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SECTION-1

Introduction to Banking

INTRODUCTION

In the history of banking, there is no unanimous opinion regarding the beginning of banks. Some trace its origin to French word BANGUI and some to Italian word 'BANCA'. According to one viewpoint, in good old days, Italian money lenders were known as " Banechi" or Banacheri" because people kept a special type of table to transact their business called "Banchi". The practice of safekeeping and saving was found in the temple of Babylon. Chankya in his Arthashastra has also mentioned about existence of powerful guilds of merchant bankers who received deposits, advanced loans and issued hundis.

First Bank in India : The first bank in India was started in 1770 as 'Bank of Hindustan'

First Bank in modern sense : 'Bank of Bengal' was the first bank in modern sense in 1806.

ANCESTORS IN THE HISTORY OF BANKING

1. The Merchants
2. The Gold Smiths
3. The Money Lenders

1. The Merchants : It was the 'merchant' who first evolved the system of banking by trading activities which needed remittance of money. They issued 'hundis' to remit funds and here merchant bankers were known as 'Seths'.

2. The Gold Smiths : Another stage was of goldsmith, who had to take special precautions against theft of gold and jewellery. People nearby his place started leaving thier bullion, money and ornaments in his care. He charged some nominal amount for taking this care and also issued a receipt. Here he also started lending of such gold coins and silver coins provided that they were payable on demand.

3. The Money Lenders : In the third stage of money lending when the withdrawls were less, the Goldsmith thought of investing or lending on interest. He also used to keep some money as reserve and hence the business of accepting and lending flourished so the Goldsmith turned into money lender.

PRE INDEPENDENCE

The largest bank, and the oldest still in existence, is the State Bank of India (S.B.I). It originated as the Bank of Calcutta in June 1806. In 1809, it was renamed as the Bank of Bengal. This was one of the three banks funded by a presidency government; the other two were the Bank of Bombay in 1840 and the Bank of Madras in 1843. The three banks were merged in 1921 to form the Imperial Bank of India, which upon India's independence, became the State Bank of India in 1955.

In 1881 first bank with limited liability to be managed by Indian Board is "Oudh Commercial Bank". First bank wholly managed and owned by Indians is "Central Bank of India" (1911 on the recommendation of Hilton Young Commission). For many years the presidency banks had acted as quasi-central banks, as did their successors, until the Reserve Bank of India was established in 1935, under the Reserve Bank of India Act, 1934.

POST INDEPENDENCE

The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted in greater involvement of the state in different segments of the economy including banking and finance. The major steps to regulate banking included:

- The Reserve Bank of India, India's central banking authority, was established in April 1935, but was nationalized on 1 January 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005).
- In 1949, the Banking Regulation Act was enacted, which empowered the Reserve Bank of India (RBI) "...to regulate, control, and inspect the banks in India."
- The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

NATIONALISATION IN THE 1960s

Despite the provisions, control and regulations of the Reserve Bank of India, banks in India except the State Bank of India (SBI), remain 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 nationalisation of the banking industry.

The Government of India issued an ordinance ('Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969') and nationalised the 14 largest commercial banks with effect from the midnight of 19 July 1969. These banks contained 85 percent of bank deposits in the country.

A second dose of nationalisation of 6 more commercial banks followed in 1980. The stated reason for the nationalisation was to give the government more control of credit delivery. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19.

LIST OF NATIONALISED BANKS IN INDIA

Allahabad Bank	Andhra Bank
Bank of Baroda	Bank of India
Bank of Maharashtra	Canara Bank
Central Bank of India	Corporation Bank
Dena Bank	Indian Bank
Indian Overseas Bank	Oriental Bank of Commerce
Punjab and Sind Bank	Punjab National Bank
Syndicate Bank	UCO Bank
Union Bank of India	United Bank of India
Vijaya Bank	

PHASES OF INDIAN BANKING

Indian banking system over the years has gone through various phases. The evolution of banking since last 5 decades after independence can be divided into following 5 phases.

Foundation Phase : It be gained from 1950s extending from nationalization of banks in 1969. Focus was to lay foundation for a sound banking system.

Expansion Phase : It gained momentum after nationalisation of banks and continued till 1984. Effort was made to make banking facilities available to masses by creating a branch network covering rural and semi-urban areas.

Consolidation Phase : It started in 1985 initiatives were taken by RBI to imporve house keeping, customer service, credit management, staff productivity.

Reforms Phase : After 1991 there were extensive financial sector reforms. Reforms brought deregulation of interest rates, more competition, technological changes, prudential guidelines on asset classification and income recognition, capital adequacy, autonomy packages etc. It was during this phase that Narsimham Committee report was prepared and submitted.

Post Reforms Phase : During this era there are developments in banking system. The focus is on bigger size, new innovative products, and global standards of serving.

RETAIL BANKING CONCEPT

One of the major development in the banking sector is the introduction of retail Banking in the country. At present, banks are focusing more on retail banking by proving various loan facilities to depositors. The banking sector is facing increased competition from non-banking institution. The Retail Banking encompasses various financial products (different type of deposit accounts, home loan, auto loan, credit cards, demate facilities, Insurance mutual funds, credit and debit cards, ATM, Stock broking, payment of utility bills) catering to diverse customer groups, offering a host of financial services, mostly to individuals. Simply speaking, it takes care of the diverse banking needs of an individual. (Kaur, Bhandri and Gupt, 2009).

Now a days, banks are focusing more on individual needs through retail banking which increased the other income of the banks significantly

PROBLEMS OF INDIAN BANKING SYSTEM

Despite of progress made by Indian Commercial banks during last two decades, there are still many problems faced by these banks. Some of them are listed below :

1. Indian banks are facing low profitability.

2. The NPA s of Indian banks have been growing rapidly.

3. The capital base of Indian banks was very low and not uniform.

4. Many bank involve in window dressing of their balance sheets. They artificially increase their deposits in last weeks of the financial year.

5. Some bank favour certain companies in advancing loans without following rigrous process, often these loans turn bad.

6. The quality of loan portfolios of many banks is very bad usually they advance loans under political pressures.

7. Many banks misutilise public deposits by indulging in share speculation. There have been various scams which revealed the negative role of public and private sector banks.

8. There have been reported many irregularities in maintaining accounts by the banks.

This shows that Indian commercial banks are not operating properly. Therefore number of committees have suggested measures to improve this workings. One of the major committee and its recommendations are explained here under.

NARSIMHAM COMMITTEE REPORT

Narasimham Committee Report Part I (1991) :

The committee on Financial system under the chairmanship of Sri M. Narasimham laid down the blue print of financial sector reforms. The committee assumed that the financial resources of commercial banks came from general public therefore these funds should be deployed for maximum benefit of the depositors.

Narasimham Committee on Banking Sector Reforms Part II (1998) :

The committee was constituted to review the progress of banking sector reforms and suggest reforms necessary to strengthen India's financial system and make it internationally competitve. The committee gave its Report on April 23, 1998.

1991 Recommendations	1998 Recommendations
More strong Banks (Cautioned merger of strong and weak banks)	Merger weak banks to reduce number
Free bank boards from interference	Free bank boards from interference
Move to three-tier structure	Move to three-tier structure
Review capital adequacy norm	Fix capital adequacy at 8%
Consider whether autonomy is consistent with public ownership	Ensure autonomy of banks. Wind up banking division of Finance Ministry

Banking Reform Measures of Government:

On the recommendations of Narasimhan Committee, following measures were undertaken by government since 1991: –

- Lowering SLR and CRR
- Recovery of Debts
- Competition from New Private Sector Banks
- Access To Capital Market
- Freedom of Operation
- Local Area Banks (LABs)
- Supervision of Commercial Banks

Nachiket Mor committee

The Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households, set up by the RBI in September 2013, was mandated with the task of framing a clear and detailed vision for financial inclusion and financial deepening in India. Key Observation :

- Universal Electronic Bank Account (UEBA)
- Ubiquitous Access to Payment Services and Deposit Products at Reasonable Charges
- Sufficient Access to Affordable Formal Credit.
- Universal Access to a Range of Deposit and Investment Products at Reasonable Charges.
- Universal Access to a Range of Insurance and Risk Management Products at Reasonable Charges.
- Right to Suitability

PJ Nayak Committee

The P J Nayak Committee or officially the Committee to Review Governance of Boards of Banks in India was set up by the Reserve Bank of India (RBI) to review the governance of the board of banks in India. The Committee was set up in January 2014. Key Observation :

- The Current Structure of PSB can be termed as model in Corporate governance.
- Too Much Government control.
- The performance and governance structure of PSB are much weak as compared to Private Banks.
- Lack of Specialised Personnel in the management.

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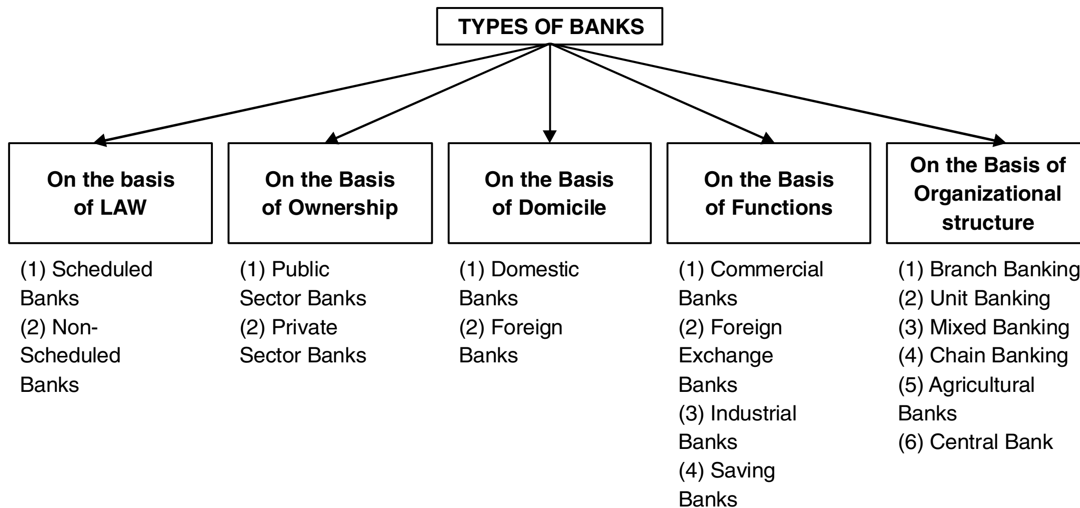
Classification and Functions of Banks

CLASSIFICATION OF BANKS



1) On the Basis of Law

Banks can classify into two categories on the basis of second schedule of the Reserve Bank of India, 1934.

A) Scheduled Banks: A Scheduled bank has been included in the second schedule of the Reserve Bank, and fulfills the following three criteria:

- It must have a paid up capital of at least Rs. 5 lakhs.
- It must fulfill the RBI norms about no activity that may be detrimental to the depositor's interests.
- It must be a Corporation (not a partnership or a single ownership firm).

B) Non-Scheduled Banks: Non-Scheduled Banks are excluded from the Second schedule of RBI. The Reserve Bank does not exercise much control over them, but they report monthly to RBI.

2) On the Basis of Ownership

A) Public Sector Banks: These are banks where majority stake is held by the Government of India or Reserve Bank of India. Examples of public sector banks are: State Bank of India, Corporation Bank, Bank of Baroda and Dena Bank, etc

B) Private Sectors Banks: In case of private sector banks majority of share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. For example: The Jammu and Kashmir Bank Ltd., Bank of Rajasthan Ltd., Development Credit Bank Ltd, Lord Krishna Bank Ltd., Bharat Overseas Bank Ltd., Global Trust Bank, Vysya Bank, etc.

C) Co-operative Banks: People who come together to jointly serve their common interest often form a co-operative society under the Co-operative Societies Act. When a co-operative society engages itself in banking business it is called a Co-operative Bank. The society has to obtain a licence from the Reserve Bank of India before starting banking business. Any co-operative bank as a society is to function under the overall supervision of the Registrar, Co-operative Societies of the State.

As regards banking business, the society must follow the guidelines set and issued by the Reserve Bank of India.

Types of Co-operative Banks:

There are three types of co-operative banks operating in our country. They are primary credit societies, central co-operative banks and state co-operative banks. These banks are organized at three levels, village or town level, district level and state level.

(i) Primary Credit Societies: These are formed at the village or town level with borrower and non-borrower members residing in one locality. The operations of each society are restricted to a small area so that the members know each other and are able to watch over the activities of all members to prevent frauds.

(ii) Central Co-operative Banks: These banks operate at the district level having some of the primary credit societies belonging to the same district as their members. These banks provide loans to their members (i.e., primary credit societies) and function as a link between the primary credit societies and state co-operative banks.

(iii) State Co-operative Banks: These are the apex (highest level) co-operative banks in all the states of the country. They mobilise funds and help in its proper channelisation among various sectors. The money reaches the individual borrowers from the state co-operative banks through the central co-operative banks and the primary credit societies.

3) On the Basis of Domicile

A) Domestic Banks: Domestic/ Indian Banks are those which are incorporated and registered in India. Therefore have their head offices in India. The bulk of Indian banking business is in hands of Indian Banks. Many Indian banks have their branches abroad. Hence their total business comprises business in India and abroad.

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

4) On the Basis of Functions

A) Commercial Banks: Commercial Banks are banking institutions that accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loan to business enterprises. Now-a-days some of the commercial banks are also providing housing loan on a long-term basis to individuals. There are also many other functions of commercial banks, which are discussed later in this lesson.

B) Saving Banks: Saving banks are established to create saving habit among the people. These banks are helpful for salaried people and low income groups. The deposits collected from customers are invested in bonds, securities, etc. At present most of the commercial banks carry the functions of savings banks. Postal department also performs the functions of saving bank.

C) Industrial Development Banks: Industrial / Development banks collect cash by issuing shares & debentures and providing long-term loans to industries. The main objective of these banks is to provide long-term loans for expansion and modernisation of industries. In India such banks are established on a large scale after independence. They are Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI).

D) Regional Rural Banks: Regional Rural Banks are local level banking organizations operating in different states of India. RRBs were established in 1975 on the recommendations of Narsimham Committee. It is followed by Regional Rural Banks Act 1976. RRBs are regulated by NABARD (National Bank for Agriculture and Rural Development) act 1981.

This bank provides credit to small farmers, small enterprises in rural areas. Basically it focused on rural areas. All states in India have RRB except Goa and Sikkim

5) On the Basis of Organisational Structure

A) Branch Banking: Branch banking involves business of banking via branches. The branches are set up under Section 23 of Banking Regulations Act, 1949. A branch should cater to all banking services and include a specialized branch, a satellite office, an extension counter, an ATM, administrative office, service branch and a credit card centre for the purpose of branch authorization policy. The advantage of branch banking is that it helps in better management, more inclusion and risk diversification. The disadvantage of branch banking is that it might encourage outside local influences.

B) Unit Banking: Unit banking is a system of banking which originated in US. It is a limited way of banking where banks operate only from a single branch (or a few branches in the same area) taking care of local community. In comparison to branch banking, the size of unit banks is very small. Due to small size and due to unit structure; the decision making in unit banks is very fast. The management in unit banks enjoy more autonomy and more discretionary powers. However, due to single units, the risk is not distributed or diversified.

C) Mixed Banking: Mixed Banking is the system in which banks undertake activities of commercial and investment banking together. These banks give short-term and long-term loans to industrial concerns. The banks appoint experts which give valuable advice on various financial issues and also help gauge the financial health of companies. Industries don't have to run to different places for differential financial needs. They thus promote rapid industrialization. They may however pose a grave threat to liquidity of a bank and lead to bad debts.

D) Chain Banking: Chain banking system refers to the type of banking when a group of persons come together to own and control three or more independently chartered banks. Each of these banks could maintain their independent existence despite common control and ownership. The banks in the chains were assigned specific functions so there was no loss of profits and overlapping of interests.

FUNCTIONS OF BANKS

The functions of commercial banks are of two types.

A) Primary functions; and

B) Secondary functions

A) Primary functions

The primary functions of a commercial bank include:

a) Accepting deposits; and

b) Granting loans and advances.

a) Accepting deposits : The most important activity of a commercial bank is to mobilise deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

b) Grant of loans and advances : The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies according to the purpose and period of loan and also the mode of repayment.

i) Loans : A loan is granted for a specific time period. Generally commercial banks provide short-term loans. But term loans, i.e., loans for more than a year may also be granted. The borrower may be given the entire amount in lump sum or in instalments. Loans are generally granted against the security of certain assets. A loan is normally repaid in instalments. However, it may also be repaid in lump sum.

ii) Advances : An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further the purpose of granting advances is to meet the day-to-day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

Types of Advances :

Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

a) Cash Credit : Cash credit is an arrangement whereby the bank allows the borrower to draw amount up to a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash Credit is granted as per terms and conditions agreed with the customers.

b) Overdraft : Overdraft is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit may be allowed either on the security of assets, or on personal security, or both.

c) Discounting of Bills : Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonoured on the due date, the bank can recover the amount from the customer.

B) Secondary Functions

In addition to the primary functions of accepting deposits and lending money, banks perform a number of other functions, which are called secondary functions. These are as follows :

a) Issuing letters of credit, travellers cheque, etc.

b) Undertaking safe custody of valuables, important document and securities by providing safe deposit vaults or lockers.

c) Providing customers with facilities of foreign exchange dealings.

d) Transferring money from one account to another; and from one branch to another branch of the bank through cheque, pay order, demand draft.

e) Standing guarantee on behalf of its customers, for making payment for purchase of goods, machinery, vehicles etc.

f) Collecting and supplying business information.

g) Providing reports on the credit worthiness of customers.

h) Providing consumer finance for individuals by way of loans on easy terms for purchase of consumer durables like televisions, refrigerators, etc.

i) Educational loans to students at reasonable rate of interest for higher studies, especially for professional courses.

RATINGS OF BANKS

Credit ratings play a key role in the financial system. A credit rating agency is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default. An agency may rate the creditworthiness of issuers of debt