



Module-C Unit-2

JAIIB PAPER-1

Indian Economy and Indian Financial System (IE & IFS)



JAIIB IE and IFS Module C Unit 2: Indian Banking Structure

Banking

What Is Banking?

- Banking is classically defined in the **Banking Regulations Act, 1949 (BR Act)**. As per **Section 5(1) (b) of the BR Act**, banking is 'the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.'
- **Section 5(1)(c), further defines** a banking company as any company which transacts the business of banking in India. **Section 6 of the BR Act defines**, in detail, the types of activities that banks are authorised to carry out, although under modern day banking, banks have embraced many other types of activities, too. The traditional types of businesses that banks.
- Another important aspect on banking in India is that, **in terms of Section 7 (1) of the BR Act**, 'No company other than a banking company shall use as part of its name any of the words "bank", "banker" or "banking" and no company shall carry on the business of banking in India, unless it uses as part of its name at least one of such words.'
- Further, **Section 7(2) states** 'No firm, individual or group of individuals shall, for the purpose of carrying on any business, use as part of its or his name any of the words "bank", "banking" or "banking company".'

Important Legislations Affecting Establishment Of Banks

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

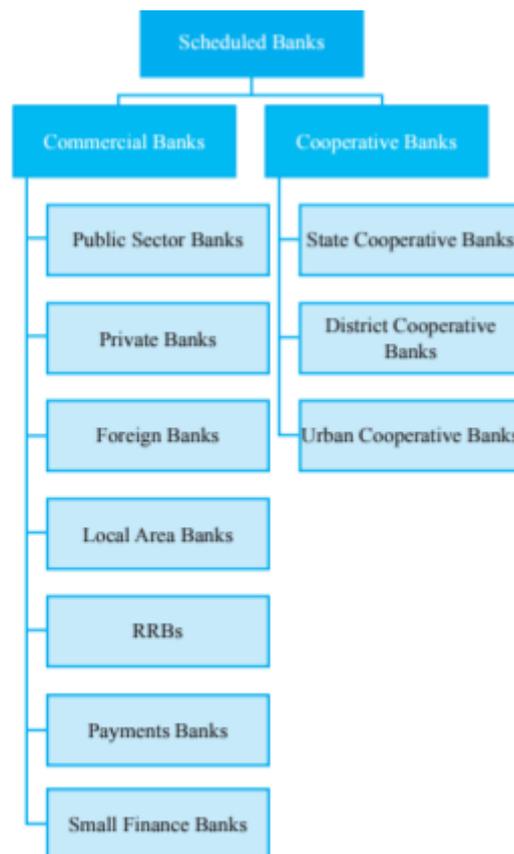
- The Reserve Bank of India Act, 1934
- The Banking Regulation Act, 1949
- The State Bank of India Act, 1955
- The State Bank of India (Subsidiary Banks) Act, 1959
- The Deposit Insurance and Credit Guarantee Corporation Act, 1961
- The Banking Companies (Acquisition and Transfer of Undertakings) Act,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

Types Of Banks

Scheduled Banks?

- By definition, any bank which is listed in the **2nd schedule of the Reserve Bank of India Act, 1934 is considered a scheduled bank.**
- The Schedule consists of those banks which satisfy various parameters, criteria **under clause 42 of this act.**

- The list includes the State Bank of India and its subsidiaries (like State Bank of Travancore), all nationalised banks (Bank of Baroda, Bank of India etc), regional rural banks (RRBs), foreign banks (HSBC Holdings Plc, Citibank NA) and some co-operative banks.
- These also include private sector banks, both classified as old (Karur Vysya Bank) and new (HDFC Bank Ltd).
- To qualify as a scheduled bank, the **paid-up capital and collected funds of the bank must not be less than Rs5 lakh.**
- Scheduled banks are eligible for loans from the Reserve Bank of India at bank rate, and are given membership to clearing-houses.



Non-Scheduled Banks?

- Non-scheduled banks by definition are those which are **not listed in the 2nd schedule of the RBI act, 1934.**
- They don't conform to all the **criteria under clause 42**, but dully follow specific guidelines as laid down by RBI.
- Banks with a **reserve capital of less than 5 lakh** rupees qualify as non-scheduled banks.
- The minimum capital requirement of non-scheduled banks is governed by Section 11 (1) of the Banking Regulation Act, 1949, whereas the capital requirement of the scheduled banks are governed by Section 42(6) of the Reserve Bank of India Act, 1934; the non-scheduled banks are not eligible to effect borrowing from RBI for their normal operations.

- Unlike scheduled banks, they are not entitled to borrow from the RBI for normal banking purposes, except, in an emergency or abnormal circumstances.
- Bangalore City Co-operative Bank Ltd. Bangalore, Baroda City Co-op. Bank Limited are a few examples

Commercial Banks

- According to the RBI, “Commercial Banks refer to both scheduled and non-scheduled commercial banks which are regulated **under Banking Regulation Act, 1949.**”
- Commercial banks operate on a ‘for-profit’ basis.
- They primarily engage in the acceptance of deposits and extend loans to the public, businesses and the government.
- Nowadays, some commercial banks are also providing housing loans on a long-term basis to individuals.

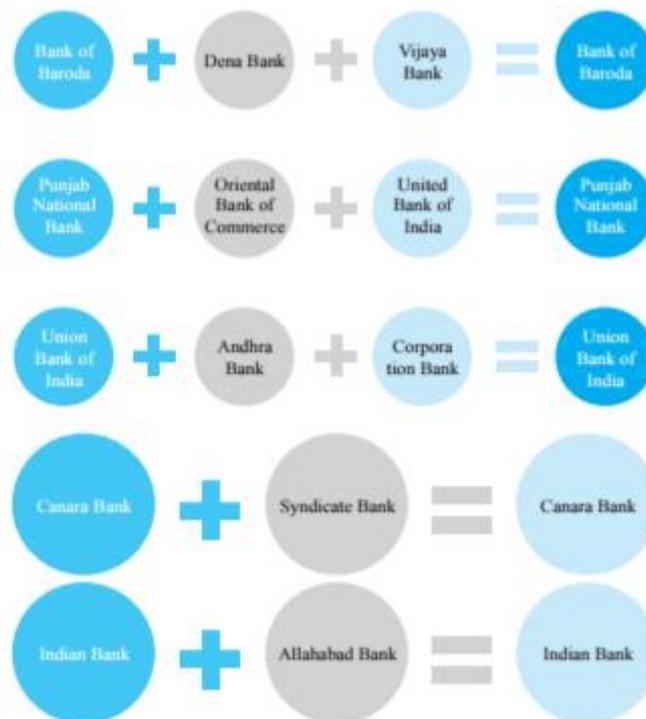
Types of Commercial Banks

Commercial banks are of three types-

- Public sector Banks
- Private sector Banks
- Foreign Banks.

Public Sector Banks

- Public Sector Banks (PSBs) are banks where a common stake (**i.e. more than 50%) is held by a government.**
- The shares of these banks are listed on stock exchanges.
- Example- State Bank of India, Corporation Bank, Bank of Baroda, Punjab National Bank, Canara Bank, Bank of India.



Private Sectors Banks

- In the case of private sector banks, the majority of the share capital of the Bank is held by private individuals.
- These Banks are registered as companies with limited liability.
- Example- ICICI Bank Ltd, ING Vysya Bank.

Pursuant to the guidelines issued in **January 1993**, the **old private sector** banks having **net worth of less than Rs 50 crore** were advised to attain the level of **Rs 50 crore by March 31, 2001**, and prepare action plans for augmenting capital funds to the **level of Rs100 crore**. The minimum capital requirement for **Private Sector Banks** was **thereafter raised to the present requirement of Rs 500 crores**. Some of the guidelines presently in force for setting up Universal banks in the Private Sector space (as against Differentiated Banks like Payments Banks and Small Finance Banks) are listed here:

- Initial minimum paid up capital of **Rs 500 crores**.
- The bank should maintain a **minimum net worth of Rs 500 crores**, at all times.
- Resident individuals having 10 years' experience in banking and finance would also be eligible to establish such banks.
- Large industrial houses are not eligible to set up banks, but can invest up to 10% in the banks.
- Foreign shareholding limit would be as per FDI guidelines of Government of India (presently maximum of 74%).
- The business plan submitted by the applicant should be viable and bring out how the bank intends to achieve financial inclusion.
- The bank should have its shares listed on the Stock Exchange, within a period of 6 years, from the time it commences its business.

- The bank should open at least 25% of its branches in unbanked rural areas. • The bank should achieve its priority sector targets and sub-targets, as applicable to scheduled commercial banks.

Foreign Banks

- These banks are registered and have their headquarters in a foreign country but operate their branches in our country.
- Some foreign banks operating in our country are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank, Standard & Chartered Bank.
- The number of foreign banks operating in our country has increased since the financial sector reforms of 1991.

The factors which are considered, while granting approval to a foreign bank for operating in India are:

- Economic and political linkages of India with the home country of the foreign bank
- Reciprocity of trade and other business with the home country of the foreign bank
- Financial soundness of the applicant foreign bank
- Ownership pattern of the applicant bank
- International/ home country ranking and rating of applicant bank
- International presence of the applicant bank
- Adequate risk management & control systems of the applicant bank.

The capital requirements of the applicant bank are as follows:

- Minimum paid up capital of Rs 500 crore
- Capital to be brought in upfront capital, by remittance from the parent bank
- The applicant must comply with Basel- III requirements, on a continuous basis
- Minimum CRAR should not be less than 10% for initial three years
- The WOS can raise non-equity rupee resources like domestic banks in India
- Core management functions of the foreign applicant bank cannot be outsourced including to group entities, either in India or overseas.

Local Area Banks

Local Area Banks were set up, as per **Government of India's Scheme announced in August 1996**. The intention of the government was to set up new private local banks, with jurisdiction over two or three contiguous districts. The objective of establishing the local area banks was to enable to mobilization of the rural savings by local institutions and making them available for investments in local areas.

The key features of the local area banks are as under:

- Each local Area bank is registered as a public limited company, under the Companies Act. However, they are licensed under the **Banking Regulation Act, 1949**.
- The Local Area Banks are non-scheduled banks.
- Local Area Banks have jurisdiction over a maximum of three contiguous districts, and their basic function is to mobilise funds in rural and semi-urban areas.
- The minimum start-up capital of an **LAB was fixed at Rs.5 crores and the promoters** were directed to bring entire minimum share capital, up-front. The promoters could be individuals, firms or societies. The family of the individual promoters was not allowed to keep more than 40% of the equity capital of the banks, and NRI promoters could not exceed more than 20% of total number of promoters.
- The Local Area banks are subject to prudential norms, accounting policies and other policies, as stipulated by the RBI.
- Each Local Area Bank is allowed to open branch in only one urban centre per District and rest of the branches were required to be opened in the rural and semi urban centres, subject to requisite clearance in respect of rural branches from the District Consultative Committee.

The functions of Local Area Banks are as under:

- Whilst Local Area Banks can undertake all normal banking business, their major function was to finance agriculture and allied activities, small scale industries, agro -industries and trading/ non-farm activities, in the rural and semi-urban areas.
- **These banks have to lend at least 40%** of their total credit to priority sectors, of which, 12% will have to be provided for the weaker sections of the society, by 2023-24.

Regional Rural Banks

- **Established:** 1975, based on the recommendations of Narasimham Committee.
- **The Committee view:** RRBs would be much better suited than the commercial banks or co-operative banks, in meeting the needs of rural areas.
- Government of India promulgated an ordinance for establishing the Regional Rural Banks in the year 1975 and the Regional Rural Banks Act, was enacted in the year 1976.
- After passing the Act, within a year, at least 25 RRBs were established in different parts of the country.
- Regional Rural Banks were established with a view to developing such type of banking institutions which could function as a commercial organization in rural areas.
- The Regional Rural Banks Act, 1976, provides for incorporation and regulation of Regional Rural Banks, with a view to developing the rural economy by providing

credit for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs and individuals.

Objectives :

- **Bridging the credit gaps in rural areas:** To develop such measures which could restrict the outflow of rural deposits to urban areas,
- **Employment generation activities in rural areas:** For achieving these objectives, the RRBs provide financial assistance to different segments of rural population engaged in rural activities.

Area of Functioning of Regional Rural Banks

- An RRB can open its branches and operate only in the jurisdiction of such districts/state, which have been notified by the Central Government.
- Head Office in its operational area only (Section 4 of the Regional Rural Banks Act).
- The branch expansion is done, as per the specific branch licensing policy of RBI prescribed for RRBs, from time to time, keeping in view the provisions of Section 23 of the Banking Regulation Act, 1949.

Capital Structure of RRBs:

- **As per Section 5 of the Regional Rural Banks (Amendment) Act, 2015:**
 - ❑ Authorized share Capital : Rs. 2000 crore.
 - ❑ out of the capital issued by a RRB,
 - 50% : by the Central Government,
 - 15% : by the concerned State Government
 - 35% : by the Sponsor Bank.

Amendment: in the recent period, contains an enabling provision for raising share capital from sources other than the Central Government, State Governments and Sponsor Banks, provided, the share capital held by the Central Government and the Sponsor Bank together, cannot be less than 51 per cent of the paid- up capital.

Further, if the shareholding of the state government in a RRB is to be reduced below 15%, the Union government would have to consult the concerned state government.

For raising share capital from sources other than Central/State Governments and Sponsor Bank, a RRB needs to adhere to the

Payments Banks

Objective : To take forward financial inclusion by offering banking and financial services to the unbanked and underbanked areas, helping the migrant labour force, low-income households, small entrepreneurs etc.

Registered: Under the Companies Act 2013, but are governed by a host of legislations such as Banking Regulation Act, 1949, RBI Act, 1934, Foreign Exchange Management Act, 1999, Payment and Settlement Systems Act, 2007, etc.

Features:

- They are differentiated banks and not universal banks.
- These operate on a smaller scale.
- Minimum paid-up capital: Rs. 100 crores.
- **Minimum initial contribution of the promoter to the paid-up equity capital is required to be at least be 40% for the first 5 years from the commencement of its business**

The activities performed

- Can accept deposits of up to Rs. 2 lakhs per customer.
- They can accept demand deposits in the form of savings and current accounts.
- The money received as deposits can be invested in government securities which are eligible for inclusion in Statutory Liquidity Ratio (SLR).
- This must amount to 75% of the demand deposit balance.
- The remaining 25% can be placed as deposits with other scheduled commercial banks.
- Payments banks are permitted to make personal payments and **receive cross border remittances on individual accounts.**
- Permitted to issue debit cards, although not credit cards.
- Permitted to handle third party products like distribution of insurance and mutual funds.

Activities Cannot be Undertaken:

- Cannot lend.
- Cannot issue credit cards.
- Cannot accept term deposits or deposits from NRI customers.
- Cannot set up subsidiaries to undertake non-banking financial activities.
- **Advantages:**
- Expansion of rural banking and financial inclusion.
- Expansion of the formal financial system.
- Effective alternative to commercial banks.

Small Finance Banks

- **OBJECTIVE:** Further financial inclusion by provision of savings vehicles, and supply of credit to small business units, small and marginal farmers, micro and small industries and other unorganised sector entities, through high technology – low- cost operations.

FEATURES:**Eligible promoters**

- Resident individuals/professionals with 10 years of experience in banking and finance;
- Companies and societies owned and controlled by residents will be eligible to set up small finance banks.
- Existing Non-Banking Finance Companies (NBFCs), Micro Finance

Capital requirement

- **Minimum paid-up equity capital** : Originally fixed at Rs 100 crores.
- **Increased:** To Rs 200 crores, except for those Urban Cooperative Banks that get converted themselves into Small Finance Banks.

Promoter's contribution

- **Minimum initial contribution to the paid-up voting equity capital is least first 5 years:** 40% at all times during the from the date of commencement of business of the bank which should be brought down within a period of 10 years : to a maximum of 30% of the paid-up voting equity capital of the bank,
- **Within 15 years:** To a maximum of 15%.

Maximum loan size and investment limit exposure :

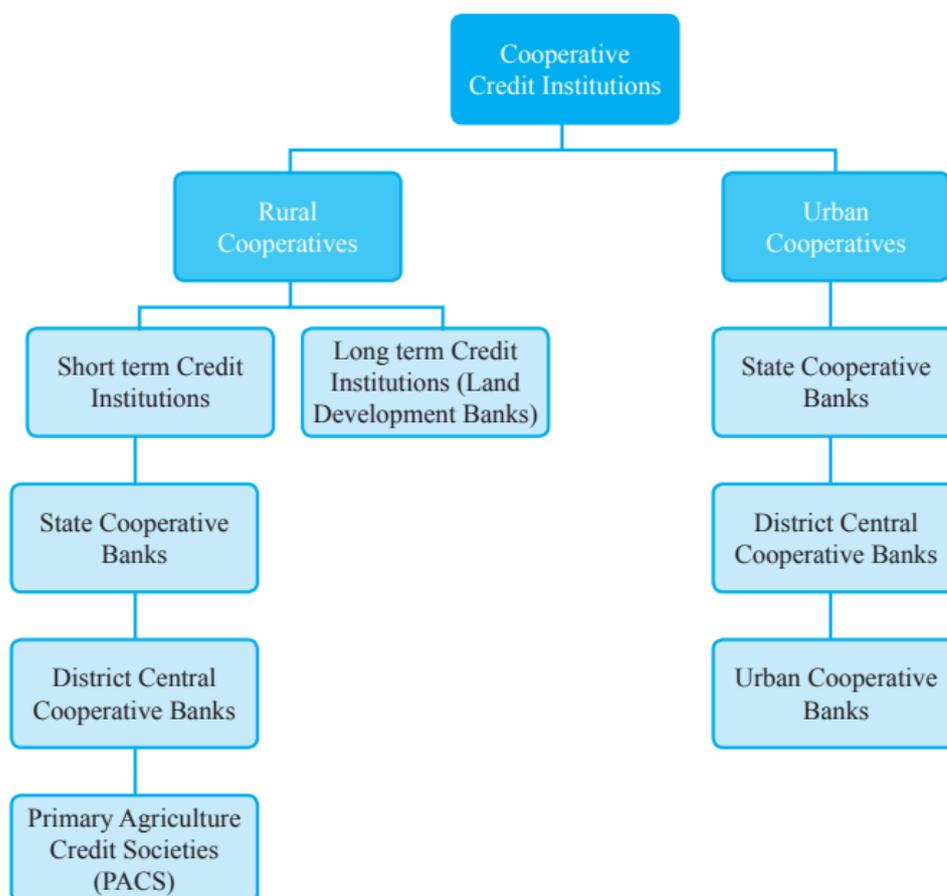
- **Single** : Restricted to 10% of its capital funds
- **Group** : 15% of its capital funds.

Cooperative Banks

- **Existence:** with the enactment of the Cooperative Credit Societies Act of 1904, which provided for the formation of cooperative credit societies.
- Subsequently, in 1912, a new Act was passed, which provided for the establishment of cooperative central banks.
- Cooperative credit institutions play a pivotal role in the financial system of the economy, in terms of their reach, volume of operations, and the purpose they serve.

These organisations were a system consisting of :

- Primary Cooperative Credit Societies,
- Central Cooperative Banks
- State Cooperative Banks.



Differences between Cooperative Banks and Commercial Banks

BASIS FOR COMPARISON	COMMERCIAL BANK	COOPERATIVE BANK
Meaning	A bank, that offers banking services to individuals and businesses is known as a commercial bank.	A bank set up to provide finance to agriculturists, rural industries and to trade and industry of urban areas (but up to a limited extent).
Governing Act	Banking Regulation Act, 1949	Cooperative Societies Act, 1965
Area of operation	Large	Small
Motive of operation	Profit	Service
Borrowers	Account holders	Member shareholders
Main function	Accepting deposits from public and granting loans to individuals and businesses.	Accepting deposits from members and the public, and granting loans to farmers and small businessmen.
Banking service	Offers an array of services.	Comparatively less variety of services.
Interest rate on deposits	Less	Slightly higher

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