banks (RRBs) were established to strengthen the rural credit delivery system and promote financial inclusion in India's underserved areas. They were designed to combine the local familiarity of cooperative banks with the professional structure of commercial banks.

- ➢ **Background And Rationale:** After bank nationalisation, although branch expansion increased, rural credit remained inadequate. A large section of rural households, especially small and marginal farmers, landless labourers, artisans, and small entrepreneurs, continued to depend on informal moneylenders charging high interest rates. To address this gap, the Government of India decided to establish specialised banks exclusively focused on rural and semi-urban areas.
- ➢ **Concept And Establishment:** The idea of RRBs was conceptualised in 1975 on the recommendation of the Narasimham Committee. The first RRB was established on 2 October 1975 was, Prathama Grameen Bank.
  - ✓ RRBs are governed by the Regional Rural Banks Act, 1976.
  - ✓ They are jointly owned by the Central Government, State Government, and a sponsoring public sector bank.
  - ✓ They function under the regulatory supervision of the RBI, while operational control is largely exercised by NABARD.
- ➢ **Objectives Of RRBs:** RRBs were created with a clear developmental mandate.
  - ✓ **Institutional Credit to Weaker Sections:** RRBs provide affordable institutional credit to small and marginal farmers, agricultural labourers, rural artisans, self-employed individuals, and small entrepreneurs to support their livelihoods and economic activities.
  - ✓ **Reduce Dependence on Moneylenders:** They offer loans at reasonable interest rates to protect rural borrowers from exploitation by informal moneylenders.
  - ✓ **Mobilise Rural Savings:** RRBs encourage rural households to develop saving habits and channel these savings into productive and income-generating activities.
  - ✓ **Promote Rural Development:** They finance agriculture and allied sectors, support cottage and village industries, encourage rural self-employment, and strengthen micro-enterprises to boost overall rural development.
  - ✓ **Advance Financial Inclusion:** RRBs promote financial inclusion by opening basic savings accounts, issuing Kisan Credit Cards (KCC), and expanding digital banking services in rural areas.

- **Special Features Of RRBs**
  - **Local Orientation:** RRBs operate within a limited & clearly defined area, usually covering a few districts of a state. This enables them to develop a deep understanding of local economic conditions, agricultural patterns, rural occupations, and credit needs. Their staff members are often recruited locally and are familiar with regional languages, which helps in better customer service, improved credit assessment, and stronger borrower relationships.
  - **Hybrid Character:** RRBs possess a unique hybrid structure that combines the strengths of cooperative banks and commercial banks. Like cooperative banks, they maintain close contact with the local population and understand grassroots-level issues. At the same time, they follow the professional banking practices, regulatory framework, and managerial efficiency of commercial banks.
  - **Target-Oriented Lending:** A substantial portion of RRB lending is directed towards priority sectors such as agriculture, micro and small enterprises, and other weaker sections of society. Their credit policies are aligned with national development goals, ensuring focused financial support to sectors that contribute to rural employment, income generation, and economic upliftment.
  - **Low-Cost Banking:** RRBs are designed to function with relatively lower operational costs compared to large commercial banks. Their simplified procedures, smaller branch networks in rural areas, and focus on basic banking services help minimize administrative expenses. This cost efficiency enables them to offer affordable banking and credit services to rural customers, making financial services accessible to economically weaker sections.
- **Shareholding Pattern:** The capital structure of RRBs reflects cooperative federalism:
  - Government of India – 50%, Concerned State Government – 15% and Sponsoring Public Sector Bank – 35%.
  - The sponsoring bank provides managerial support, technical assistance and financial guidance.
- **Area Of Operation**
  - **Geographically Limited Operations:** Regional Rural Banks operate only in notified districts within a particular state, rather than across the entire country. Each RRB is assigned specific districts for its operations, which allows them to concentrate their resources, policies, and services in a defined area. This limitation ensures that the bank can focus on the development of that particular region rather than spreading its efforts too thinly.
  - **Focused Rural Development**: By restricting operations to selected districts, RRBs can adopt a development-oriented approach tailored to local conditions. They are better able to identify priority sectors, such as small and marginal farmers, rural artisans, and micro-enterprises, and channel credit effectively toward these groups. This targeted focus promotes inclusive growth and strengthens the local economy.
  - **Deep Understanding of Local Needs:** Operating in a limited geographical area allows RRBs to gain an in-depth knowledge of the socio-economic conditions, agricultural patterns, and occupational structures of the community. This local expertise helps in designing suitable loan products, offering advisory services, and implementing welfare schemes more effectively.
  - **Improved Monitoring and Recovery:** A smaller operational area enables RRB staff to closely monitor borrowers' activities and repayment behavior. This proximity reduces default risks, enhances recovery rates, and ensures that credit is utilized productively.
  - **Stronger Community Connection:** Being embedded within specific districts helps RRBs build trust and stronger relationships with the local population. The familiarity of staff with local language, customs, and challenges fosters better communication, enhances customer satisfaction, and encourages rural people to adopt formal banking channels over informal lenders.

Financial Sector Reforms (Post-1991)

- **Background:** Economic reforms initiated in 1991 reduced the role of the state and encouraged greater private sector participation in the economy. In this new liberalised environment, the banking system required restructuring to improve operational efficiency, enhance competitiveness, align with international standards, and effectively support the needs of a market-oriented economy.
- **Narasimham Committee I (Committee on Financial System):** A high-level Committee on Financial System was set up on 14 August 1991 under the chairmanship of M. Narasimham. The committee's guiding principle was that bank funds primarily belong to depositors and must therefore be used prudently, efficiently, and responsibly. Based on this principle, it emphasized that the government should not misuse banks as instruments for financing fiscal deficits. Instead, banks should function on sound commercial principles, focusing on profitability, efficiency, financial discipline & professional management while maintaining prudential norms & accountability. Major Recommendations Of The Committee involved:
  - ✓ **Directed Investment Reforms:** The committee recommended reducing the Cash Reserve Ratio and gradually bringing down the Statutory Liquidity Ratio to 25% to release more funds for productive lending. It suggested that Open Market Operations should become the primary monetary policy tool instead of relying heavily on CRR. Government borrowing should be market-based rather than through compulsory bank investments.
  - ✓ **Directed Credit Programme (Priority Sector Lending):** The committee proposed a gradual phasing out of excessive directed credit programmes. It recommended redefining the priority sector to focus mainly on weaker sections of society and suggested limiting priority sector lending to 10% of total bank credit.
  - ✓ **Interest Rate Structure:** Interest rates should be deregulated & determined by market forces instead of being administered by authorities. The committee recommended removing the complex administered interest rate structure. The Bank Rate should function as the anchor rate for the system, with the RBI regulating and simplifying the overall interest rate framework to ensure transparency and efficiency
  - ✓ **Structural Reorganisation of Banks:** The committee suggested reducing the number of Public Sector Banks through mergers to create stronger and more competitive institutions. It recommended ending the dual control of the RBI and the Ministry of Finance, granting greater operational autonomy to public sector banks, and ensuring professional appointments to top management positions.
  - ✓ **Asset Reconstruction Mechanism:** To address the problem of rising Non-Performing Assets, the committee proposed setting up Asset Reconstruction Companies. It recommended introducing prudential norms, income recognition standards, and capital adequacy requirements in line with international banking standards.
- **Outcomes Of Financial Reforms:** Following reforms were implemented:
  - ✓ **Entry of New Private Sector Banks (1993 onwards):** New private sector banks were allowed to enter the banking industry, increasing competition and efficiency. Banks such as HDFC Bank, ICICI Bank, and Axis Bank emerged. Their entry introduced better customer service, improved technology adoption, innovative financial products, and enhanced operational efficiency, thereby modernising the banking landscape.
  - ✓ **Introduction of Capital Adequacy Ratio (CAR):** Banks were required to maintain a minimum CAR to ensure financial stability and protect depositors' interests. This reform aligned Indian banks with international standards such as the Basel norms, strengthening their ability to absorb losses and reducing the risk of bank failures.

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- ✓ **Prudential Norms for Income Recognition and Asset Classification:** Prudential norms were introduced for proper income recognition, asset classification, and provisioning for bad loans. Banks were required to classify assets as standard or non-performing based on clear guidelines. This improved transparency, ensured realistic reporting of profits, and addressed the growing issue of Non-Performing Assets (NPAs).
- ✓ **Strengthened Supervision by RBI:** The supervisory role of the RBI was significantly strengthened as it introduced stricter inspection systems, monitoring mechanisms, and regulatory controls to ensure compliance with prudential norms, maintain financial discipline, and safeguard systemic stability.
- ✓ **Gradual Deregulation of Interest Rates:** The administered interest rate structure was gradually dismantled, allowing interest rates to be determined by market forces. This reform enhanced competition among banks, improved resource allocation, and made the financial system more responsive to economic conditions.

Overall Impact Of Nationalisation And Reforms

The nationalisation of banks followed by financial sector reforms has had a profound and lasting impact on the Indian banking system. While nationalisation focused on social objectives and inclusive growth, post-1991 reforms aimed at efficiency, competitiveness, and financial stability.

Achievements

- ➢ **Rapid Expansion of Banking Network:** Bank nationalisation led to a massive expansion of bank branches, especially in rural and semi-urban areas. Banking services, which were once concentrated in urban centres, became accessible across the country. This geographical spread significantly increased deposit mobilisation and brought formal banking closer to the common people.
- ➢ **Financial Inclusion of Rural and Weaker Sections:** Nationalisation ensured that credit was extended to priority sectors such as agriculture, small industries, and weaker sections of society. Rural households, small farmers, artisans, and economically disadvantaged groups gained access to institutional finance, reducing dependence on moneylenders and promoting social equity.
- ➢ **Growth of Agricultural and Small-Scale Credit:** There was a substantial rise in lending to agriculture and small-scale industries. Priority Sector Lending (PSL) norms ensured directed credit to productive sectors, contributing to rural development, employment generation, and balanced regional growth.
- ➢ **Modernisation of Banking Post-1991:** Economic reforms brought technological advancement, competition, and improved regulatory standards. Introduction of prudential norms, capital adequacy requirements, private sector participation, and digital banking transformed the sector into a more efficient and globally aligned system.

Challenges

- ➢ **Political Interference in Lending:** Public Sector Banks (PSBs) sometimes faced political pressure in loan sanctioning and credit policies. Directed lending and loan waivers affected financial discipline and weakened credit culture.
- ➢ **Rise in Non-Performing Assets (NPAs):** Excessive or poorly monitored lending, especially under directed credit programmes, led to a significant rise in NPAs. This affected profitability, capital adequacy, and overall financial health of banks.
- ➢ **Efficiency Issues in Public Sector Banks:** Despite reforms, many PSBs continued to face issues related to operational inefficiency, overstaffing, slower decision-making, and lower competitiveness compared to private sector banks.

Banking Sector Reforms In India

- **Second Generation Banking Reforms:** After initiating financial sector reforms in 1992–93 based on the recommendations of the first Narasimham Committee (1991), the Government of India undertook a further review of the banking system. In December 1997, a new committee under the chairmanship of M. Narasimham was constituted. Popularly known as Narasimham Committee–II, its mandate was: To review the progress of earlier reforms and recommend measures to strengthen the Indian banking system and make it globally competitive. The Committee submitted its report in April 1998.
- **Major Recommendations Of Narasimham Committee-II (1998)**
  - ✓ **Strengthening the Structure of the Banking System**
    - **Consolidation through Mergers:** The committee recommended consolidation of the banking sector by merging strong Public Sector Banks. with Development Financial Institutions (DFIs/AIFIs) to create larger and financially stronger entities. Weak and unviable banks should be closed or restructured to improve overall system efficiency. The main objective was to build large, well-capitalised banks capable of competing at the global level, supporting large-scale financing needs, and enhancing financial stability.
    - **Three-Tier Banking Structure:** The committee proposed a structured three-tier banking system. Tier I would consist of 2–3 large banks with significant international presence. Tier II would include 8–10 banks operating nationwide with a strong domestic reach. Tier III would comprise numerous local and regional banks catering to specific areas and community needs. Tier I and Tier II banks were expected to focus on corporate banking and large-scale financing, while Tier III banks would serve local and regional markets.
  - ✓ **Capital Adequacy Norms**
    - Capital to Risk Weighted Assets Ratio should be raised to 10%.
    - Banks must strengthen their capital base to absorb risks.
    - Budgetary recapitalisation of PSBs should be phased out as it burdens the government.
  - ✓ **Legal Framework for Loan Recovery**
    - Strengthen recovery laws.
    - Speed up enforcement of securities.
    - This led to enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act).
  - ✓ **Reduction of Non-Performing Assets (NPAs)**
    - Net NPAs to be reduced below 5% by 2000.
    - Further reduction to 3% by 2002.
  - ✓ **Operational Reforms**
    - Rationalisation of bank branches and workforce.
    - Continued licensing of new private banks (domestic and foreign).
    - Depoliticisation of bank boards.
    - Creation of a Board for Financial Regulation and Supervision (BFRS).
- **Differential Rate Of Interest Scheme:** Launched in April 1972. **Key Features:**
  - ✓ Public sector banks must lend 1% of total advances (previous year) to the poorest.
  - ✓ Concessional interest rate of 4% per annum.
  - ✓ Target: "Poorest of the poor" who lack access to formal credit.
- **Non-Performing Assets:** An NPA is a loan where:
  - ✓ Interest or principal remains overdue for more than 90 days.
  - ✓ Known as the “90-day overdue norm” (adopted in 2004 to align with international standards).
  - ✓ For agricultural loans, norms depend on crop cycles.

- ✓ **Classification of NPA**
  - **Sub-standard Assets –** NPA up to 12 months.
  - **Doubtful Assets –** NPA beyond 12 months
  - **Loss Assets –** Identified as uncollectible but not yet written off.
- ✓ **Rising NPAs and Twin Balance Sheet (TBS) Problem:** India faced a "Twin Balance Sheet" problem:
  - Stressed corporate sector
  - Stressed banking sector
  - **Major Causes:**
    - ☞ **System-based identification of bad loans:** Improved asset quality reviews and stricter recognition norms led to the transparent identification of stressed assets. Loans that were earlier restructured or evergreened were officially classified as NPAs, revealing the true extent of banking stress.
    - ☞ **Economic slowdown:** A slowdown in economic growth reduced corporate revenues and cash flows, making it difficult for companies to service their debt. Sectors like infrastructure, steel, power, and construction were particularly affected.
    - ☞ **High interest rates:** Relatively high borrowing costs increased the debt servicing burden on companies, especially those with large leveraged positions, contributing to loan defaults.
    - ☞ **Aggressive lending during boom years:** During the high-growth period (mid-2000s), banks expanded credit rapidly, particularly to infrastructure and core industries. Over-optimistic growth projections and easy credit led to excessive borrowing and over-leveraging by corporates.
    - ☞ **Weak project appraisal:** Inadequate risk assessment, poor due diligence, delays in project clearances, cost overruns, and governance lapses weakened project viability. This resulted in stalled projects and mounting bad loans.
  - **RBI Measures For NPA Resolution**
    - ☞ **Special Mention Accounts (SMAs):** SMAs were introduced for early identification of financial stress in loan accounts before they turn into NPAs, enabling timely corrective action by banks.
    - ☞ **5/25 Refinancing Scheme:** This scheme allowed infrastructure and core industry loans to have a repayment tenure of up to 25 years, with interest rates reset every 5 years, but it was later criticized for enabling "evergreening" of stressed loans.
    - ☞ **Asset Reconstruction Companies (ARCs):** Established under the SARFAESI Act, ARCs purchase NPAs from banks to help clean bank balance sheets, though later regulations required higher upfront cash payments to improve accountability.
    - ☞ **Strategic Debt Restructuring (SDR) – 2015:** SDR allowed banks to convert outstanding debt into at least 51% equity and change management control, but it achieved limited success due to poor project viability.
    - ☞ **Asset Quality Review (AQR):** The AQR exercise ensured transparent classification of bad loans and compelled banks to recognize previously hidden NPAs, strengthening financial disclosure standards.
    - ☞ **S4A Scheme (2016):** Under the S4A scheme, the sustainable portion of debt remained as regular debt while the unsustainable portion was converted into equity or preference shares, without changing ownership.
    - ☞ **Public Sector Asset Rehabilitation Agency (PARA):** Proposed in the Economic Survey 2016–17, in the context of the Twin Balance Sheet problem. The primary purpose was to handle large and complex stressed loans, particularly those involving multiple lenders and high-value infrastructure or core sector projects. By taking over major non-performing assets from banks, PARA aimed to clean up bank balance sheets, restore credit flow to the economy, and strengthen overall financial stability.