



Module-C Unit-1

JAIIB PAPER-1

**Indian Economy and Indian
Financial System (IE & IFS)**



JAIIB IE and IFS Module C Unit 1: Indian Financial System

Financial System

- For the growth of any economy, capital formation is essential.
- Capital is the source of funds with which, an entrepreneur is able to take the risk of setting up and operating a business enterprise
- The capital is available, instead, with persons with wealth who have savings. These persons with wealth, howsoever little it may, needs to be able to make the wealth available with the entrepreneurs, who can invest the savings made available to them.
- Examples of wealth possessors are individuals, firms, corporates and government.
- These entities are also those who require finance for producing goods and services, in the role of entrepreneur and businesses.
- Wealth must, therefore, flow from pockets of surplus to pockets of deficit.
- It is for that purpose the financial and banking systems are required.

Types Of Financial Systems

In all economies, financial systems are of two basic types

- Informal System
- Formal System

Informal Financial System

Evolved: As an extension of the social structure and

Characteristics:

- lack of regulations,
- low transaction cost,
- Unstructured procedures,
- No transparency and
- low default rates.

Typical examples components:

- Individual money lenders who could be traders, relatives, neighbours, etc.
- Groups of persons who could be operating as associations and funds
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

- Although informal and unregulated, this section of financial system has its own importance, especially in the earlier days and in rural and lesser developed geographies.

Formal Financial System

Characteristics:

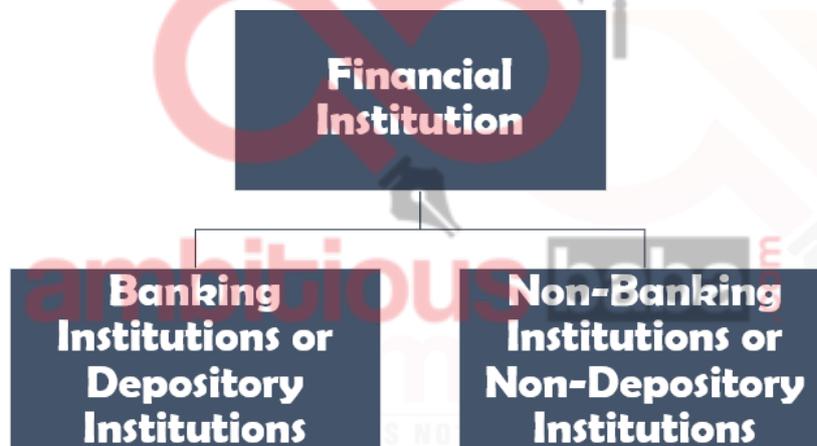
- Presence of an organised, institutional and regulated system, which caters to the financial needs of the modern spheres of economy.
- Forms the backbone of any economy and one of the most important systems in the growth of any nation.

Components:

- The financial institutions,
- Financial instruments
- Financial markets.

Financial Institutions

While on one hand, cater to the entities who possess wealth, on the other hand, they cater to those entrepreneurs and businesses who require the wealth in the form of capital, for their investments.



Examples

- Financial Regulators
- Commercial and Cooperative Banks
- Non-Banking Financial Companies (NBFCs)
- Development Financial Institutions (DFIs)
- Insurance companies
- Insurance brokers
- Mutual Funds
- Pension Funds

Banking Institutions or Depository Institutions –

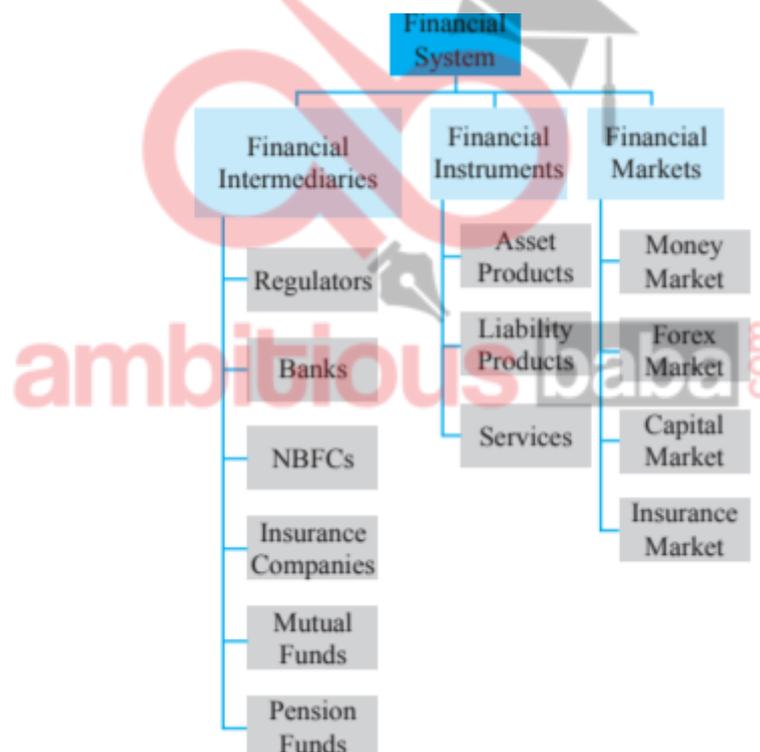
- This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need.

Non-Banking Institutions or Non-Depository Institutions –

- Insurance, mutual funds and brokerage companies fall under this category.
- They cannot ask for monetary deposits but sell financial products to their customers.

Further, Financial Institutions can be classified into three categories:

- **Regulatory** – Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.
- **Intermediates** – Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.
- **Non Intermediates** – Institutions that provide financial aid to corporate customers.
- It includes NABARD, SIBDI, etc.

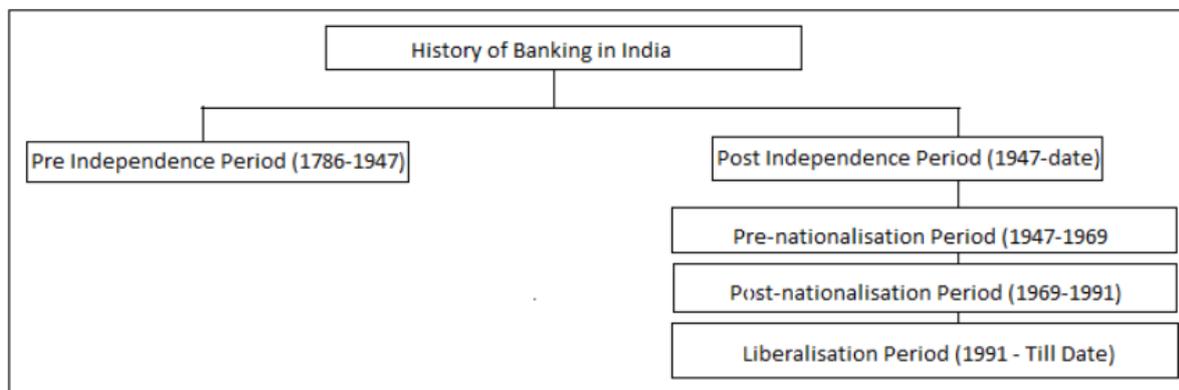


History Of Banking In India

The banking sector development can be divided into three phases:

- **Phase I:** The Early Phase which lasted from 1770 to 1969

- **Phase II:** The Nationalisation Phase which lasted from 1969 to 1991
- **Phase III:** The Liberalisation or the Banking Sector Reforms Phase which began in 1991 and continues to flourish till date



Pre Independence Period (1786-1947)

The first bank of India was the “**Bank of Hindustan**”, established in **1770** and located in the then Indian capital, Calcutta. However, this bank failed to work and **ceased operations in 1832**.

During the Pre Independence period over 600 banks had been registered in the country, but only a few managed to survive.

Following the path of Bank of Hindustan, various other banks were established in India. They were:

- The General Bank of India (1786-1791)
- Oudh Commercial Bank (1881-1958)
- Bank of Bengal (1809)
- Bank of Bombay (1840)
- Bank of Madras (1843)

During the British rule in India, The East India Company had established three banks: Bank of Bengal, Bank of Bombay and Bank of Madras and called them the Presidential Banks. **These three banks were later merged into one single bank in 1921**, which was called the “**Imperial Bank of India.**”

The Imperial Bank of India was later nationalised in 1955 and was named The State Bank of India, which is currently the largest Public sector Bank.

Independence Banks in India	
Bank Name	Year of Establishment
Allahabad Bank	1865
Punjab National Bank	1894
Bank of India	1906
Central Bank of India	1911
Canara Bank	1906
Bank of Baroda	1908

Post Independence Period (1947-1991)

- At the time when India got independence, all the major banks of the country were led privately which was a cause of concern as the people belonging to rural areas were still dependent on money lenders for financial assistance.
- With an aim to solve this problem, the then Government decided to nationalise the Banks. These banks were nationalised under the **Banking Regulation Act, 1949**. Whereas, the **Reserve Bank of India was nationalised in 1949**.

Candidates can check the list of Banking sector reforms and Acts at the linked article.

- Following it was the formation of **State Bank of India in 1955 and the other 14 banks were nationalised** between the time duration of **1969 to 1991**. These were the banks whose national deposits were more than 50 crores.

Given below is the list of these 14 Banks nationalised in 1969:

- 1.Allahabad Bank
- 2.Bank of India
- 3.Bank of Baroda
- 4.Bank of Maharashtra
- 5.Central Bank of India
- 6.Canara Bank
- 7.Dena Bank
- 8.Indian Overseas Bank
- 9.Indian Bank
- 10.Punjab National Bank
- 11.Syndicate Bank
- 12.Union Bank of India
- 13.United Bank
- 14.UCO Bank

In the year 1980, another 6 banks were nationalised, taking the number to 20 banks. These banks included:

- Andhra Bank
- Corporation Bank

- New Bank of India
- Oriental Bank of Comm.
- Punjab & Sind Bank
- Vijaya Bank

Apart from the above mentioned 20 banks, there were seven subsidiaries of SBI which were nationalised in 1959:

- State Bank of Patiala
- State Bank of Hyderabad
- State Bank of Bikaner & Jaipur
- State Bank of Mysore
- State Bank of Travancore
- State Bank of Saurashtra
- State Bank of Indore

All these banks were later merged with the State Bank of India in 2017, except for the State Bank of Saurashtra, which merged in 2008 and State Bank of Indore, which merged in 2010.

Note: The Regional Rural Banks in India were established in the year 1975 for the development of rural areas in India.

Liberalisation Period (1991-Till Date)

Once the banks were established in the country, regular monitoring and regulations need to be followed to continue the profits provided by the banking sector. The last phase or the ongoing phase of the banking sector development plays a hugely significant role.

To provide stability and profitability to the Nationalised Public sector Banks, the Government decided to set up a committee under the leadership of **Shri. M Narasimham** to manage the various reforms in the Indian banking industry.

The biggest development was the introduction of Private sector banks in India. RBI gave license to 10 Private sector banks to establish themselves in the country. **These banks included:**

- Global Trust Bank
- ICICI Bank
- HDFC Bank
- Axis Bank
- Bank of Punjab
- IndusInd Bank
- Centurion Bank
- IDBI Bank
- Times Bank
- Development Credit Bank

The Firsts In Indian Banking System:

- First bank in India was Bank of Hindustan (1770)
- First Bank managed by Indians was Oudh Commercial Bank
- First Bank with Indian Capital was Punjab National Bank (Founder of the Bank is Lala Lajpat Rai)
- First Foreign Bank in India is HSBC
- First bank to get ISO certificate is Canara Bank
- First Indian bank outside India is Bank of India
- First Bank to introduce ATM is HSBC (1987, Mumbai)
- First Bank to have a joint-stock public bank (Oldest) is Allahabad Bank
- First Universal bank is ICICI (Industrial Credit and Investment Corporation of India)
- First bank to introduce saving account is Presidency Bank (1833)
- First Bank to Introduce Cheque system is Bengal Bank (1833)
- First bank to give internet banking facility is ICICI
- First bank to sell mutual funds is State Bank of India
- First bank to issue credit cards is Central Bank of India
- First Digital Bank is Digibank
- First Rural Regional Bank (Grameen Bank) is Prathama Bank (sponsored by Syndicate Bank)
- First bank to get 'in principle' banking license is IDFC and Bandhan Bank
- First Bank to introduce merchant banking in India is Grind lays bank
- First bank to introduce blockchain technology is ICICI
- First bank to introduce voice biometric is Citi Bank
- First bank to introduce robot in banking service is HDFC

Important Legislations Affecting Establishment Of Banks

Important legislations affecting the establishment of banking institutions are the following:

- The Reserve Bank of India Act, 1934
- The Banking Regulation Act, 1949
- The State Bank of India Act, 1955
- The State Bank of India (Subsidiary Banks) Act, 1959
- The Deposit Insurance and Credit Guarantee Corporation Act, 1961
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- The State Banks (Repeal and Amendment) Act, 2018

Narasimham Committee – I (1991)

The recommendations of the Narasimham Committee – I were as follows:

- Establishment of a 4-tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at the top and, at the bottom, rural banks engaged in agricultural activities.

- The supervisory functions over banks and financial institutions to be assigned to a quasi-autonomous body sponsored by RBI.
- A phased reduction in Statutory Liquidity Ratio.
- Phased achievement of 8% Capital Adequacy Ratio.
- Abolition of branch licensing policy.
- Proper classification of assets and full disclosure of accounts of banks and financial institutions.
- Deregulation of interest rates.
- Setting up an Asset Reconstruction Fund to take over a portion of the stressed asset loan portfolio of banks.

Based on the above-listed recommendations of the Narasimham Committee -I, the government implemented the following measures:

Lowering SLR and CRR:

- The high SLR and CRR reduced the profits of the banks.
- This measure has resulted in increase in loanable funds with banking system for allocation to agriculture, industry, trade, etc.

Prudential Norms:

- Introduced by RBI, in order to impart professionalism in commercial banks.

Capital Adequacy Norms:

- Ratio of minimum capital to risk
- Weighted assets.
- In April 1992, RBI fixed CAR at 8%, and by March 1996, all public sector banks had attained the ratio of 8%.

Deregulation of Interest Rates:

- The Narasimham Committee advocated that the interest rates should be allowed to be determined by the market forces.
- Since 1992, interest rates were freed, in stages, both for deposits as well as for advances

Recovery of Debts:

- GOI passed the “Recovery of Debts due to Banks and Financial Institutions Act 1993” in order to facilitate and speed up the recovery of debts due to banks and financial institutions, and six Special Debt Recovery Tribunals were set up.

Competition from New Private Sector Banks:

- Banking was opened to the private sector and new private sector banks were licensed and started functioning.
- These new private sector banks are allowed to raise capital contribution from foreign institutional investors up to 20% and from NRIs up to 40%. Freeing of the banking space to private banks, led to increased competition.

Access to Capital Market:

- The Banking Companies (Acquisition and Transfer of Undertakings) Act was amended, in order to enable the banks raise capital through public issues.
- This was, subject to the provision that the holding of Central Government would not fall below 51% of paid-up capital.

Freedom of Operation:

- Scheduled Commercial Banks are given freedom to open new branches and upgrade their extension counters, after attaining the required capital adequacy ratio and adhering to the prudential accounting norms.
- The banks are also permitted to close non-viable branches, in centres other than those in rural areas.

Local Area Banks (LABs):

- In 1966, RBI had issued guidelines for setting up Local Area Banks, and it gave its approval for setting up 7 LABs in the private sector.
- LABs were instrumental in mobilizing rural savings and in channelling them into investments, in the designated local areas.

Supervision of Commercial Banks:

- The RBI had set up a Board for Financial Supervision (BFS) with an Advisory Council to strengthen the supervision of banks and financial institutions.
- In 1993, RBI established a new department known as Department of Supervision, as an independent unit for supervision of commercial banks.

Narasimham Committee – II (1998)

- In 1998, the government appointed yet another committee under the chairmanship of Shri Narasimham.
- Known as the Committee on Banking,
- To review the progress in banking reforms and to recommend a path, for further strengthening the financial system in India.
- submitted its report to the government in April 1998, with the following recommendations.

Strengthening of Banks in India:

- The committee considered a stronger banking system, in the context of the Current Account Convertibility.
- It postulated that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of the convertibility.
- Recommended the MERGER OF STRONG BANKS which could have a 'multiplier effect' on the industry.

Narrow Banking:

- In those days, problems of high non-performing assets (NPAs). Some of them had gross NPAs that were as high as 20% of their assets. Thus, for successful rehabilitation of these banks, it recommended the '**Narrow Banking Concept**'

Capital Adequacy Ratio:

- Committee recommended that the Government should raise the prescribed minimum capital adequacy norms to 9%. This would further improve their loss absorption capacity also.

Bank ownership:

- The committee opined that government control over the banks in the form of management and ownership and bank autonomy did not go hand in hand and thus, it recommended a review of the functioning of Boards of Banks so as to enable them to adopt professional corporate strategies.

Review of banking laws:

- The committee considered that there was an urgent need for reviewing and amending major laws governing the Banking Industry like **RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc.** These modifications would bring them in line with the obtaining needs of the banking sector in India.

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