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~~NATIONAL SCHOOL OF BANKING~~

(1) BANKING - HISTORY AND CONCEPT

The word 'bank' was borrowed in Middle English from Middle French 'banque', Old Italian 'banca', Old High German 'banc', bank "bench, counter". Benches were used as desks or exchange counters during the Renaissance by Florentine bankers, who used to make their transactions atop desks covered by green tablecloths. The "Banca" became Bank over a period of time.

Banking in the modern sense, can be traced to medieval and early Renaissance Italy, to the rich cities in the north like Florence, Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14th century Florence, establishing branches in other parts of Europe. The most famous Italian bank was the Medici bank, set up by Giovanni Medici in 1397 at Genoa, Italy. **The oldest bank still in existence is Monte dei Paschi di Siena, headquartered in Siena, Italy, which has been operating continuously since 1472.**

Because of the important role Banks/depository institutions play in the [redacted] system, the banking industry is generally regulated with government controls on financial activities undertaken. In some countries, such as Germany, banks have historically owned major stakes in industrial companies, while in other countries, such as the United States, banks have traditionally been prohibited from owning non-financial companies. In Japan, banks are usually the nexus of a cross-share holding entity known as the "keiretsu". In Iceland, banks followed international standards of regulation prior to the recent global financial crisis that began in 2008. A Bank's main source of income is interest. A bank pays lower interest rate on deposits and charges higher interest rate on loans. The difference between these rates represents the bank's net interest income.

For those who are interested in taking up banking as a career, it is very essential to gain the basic knowledge of banking viz. What is banking ? What is the significance of banking in a developing economy ? What are the various types of banks in India and their respective functions ? What are the functions of Reserve Bank of India ? etc. Hence we have tried to acquaint you with the basics of banking & finance in this note, which will help you both in the written test and your interview.

A bank is a financial institution that serves as a financial intermediary. The term "bank" may refer to one or several related types of entities :

- A central bank circulates money on behalf of a government and acts as its monetary authority by implementing the monetary policy, which regulates the money supply.
- A commercial bank accepts deposits and provide credit, by lending to the agriculture, manufacturing and services sector and to individuals for asset creation such as house, car etc. thereby acting as an intermediary.

  Within the global financial markets also, such institutions connect market participants with capital deficits (borrowers) to market participants with capital surpluses (depositors) by transferring funds from surplus elements to deficit elements.

<u>Economic functions</u> -

The economic functions of banks include the following :

a) **The most important function of a bank is collection, aggregation of scarce resources i.e. the financial savings of the household sector, the corporate, Government and other sector and rational allocation of the financial savings of the community/nation to deserving economic activities, in the form of lending, to generate economic growth. A bank is a financial intermediary through whom the policies of the Government translate into real economic activity.**

b) Issue of money, in the form of banknotes and current accounts, subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable or repayable on demand, and hence valued at par. They are effectively transferable by mere delivery, in the case of banknotes, or by drawing a cheque that the payee may bank or cash.

c) Netting and settlement of payments – Banks act as both collecting and paying agents for customers, participating in interbank clearing and settlement systems to collect, present, be presented with, and honour payment instruments. This enables banks to economise on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.

d) **Credit quality improvement – Since banks lend funds which belong to the people, they have to be very discreet in lending. This is done by evaluation of various types of risks involved in lending such as credit worthiness of the borrower, industry scenario, markets scenario, product risk, and sovereign risk in case of cross border transactions. Internal checks and balances and close monitoring of assets quality becomes very important.** Credit audit is an important function. Migration analysis enables bank to evaluate the deterioration or improvement in assets quality.

e) Maturity transformation – Most of the resources (deposits) deployed [redacted] banks for lending are short term - maturing upto one year. Some of these are lent on long term basis for term loans. There is a possibility of maturity mismatch, as the repayment of a [redacted] term loan may take two to seven years, while funds in current account/savings account are payable on demand/ at short notice. To avoid this situation, bank on a regular basis conducts the maturity analysis of deposits and loans. **The deposits and loans are placed in various maturity buckets and it is ensured that the mismatch does not cross a predetermined tolerance limit.**

f) Money creation – Whenever a bank gives out a loan in a fractional-reserve banking system, a new sum of virtual money is created.

<u>Bank Crisis</u> -

Banks are susceptible to many forms of risk which have triggered occasional systemic crises. These include liquidity risk (where many depositors may request withdrawals in excess of available funds), credit risk (the chance that those who owe money to the bank will not repay it), and interest rate risk (the possibility that the bank will become unprofitable, if rising interest rates force it to pay relatively more on its deposits than it receives on its loans).

Banking crises have developed many times throughout history, when one or more risks have materialized for banking sector as a whole. Prominent examples include the bank run that occurred during the Great Depression in the 1930s, the U.S. Savings and Loan crisis in the 1980s and early 1990s, the Japanese banking crisis during the 1980s and the South East Asian crisis of the 1990s and the subprime mortgage crisis which originated in the U.S. in 2008.

<u>Regulation</u> -

Currently in most jurisdictions, commercial banks are regulated by government entities and require a special bank licence to operate. The definition of "Banking", in the Banking Regulation Act says, "Banking is accepting of deposits for the purpose of lending, deposits that are repayabl[redacted]n demand and withdrawable by cheque, draft, order or otherwise". Unlike most other regulated industries, the regulator (Central Bank i.e. in our case the RBI,) is typically also a participant in the market, being mostly an autonomous body, independent of the Government. Central banks also typically have a monopoly on the business of issuing banknotes which are in the nature of promissory notes. Legal tender, on the other hand, in every country and in the case of India, the one rupee note and all coins are issued by the sovereign, i.e. the Central Government. One rupee note is not a promissory note unlike all other notes, which are issued by RBI. If you read the one rupee note, it just says "One Rupee" - nothing more, because it is a Legal tender issued by the sovereign i.e. the GOI in our case. If you pay in rupee notes or coins fully, any loan stands fully discharged instantly. No one can refuse to accept payment of his or her loan when made in rupees.

Banking law is based on a contractual analysis of the relationship between the bank (defined above) and the customer - defined as a legal person i.e. any entity for which the bank agrees to conduct an account.

The law implies rights and obligations for this relationship as follows :

a) The bank account balance is the financial position between the bank and the customer: when the account is in credit, the bank owes the balance to the customer; when the account is overdrawn, the customer owes the balance to the bank.
b) The bank agrees to pay the customer's cheques up to the amount standing to the credit of the customer's account, plus any agreed overdraft limit.
c) **The bank may not pay from the customer's account without a mandate from the customer, e.g. a cheque drawn by the customer.**
d) The bank agrees to promptly collect the cheques deposited to the customer's account as the customer's agent, and to credit the proceeds to the customer's account.
e) **The bank has a lien on cheques deposited to the customer's account, to the extent that the customer is indebted to the bank.**
f) **The bank must not disclose details of transactions of the customer's account — unless the customer consents/there is a public duty to disclose/the bank's interests require it/ or the law demands it.**
g) The bank must not close a customer's account without reasonable notice, since cheques are outstanding in the ordinary course of business for several days.

These implied contractual terms may be modified by express agreement between the customer and the bank. The statutes and regulations in force within a particular jurisdiction may also modify the above terms and/or create new rights, obligations or limitations relevant to the bank-customer relationship. Some types of financial institutions, such as building societies in India and credit unions in some other countries may be partly or wholly exempt from bank licence requirements, and therefore regulated under separate rules.

The requirements laid down by Central Banks for the issue of a bank licence vary between jurisdictions but typically include :

1. Minimum capital.
2. Minimum capital ratio.
3. 'Fit and Proper' requirements for the bank's controllers, owners, directors, or senior officers.
4. Approval of the bank's business plan as being sufficiently prudent and plausible.

Types of retail banks -

- **Commercial Bank :** The term used for a normal bank to distinguish it from an investment bank.
- **Community Banks :** Locally operated financial institutions that empower employees to make local decisions to serve their customers and the partners.
- **Community Development Banks :** Regulated banks that provide financial services and credit to under-served markets or population.
- **Credit Unions :** Not-for-profit cooperatives owned by the depositors and often offering rates more favourable than for-profit banks. Typically, membership is restricted to employees of a particular company, residents of a defined neighbourhood, members of a certain labour union or religious organizations, and their immediate families.
- **Postal Savings Banks :** Savings banks associated with national postal systems.
- **Private Banks :** Banks which are owned by institutions/individual shareholders.
- **Offshore Banks :** Banks located in jurisdictions with low taxation and regulation. Many offshore banks are essentially private banks.
- **Savings Banks :** Banks aimed at promoting and encouraging saving habits.
- **Ethical Banks :** Banks that prioritize the transparency of all operations and make only what they consider to be socially-responsible investments.
- **A Direct or Internet-Only bank :** Banking operation without any physical bank branches, conceived and implemented wholly with networked computers.
- **Payment banks :** Authorised to conduct mainly collection and settlement functions. They can accept limited deposits and cannot do lending operations.

- **Small Finance Banks :** Banks with a small finance bank licence can provide basic banking service of acceptance of deposits and lending. The firms must have a capital of Rs.100 crore.

Types of Investment Banks -

- Investment banks "underwrite" (guarantee the sale of) stock and bond issues, trade for their own accounts, make markets, and advise corporations on capital market activities such as mergers and acquisitions.
- Merchant banks were traditionally banks which engaged in trade finance. The modern definition, however, refers to banks which provide capital to firms in the form of shares rather than loans. Unlike venture capital firms, they tend not to invest in new companies.

Both combined -

- Universal banks, more commonly known as financial services companies, engage in several of these activities. These banks are very diversified groups that, among other services, also distribute insurance - hence the term bancassurance, a portmanteau word combining "banque or bank" and "assurance", signifying that both banking and insuranc[redacted]re provided by the same corporate entity.

Other Types of Banks -

- Central banks are normally government-owned and charged with quasi-regulatory responsibilities, such as supervising commercial banks, or controlling the cash interest rate. They generally provide liquidity to the banking system and act as the lender of last resort in the event of a crisis.

- Islamic banks adhere to the concepts of Islamic law. This form of banking revolves around several well-established principles based on Islamic canons. All banking activities must avoid interest, a practice that is forbidden in Islam. Instead, the bank earns profit (markup) and fees on the financing facilities that it extends to customers.

Banking in India -

Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1790; both are now defunct.

The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years, the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, in the year 1955, was converted into the State Bank of India vide a special act of parliament.

Nationalisation -

Despite the provisions, control and regulations of Reserve Bank of India, until the 1960s, banks in India except the State Bank of India or SBI, continued to be owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry. Smt. Indira Gandhi, (then Prime Minister of India), expressed the intention of the Government of India to nationalise major commercial banks in a paper titled "Stray thoughts on Bank Nationalisation" at the annual conference of the All India Congress. The meeting received the paper with enthusiasm. Thereafter, her move was swift and sudden. The Government of India issued an ordinance and nationalised the fourteen largest commercial banks with effect from the midnight of 19th July, 1969. Jayaprakash Narayan, a national leader of India, described the step as a "masterstroke of political sagacity." Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9th August, 1969. A second phase of nationalization of six more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second phase of nationalization, the Government of India controlled around 91% of the banking business of India. Later on, in the year 1995, the government merged New Bank of India with Punjab National Bank. It was the first merger between two nationalized banks and resulted in the reduction of the number of nationalised banks from twenty to nineteen. After this, until the 1990s, the nationalised banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. However, in 2019, Govt. of India has merged two more nationalised banks - Dena Bank and Vijaya Bank - with another nationalised bank, Bank of Baroda. Thus the number of nationalised banks stands reduced to 17, controlling 69% of the banking business in India.

<u>Liberalisation</u> -

In the early 1990s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as Ne[redacted]eneration tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, UTI bank (now Axis Bank), ICICI Bank and HDFC Bank. This move, along with the rapid growth in the economy of India, revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks.

The next stage for Indian banking envisages relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the then prevalent cap of 10%, at present it has gone up to 26% with some restrictions. However, relaxations and exemptions have been granted by RBI and Govt. of India in certain cases, for e.g. IDBI Bank, Catholic Syrian Bank etc.

<u>IMPORTANT BANKING LEGISLATIONS</u> -

<u>The Reserve Bank of India Act, 1934</u> :- This Act constitutes the Central Banking legislation. Under this Act, the Reserve Bank has acquired certain special powers to see that the banking business is carried on by the commercial and co-operative banks on some principles as well as to help in extending banking facilities all over the country.

<u>The Banking Regulation Act, 1949 and Amendments</u> :-

The Banking Regulation Act, 194[redacted]epresents legislation for regulating the activities of commercial banks. It was partly made applicable to co-operative banks in 1966. When it was passed in 1949, it was known as Banking Companies Act, as it was applicable only to joint stock banking companies. When some of its provisions were made applicable to co-operative banks, it came to be known as The Banking Regulation Act, 1949 on 18th March, 1966. It was further amended in 1969 in order to implement the Government's policy of 'social control' on the banking system.

The Banking Regulation Act, 1949, was amended in February, 1994 through a Presidential Ordinance. Two important changes have been made in the regulations - increase in the voting rights of promoters from one to ten per cent and a hike in penalties for both banks and bank officials violating the provisions of the Act. While the increase in voting rights will encourage the private sector to set up banks, stiffer penalties will ensure that stricter controls are developed both by the central monetary authority and the bank managements. The amendment allows splitting of the post of Chairman and Managing Director & CEO. The Ordinance provides for a part-time non-executive Chairman.

The Banking Laws (Amendment) Bill 2011 was introduced in order to amend the Banking Regulation Act, 1949, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980. The said Bill was passed by both the Houses of Parliament during its Winter Session of 2012.

The salient features of the Bill are as follows:

- **To enable the nationalized banks to raise capital through "bonus" and "rights" issue and also enable them to increase or decrease the authorized capital with approval from the Government and RBI without being limited by the ceiling of a maximum of Rs. 3000 crore under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980.**