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REGULATION AND SUPERVISION OF BANKS IN THE CONTEXT OF INDIAN BANKING SYSTEM - AN ANALYSIS

(A critical analysis of the Existing Legal Regime on the Regulation and Supervision of Banks with Specific Emphasis on the role of the regulator in India)

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MASTER OF LAWS

Submitted by

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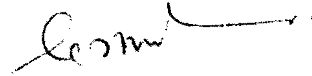
DECLARATION

I hereby declare that this dissertation entitled "Regulation & Supervision of Banks in the context of India Banking System" is the outcome of research conducted by me under the guidance of Dr. N. L. Mitra, Former Director, National Law School of India University, Bangalore.

I also declare that this work is original except for such help taken from such authorities as has been acknowledged at the appropriate places.

I further declare that this work has not been submitted in part or in whole for any degree at any other university.



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REGULATION AND SUPERVISION OF BANKS IN THE CONTEXT OF INDIAN BANKING SYSTEM - AN ANALYSIS

A. INTRODUCTION

Banking constitutes a set of operations, which have a far-reaching impact in the entire financial sector. Where the foundation of banking is shaken, the whole economy shakes along with it. Where it collapses the entire economy collapses. It is in this sector that lot of focus and attention needs to be given. This was realised more so in the wake of crisis in our country and internationally that Ministry of Finance, Government of India had set up a Committee to look into the financial and banking sector reforms. The Committee had suggested needful changes amongst others are the requisite changes that are to be carried out in the existing legal system.

The south East Asian crisis which affected even the 'South Asian Tiger' - Thailand, left the entire Asian market in panic. Those countries, which had gone for full-scale liberalisation, were affected most. The collapse of Barring Bank created a crisis in the financial sector, which had a direct impact on the Singapore economy. One of the reasons that were pointed out leading to such crisis was the absence of an appropriate monitoring by the regulators. The crisis has brought to sharp focus, the importance of strong and vibrant financial systems, of which banks are an integral part. The role of the regulators and supervisors have been questioned and criticised for their laxity leading to such crisis.

Last decade has seen a lot of changes, nationally and internationally in the financial sector. The liberalisation programme was announced in the early 1990's throwing open the economy in a partial way. Also around the same time the stock

market scams were unearthed which had affected the entire financial sector. Among the most affected were the small investors and depositors. The main culprits in the financial scam were brokers, bankers, financial institutions, who had manipulated the market in the absence of an appropriate regulatory framework in the country. Though this scam was a partial set back to the liberalisation process in terms of building confidence in the market as well as the investors, the Government took adequate steps to strengthen the market. The need for an appropriate legal environment was felt so as to empower the regulators in the financial markets in taking appropriate decisions and also to plug the loopholes in the system.

B. FRAME WORK

Banking system requires a legal system that facilitates the enforcement of financial contracts. The regulation aims at strengthening the factors that determine the soundness of a banking system viz., the operating environment, bank system and procedures, internal control and market discipline by laying down suitable guidelines. Regulation by itself does not become effective unless an adequate supervisory system is also put in place. Supervision mainly involves ensuring compliance with the regulatory rules. It also encompasses the process of maintenance and vigilance over developments in the market, their likely impact on banks and adoption of suitable remedial steps.

The rational behind regulation may vary from one part of the globe to another as different economies have inherently different features. Contemporary arguments for the regulation of banking are not on the functions of banks but on their ability to overcome important informational asymmetries. Traditionally, the need to supervise banks and financial institutions has been accepted on the grounds of the particular nature of activities of banks. There can be regulation by some public

authority, self-regulation, or regulation within a statutory framework. Many reasons have been given to justify the need for regulation.

Structural regulation is needed in order to enhance the stability of the key elements of the banking system. Some of the elements of structural regulation would include the establishment of measures of capital adequacy and risk on portfolio investments, deposit insurance schemes and the enforcement of regulatory standards for disclosure of information etc. There are approaches to the structure of regulation.

In the institutional approach, regulation is directed at financial institutions irrespective of the mix of business undertaken by them. Different regulation applies to different types of institutions and specialist regulatory agencies are responsible for different types of financial institutions. This approach is particularly appropriate when considering prudential issues, which must necessarily focus on institutions because after all, it is institutions and not functions that become insolvent.

Functional regulation focuses on the business undertaken by the institutions irrespective of which institutions are involved. This approach requires specialist functional regulators. The distinction between functional and institutional regulation is of little importance when financial institutions are specialised in narrow business areas, for then functions and institutions are co-extensive. Thus, regulating banks would be the same as regulating the banking business and so on. When, however, financial institutions are diversified, the distinction between function and institution becomes more complex.

Regulation of banking sector encompasses laying down two distinct sets of rules. One covering the structure of the market entry, restriction on diversification into certain arenas and the other relating to the conduct of business like how financial

intermediaries execute their deals. Regulations from the perspective of fairness, seeks to ensure level playing field for all market players, allowing the market forces and efficiency of individual players to determine growth. It aims at creating a competitive financial system, by preventing the undue concentration of banking resources, which may be anti-competitive in nature, yet allowing banks to alter their product mix and delivery system to meet economic and market needs.

Regulations may take the character of formal or informal regulation. A formal regulation consists of written rules to be used as benchmark, the informal regulations comprise of the advisory exhortations of the regulator about the proper financial practices to be adopted. Thus regulations assume great significance in an open economy.

C. PROBLEM DEFINITION

The case for regulating bank rests on two propositions: The first is that banks are central to the smooth functioning of an economy: widespread failures amongst banks could seriously disrupt other sectors of an economy. Second is that they are vulnerable to many risks.

There is no financial or banking system anywhere in the world that is unregulated. In most countries central bank play as a regulator and supervisor of financial and banking systems and they play an important role in an economy's functioning and also the responsibility for ensuring the safety of funds committed by depositors in financial institutions. The primary goal of any supervisor or regulator to maintain the safety and soundness of the banking system, which involves both at the micro and macro level.

The challenges that are faced by the regulator in India are the same as faced elsewhere. In this regard, the regulatory measures has important lessons for India. There were various committees set up to review the regulatory and supervisory arrangements in India. One such important committee that has looked into this area was under the chairmanship of Shri Narasimham. The Narasimham Committee Report II has raised serious concern about the regulatory and supervisory aspects of banks. The Committee had emphasised the need for proper system and had recommended the changes under the present law governing banks in India.

In this connection, a review of international experience has been made which shows a multitude of cases where the explanation for bank and the measures adopted to overcome such failures in the system. The Committee on Banking Supervision has laid down 25 core principles that each country can adopt in order to have the best practices in the banking sector.

With the onset of the globalisation programme more cross border operations are being performed. These operations could be possible only when the legal framework such as the entry norms, prudential guidelines etc. are at par with the domestic players and are also in tune with the international standards. This has led to wide spread competition. In India too, the business of banking has become more competitive with the entry of foreign players. This necessarily has mandated the need for analysing the present legal framework and removes the grey areas, if any, so as to have uniformity and certainty in the legal system as is present elsewhere.

The role of regulators has come to criticism in the wake of various failures and scams. There are problems that are faced by the regulators of bank say in the area of co-operative sector where there is duality of control. In some countries there are

separate bodies for regulation and supervision. While Reserve Bank of India (RBI) is the sole regulator and supervisor of banks in India, the failures in the past have put a question i.e. should there be a separate agency for supervision so that RBI could concentrate on the regulatory and monetary management in the country.

The concern raised by the Narasimham Committee mentioned herein above for a sound banking system, is the need of the hour. No reforms will take off unless there is a sound and healthy legal and regulatory framework in the system. There are hosts of laws that governs the Indian banking system most of which are archaic need to be either done away with or updated or consolidate into one single code.

With the bank diversifying its business they may come under the jurisdiction of different regulators. Information sharing among different regulators and close co-operation between them are also equally important for taking appropriate decisions. In this regard the questions as to whether there should be a regulator among the regulators or in other words, a mega regulator or super regulator as this may reduce the possibility of any overlap and other information that may be needed for this purpose.

In order to examine the aforesaid aspect most of which are closely related to the regulatory and supervisory aspects of banks, the following research questions have been framed which are as under:

1. Who should be the regulator/s in a banking sector?
2. What should be the role of regulator and supervisor?
3. What method that one needs to adopt to regulate a bank?
4. Can there be a multiple role for a regulator?
5. What are the international experiences in the banking sector reforms?
6. Is the present banking system or law adequate to take care of the changes to become universal banking?

7. In the context of so many laws governing the banks, is there a possibility of having a one single code for better regulation? If not so, what changes should be made to the existing law?

Analytical study has been made from various literatures and Internet sources. Literatures include books, journals and committee reports. A uniform mode of citation is followed in this paper, which are as follows:

ARTICLES :

Surname, name of the author, *name of the article*, Year,Vol.(No.), Name of Journal, Page number

e.g. Bhalla,A.S., *Collapse of Barring Bank: Case of market failure*, 1995 Vol..30 (13) EPW 658

BOOKS :

Name of the author, **Name of the Book**, Edition, Vol. No., Name of the Publisher : Place, Year

e.g. Tannan's, **Banking Law and practice in India**, 19th edn. Vol.1, , India Law House: New Delhi, 1997

COMMITTEE REPORT:

Name of the Chairperson, Name of the Report, Year

e.g. M. Narasimhan, Report of the Committee on the financial system, 1991

URLs :

Name of the article, Name of the author, URL address

e.g. The future of banking supervision, Jerry L.Jordan, www.cler.frb.org/ccca/jorlando.htm

CHAPTER 1

MODELS IN REGULATION AND SUPERVISION

Banks play a vital role in economic life and the continued strength and stability of banking system is a matter of general public concern. Banks hold the savings of the public, provide a means of payment for goods and services and finance the development of business and trade. To perform these functions securely and efficiently, individual banks must command the confidence of the public and those with whom they do business. The stability of the banking system, national and international, has therefore come to be recognised as a matter of general public interest which are subject to supervision of their financial soundness (usually referred to as prudential supervision) by central banks.

1.1 Why Regulate Financial services?

The rational behind regulation may vary from one part of the globe to another as different economies have inherently different features. For example in Latin American countries, the level of institutional and economic development and the volatility of their economies have influenced the need for and nature of banking regulation. Also it is seen that banking crises are generally preceded by macroeconomic shocks that cause deterioration in the quality of bank assets and a loss of funding[1].

Contemporary arguments for the regulation of banking are not on the functions of banks but on their ability to overcome important informational asymmetries[2]. Traditionally, the need to supervise banks and financial institutions has been

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[1] The economic breakdown of Argentina is a classic example to this effect.

[2] Banks arise to mitigate informational asymmetries in lending, where the borrower knows more about the uses of the loan than the lender. The asymmetries between borrower and lender lead to problems associated with moral hazard and adverse selection that may limit the scope of direct lending. Moral hazard happens

accepted on the grounds of the particular nature of activities of banks. There can be regulation by some public authority, self-regulation, or regulation within a statutory framework. Many reasons have been given to justify the need for regulation[3].

Structural regulation is needed in order to enhance the stability of the key elements of the banking system. Some of the elements of structural regulation would include the establishment of measures of capital adequacy and risk on portfolio investments, deposit insurance schemes and the enforcement of regulatory standards for disclosure of information etc[4].

1.2 Models of regulation or supervision

There are three broad approaches to the structure of regulation: institutional, functional and objective[5].

In the institutional approach, regulation is directed at financial institutions irrespective of the mix of business undertaken by them. Different regulation applies to different types of institutions and specialist regulatory agencies are responsible for different types of financial institutions. This approach is particularly appropriate when considering prudential issues, which must necessarily focus on institutions because after all, it is institutions and not functions that become insolvent.

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due to some bad judgement on the part of the bank which is at risk of being run over thereby affecting the depositors.

[3] Some authors have pointed out externalities and market power as sources of divergence from the competitive ideal: First of all, the gearing or leverage incurred by banks in financial intermediary operations is extremely high compared with that of companies. Secondly, the role of banks as intermediaries between depositors and borrowers causes the term structures of assets and liabilities to be generally mismatched, with assets tending to have a longer maturity than liabilities.

[4] The future of banking supervision, Jerry L.Jordan, www.cler.frb.org/ccca/jorlando.htm visited on 02.07.2000

[5] Banking Supervision and Regulation, http://minneapolisfed.org/banking/regs/ visited on 28.06.2000.

Functional regulation focuses on the business undertaken by the institutions irrespective of which institutions are involved. This approach requires specialist functional regulators. The distinction between functional and institutional regulation is of little importance when financial institutions are specialised in narrow business areas, for then functions and institutions are co-extensive. Thus, regulating banks would be the same as regulating the banking business and so on. When, however, financial institutions are diversified, the distinction between function and institution becomes more complex.

Regulation by objectives is focused on regulation based on the objectives being sought, with institutional structure following as a consequence.

The problem with the purely institutional approach is the issue of competitive neutrality (different institutional regulators may adopt different functional regulation for the same activity), and the issue of socially wasteful duplication (of regulation of the same functions that are carried out by different institutions and hence regulated by different bodies).

The obvious problem with a purely functional approach is that the position of the institution as a whole may be obscured, especially with respect to overall risk and solvency, because no agency is clearly responsible for prudential management of the institution as an entity.

In practice, a matrix approach is needed when financial institutions conduct a wide range of business. Institutions need to be regulated both on a functional basis for conduct of business purposes and on an institutional basis for prudential reasons. Even if a single agency is responsible for both functional and institutional regulation and supervision, the matrix approach still applies. The specialist divisions between the single agency need co-ordination, just as co-ordination is needed between different agencies in the absence of a mega or super regulator. The basic problems of information sharing consistency and co-ordination apply

equally between specialist divisions of a single agency as between different agencies.

1.3 Meaning of Regulation and Supervision

Although the term 'regulation' and 'supervision' are often inter-changeably used, they actually refer to distinct, but complementary activities. Regulation is the formulation and issuance by authorised agencies of specific rules or regulations, under governing law, for the structure and conduct[6]. These laws and regulations establish a framework for behavior that foster the maintenance of a safe and sound system and the fair and efficient delivery of services. Supervision is concerned primarily with the safety and soundness and involves general and continuous oversight to ensure that banks are operated prudently and in accordance with applicable statutes and regulations.

The words “regulation” and “supervision” have often been interchangeably used. But these two words have difference as far as the meaning and the functions are concerned. In this regard it would be pertinent to be clear as to the meaning and the distinction between the two are clearly spelt out.

The word regulate has its origin in Latin word ‘Regulatus’ which means to control, govern, direct according to rule or a principle or a system.

Blacks Law Dictionary has defined the word regulate as “ To fix, or control; to adjust by rule, method, or established mode; to direct by rule or restriction; to subject to governing principles or laws. Regulate means to govern or direct according to rule or to bring under control of constituted authority, to limit and prohibit, to arrange in proper order, and control that which already exists.” The word regulation has been defined as “The act of regulating; a rule or order prescribed for management or government; a regulating principle; a precept, Rule

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[6] ibid at p.1

of order prescribed by superior or competent authority relating to action of those under control. Regulation is rule or order having force of law issued by executive authority of government."

Regulation is defined in the **American Heritage Dictionary (1992)** as "a principle, rule, or law designed to control or govern conduct" whereas supervision mean, "to have the direction and oversight of the performance of others". In the context of banking these represent the changes in central bank approaches since deregulation. Under regulation, banks were subject to rules that governed their decision making, effectively making the regulators the bank managers.

The **Dictionary of Finance** defines regulation as actions that 'command and control' the individual decisions of firms, in an effort to prevent private decision-making that would take inadequate account of the 'public interest'. Regulation may be self-imposed, or, as is usual, by a third party. The Government may intervene in a market or industry in the form of law, administrative rules, taxation or moral suasion. Self-regulation could be imposed through industry associations and codes of conduct.

The regulatory framework will shape market behaviour. Therefore, the design and practice of the regulatory framework determines the efficiency and performance of the regulated market.

Supervision has been defined as an act of occupation of supervising inspection.

1.4 Distinction between Regulation and Supervision

Jurisprudentially, regulations can be related as an *a priori* concept and supervision as an *a posteriori* concept.

Regulation is prescriptive and futuristic in nature but supervision is a diagnostic post-facto exercise. Regulation provides for prescription but supervision presupposes checking of realities with expectations or prescriptions[7].

Regulation address to entire system but supervision address to procedural aspects. Regulation provides for framework of rules, which facilitates development and adoption of various policies, procedures and documentation. Supervision entails assessment of compliance of laid-down rule, procedures and practices. Regulation confines to making rules, supervision is checking of adherence to rules. Outcome of regulatory compliance checking is attained through 'examination' whereas supervisory exercise can be termed as 'inspection' or 'audit'[8].

Regulation can be categorised into preventive and protective regulation. The example of preventive regulation include branch licensing, capital adequacy requirement, limits on Forex exposures, permissible business activities, limits on loan concentration, liquidity prescriptions etc. Protective regulations include deposit insurance, facility as lender of last resort and emergency measure for bailing out weak banks. Supervision cannot be categorised as preventive and protective as that of regulations[9].

Supervision is micro economic in nature, whereas regulation reflects the macro economic posture of the Central Bank. Supervision has a wider macro-economic support when it traverses on issues at systemic level and in the interest of enforcing market discipline. Regulation would then be termed as the framework of policy, while supervision, as the instrumentality of ensuring compliance of the regulatory prescription through both on-site and off-site supervision[10].

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[7] FRB Minneapolis Research Archive, Bank Regulation, http://minneapolisfed.org/research/qr/qr113.html visited on 02.07.2000.

[8] Future of Bank Regulation/supervision, www.cbs.curtin.edu.au/UNITS/EF/BankMgmt/student.updates/futurebankreg.htm visited on 30.06.2000

[9] ibid at p.2

[10] ibid at p.2

1.5 Objectives of regulation and supervision

The fundamental or core objectives of regulation and, as a corollary of supervision could be categorised under the broad canvas of stability, efficiency and fairness. The success of regulation lies, to a great extent in the ability of regulators to contrive a sound and efficient regulatory framework, which has the capability of steering the financial system on safe and sound lines, so that the benefit derived would far outweigh these costs. The primary objective of regulation is to ensure the stability of the financial institution by the solvency and liquidity and thus, protect the interests of the depositors[11]. The presence of regulator protects against risks, helps building confidence on a sustainable basis. Regulation from the perspective of fairness seeks to ensure level playing field for all the market players, allowing market forces and efficiency of individual players to determine growth. It aims to create a competitive financial system by preventing undue concentration of banking resources, which may be anti-competitive in nature. It allows banks to alter their product mix and delivery systems to meet the economic and market needs[12].

Regulation seeks to protect the efficiency and integrity of the clearing and payment mechanism, ensuring speed; accuracy, efficiency, interest cost and settlement[13]. The regulation improves the overall efficiency of the banking operation thereby protecting the economic growth. The regulatory system with the dominant objective of depositor protection and the role of 'the lender of last resort' may sometimes unintentionally encourage participants to embark upon unbridled risky business propositions.

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[11] *Supra note 5* at Pp.1-3
[12] *supra note 8* at p.3
[13] Global Financial Crisis: Implications for banking and regulation, www.worldbank.org/html/extdr/exlme/jsst050699.htm visited on 02.07.2000

There are two objectives for regulation of banks[14] :

1) The protection of depositors, and

2) The maintenance of stability in the financial system.

However, the aspect of full deposit protection cannot be the sole objective of regulation. In the event of any bank failure it will be upon the supervisor who had failed to monitor the bank.

There are various risk involved in transacting business of the bank and unless there is an effective risk control mechanisms which eliminates any possibility of loss to a bank or its depositors it attributes an inadequate management. So here the role of the regulator comes into play. The regulator should take some initiative to present any further collapse of the banks. So in the event of any banks facing crisis, everything possible would be done to protect the bank's business and also to ensure that the depositors suffer no loss. The focus of the regulator should be not to eliminate all the risk in the financial system but on the 'systemic risk' that one failure could lead to others rather than presenting the failure of any particular bank[15].

Deposit protection creates its own problems for regulations. Regulations seeks to impose discipline and prudence on management with the object of banking supervision, namely to prevent failures and thereby protect the stability of the financial system and depositors in the short term. Availability of deposit protection may encourage banks to undertake more risky activity, which is referred as 'moral hazard' argument[16].

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[14] Adapting Bank Regulation to a changing financial environment, Thomas M.Hoeing, www.kc.frb.org/spch&bio/bankreg2.txt visited on 01.07.2000

[15] The stability of banking system, www.fiet.org/Bank/TSMstabilityofbanking.htm visited on 28.06.2000

[16] ibid

It is possible to distinguish three broad categories of regulation and supervision: systemic, prudential and conduct of business[17].

Systemic supervision takes a broader view of the economy than merely the undertakings of individual institutions. Such supervision is focused on the health and ability of financial systems to withstand shocks, with special regard to the likely impact of financial disturbances on the economy as a whole. In practice, this area of supervision is essentially the domain of central banks, given their knowledge of the macro-economy, financial markets and payment systems and their ability to assist in managing threats to systemic stability.

Prudential supervision, on the other hand, examines the health of individual financial institutions. In other words, such supervision places explicit emphasis on analyzing the balance sheet of individual institutions, especially with regard to their compliance of certain broad parameters (e.g., capital adequacy, asset classification and provisioning norms, credit concentration norms, etc) as laid down by the regulatory authorities. The aims of prudential supervision can be seen as both consumer protection and reducing the threat of spill-over effects on the larger economy. The latter concern is especially relevant for the larger financial institutions.

The final type relates to the *conduct of business regulation.* In other words, it seeks to examine how financial firms carry out business with their customers. It is focused more on aspects of consumer protection, such as information disclosure, honesty, integrity and fair business practices. Conduct of business regulation sets rules and guidelines as to appropriate behaviour and business practices when dealing with customers.

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[17] *Supra note 8* at p.3

1.6 Preconditions for effective Banking Supervision

An effective system of banking supervision should have a clear responsibility and objective for each agency involved in the supervision of banking organisation. Moreover, in order to make it more effective these agencies should possess operational independence and adequate resources[18].

Banking supervisions must have the authority to reject any proposals to transfer significant ownership or controlling interest in existing banks to other parties. Banking supervisors must have the authority to establish evidence for reviewing major acquisitions or investments by a bank and to ensure that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision[19].

An essential part of any supervisory system is the evaluation of the bank's policies, practices and procedures related to granting of loans and making of investments and the ongoing management of the loan and investment portfolios. Banking supervisors must be satisfied that banks establish and adhere to adequate, policies, practices and procedures for evaluating the quality of assets and the adequacy of provisioning of bad debts. Banking supervisors must be satisfied that banks have Management Information Systems that enable management to identify concentrations within the port folio, and supervisions must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers[20].

In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arms length basis, and that other appropriate steps are taken to

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[18] *Supra note 5 at p.3*
[19] *Supra note 8* at Pp.4
[20] *Supra note 14* at p.5

control or mitigate the risks. An effective banking supervisory system should consist of some form of both on-site and off-site supervision. Banking supervisors must have an effective contact with bank management and thorough understanding of the institution's operations.

Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a consolidated basis[21]. Banking supervisions must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting methods, standards and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business.

Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet the prudential requirements (such as a minimum capital adequacy ratio), when there are regulatory violations or where depositors are threatened in any other way.

1.7 Need for Supervision

The reasons for supervisory intervention in the banking system, and in the financial system more generally, can be summed up as promoting financial stability and minimizing systemic risk. This is a broad mandate. One that encompasses the responsibility to ensure that markets operate in a fair, transparent and efficient manner, and that participants/players shall comply with the rules of the game.

Supervisors bring a number of comparative advantages. First, supervisors have clear perspective to monitor risks to the financial system as a whole. Second, supervisors are able to obtain and monitor proprietary information about an

institution's risk exposures, its management information systems and its internal controls when such information is not publicly disclosed. Third, supervisors are in a unique position to observe trends across groups of financial institutions and, based on these insights, to provide the industry with a perspective on what constitutes best practice. Fourth, supervision is needed to enforce compliance with applicable laws and regulations. The violations, if any, can threaten the well being of a financial institution and carry the potential for systemic risk and finally, supervisors are able to assure that prompt corrective actions (PCAs) are taken when serious financial or other problems are identified, particularly if the problems are not known to the market[22].

1.8 The role of the banking supervisor

From a broad perspective, there are a number of critical elements to effective banking supervision such as independence, availability of accurate information, public, industry and political acceptance, skilled personnel and appropriate legal and regulatory framework. The customary role of the supervisor, and one that is often written into statute, is to protect the interests of depositors of the bank. In practice, however, this role has increasingly combined with a wider duty to safeguard the soundness and stability of the banking system[23].

The supervisor is primarily concerned with the stability of the bank in order to protect the interests of the depositors. Therefore, he monitors its present and future viability and uses financial statements to assist in assessing its developing

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[21] At present there is no law whereby the banks should prepare the statement on a consolidated basis. Section 212 of the companies Act,1956 mentions the annexing of the balance sheet of the subsidiary in the holding company.

[22] Ibid at Pp.4-5

[23] In some countries, supervision may also be directed towards ensuring compliance with monetary or exchange rate policies. However, in this Statement the focus is on the prudential aspect of the supervisor's role.

activities. The supervisor is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the bank's business.

CHAPTER 2

APPROACHES TO REGULATION AND SUPREVISION OF BANKS

2.1 Approaches to regulate and supervise banks

There are variety of approaches and control to regulate and supervise banks with regard to maintaining its safety and soundness and maintaining confidence in the banking system as a whole. Broadly, there are three main techniques that are adopted by the regulators and supervisors. These are :

(a) Preventive regulation, designed to limit risks incurred by banks;

(b) Protective regulation, designed to protect the interest of the depositors in the event of any bank failure(deposit insurance protection); and

(c) Support provided by the monetary authorities/central banks in meeting the liquidity difficulty faced by banks (lender of last resort).

2.2 Regulatory and Supervisory approaches

The regulatory and supervisory arrangements adopted generally by countries broadly are as follows[24] :

(i) Entry level norms : In almost all countries, regulation begins at the entry level. The banks must satisfy various requirements viz. capital requirement, minimum subscribed capital, asset criteria. There are different levels of entry norms for foreign banks having their business outside their country[25].

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[24] Richard Dale, **The Regulation of International Banking**, Cambridge: Woodhead, Faulkner, 1984. At Pp.53-70

[25] Countries like Canada, U.K., Hong Kong and Singapore requests for Letters of Comfort from foreign banks wishing to establish subsidiaries. Although these Letter of Comfort are not legally binding but in

(ii) Licencing: The ultimate power on which the authority of most regulators is based is the power to authorise or license an entity to conduct a banking business and to withdraw such authorisation or licence. In order to qualify for and to retain a banking licence, entities must observe certain prudential requirements. These requirements may differ from country to country in their precise specification; some may be closely defined in regulation and others may be more broadly drawn, allowing the supervisory authority a measure of discretion in their interpretation.

Failure by a bank to observe the various conditions or requirements for authorisation will provide grounds for the supervisor to consider withdrawing the licence. But withdrawal of a licence, effectively terminating the business, may well result in liquidation of the bank and, therefore, is to used only when it is clear that no other possibilities for corrective action remain. As a less drastic procedure, in order to remedy the weaknesses, supervisors generally have powers to issue formal directives to a bank requiring it to take action to strengthen some aspect of its business, for example, by infusing additional capital or improving internal controls[26].

(iii) Capital Adequacy: One of the main pillars of prudential supervision is capital adequacy. In most countries there are minimum capital requirements for the establishment of new banks and capital adequacy tests are a regular element in ongoing supervision. The definition of capital may differ from one country to another[27]. Capital adequacy may or may not be assessed on

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some instances they have had the force of law. In Germany foreign banks have to provide binding letters of indemnification from their parent institutions in respect of any payments that may be made by the German Deposit Protection Fund to the subsidiaries depositors.

[26] It is seen in the recent past especially with regard to the public sector banks that recapitalisation bonds have been issued to infuse capital in the bank.

[27] Capital adequacy is measured in most countries by comparing the capital resources of a bank with its total assets and off-balance-sheet engagements, weighted to reflect the relative risk inherent in the various categories of assets or off-balance-sheet items. The supervisors in terms of the recommendations of the

a world wide consolidated basis, although the general trend is towards consolidation. As regards the foreign banks, some host countries treat branches of foreign banks as separate entities for capital adequacy purposes, whereas other treats them as one and the same.[28] In addition to a stipulated minimum amount of capital, banks are generally required to maintain an appropriate relationship between capital on one hand and total assets, risk assets or liabilities on the other. More detailed requirements are often prescribed, including minimum ratios for capital adequacy and liquidity. Whatever be the precise form of the regulations, their objective is to set conditions to ensure that banks' management in conducting their business prudently and have adequate financial resources to overcome adverse circumstances and protect the interest of the depositors.

(iii) Risk analysis: Banks are subject to a variety of risks. The most significant of these is credit risk - the risk that a borrower will not be able to repay his loan when due. It is not the supervisor's role to direct banks' lending policies but he has an interest in seeing that banks have effective credit review procedures which are applied consistently. He also seeks to ensure that credit risk is adequately diversified by means of rules to limit exposures, whether in terms of individual borrowers, industrial or commercial sectors or particular countries. Supervisors also seek to monitor and limit a range of other banking risks, such as liquidity and funding risk, interest rate and investment risk, foreign exchange risk and off-balance-sheet risk. Increasingly, supervisors are attempting to develop systems of measurement, which will capture the extent of exposure to specific risks.

Basle Committee have agreed these methods on capital adequacy. For some of the major international banks the members of the Basle Committee have agreed that a minimum standard for this ratio of 8% should apply. Capital is also often used as a standard against which to measure or to limit the risks inherent in the types of transactions undertaken by banks.

[28] Countries like Hong Kong, Italy, Japan do not formally regulate capital adequacy as essential element.

These systems often form the basis for specific controls or limits on the various categories of exposure.

(iv) Asset valuation and provisioning: One of the most important determinants of a bank's stability, though one of the most difficult to assess, is the quality of its assets[29]. It is therefore essential for the supervisor to be satisfied that adequate provisions have been made more specially with regard to bad and doubtful debts. While the correct valuation of assets is the primary responsibility of management, it is often a matter of judgement and supervisors seek to satisfy themselves that this judgement is properly and reasonably exercised.

(v) Management : The primary responsibility for the conduct of the business of a bank is vested in the board of directors and management appointed by it. This responsibility includes ensuring that:

- those entrusted with managing the affairs of banking are professionally competent;
- proper control systems exist and are functioning;
- the operations of the bank are conducted with due regard to prudence taking into account the interest not only of the shareholders but also of the depositors and other creditors are adequately protected; and
- all the statutory and regulatory directives/ guidelines are observed and complied with.

[29] Accurate and prudent valuation of assets is of great importance for supervisors because it has a direct bearing on the determination of the amount of net assets held by a bank and the amount of shareholders' equity (capital plus retained earnings).

Management is responsible for preparing financial statements in accordance with the law[30]; and such statements must give "a true and fair view" of the bank's financial position and the result of its operations in accordance with generally accepted accounting standards/methods/principles as they apply to banks. This responsibility ensures that the auditor who examines and reports on such statements is provided with all necessary information that can materially affect the financial statements and consequently his opinion thereon. The management also has the responsibility to provide all information to the supervisory agencies, which such agencies are entitled by law or regulation to obtain. The information provided to supervisory agencies normally includes the financial statements, which are often used by supervisors in their appraisal of the financial condition of the bank. Supervisors are concerned to ensure that accounting records are properly maintained and that standard accounting procedures are followed so that the whole banking operation is effectively and efficiently handled which will further enable the management to monitor, control and plan future course of action. This would also ensure that possibility of frauds by its staff is reduced.

Management is also responsible for the establishment and the efficient operation of an internal audit function in a bank appropriate to its size and to the nature of its operations. This function constitutes a separate component of internal control undertaken by specially assigned staff within

[30] Section 211 of the Indian Companies Act, 1956 states that the accounts must be true and fair. Section 2 of the Banking Regulation Act, 1949 states that the provisions of the BR Act are in addition to and not in derogation of the Companies Act, 1956. Where the provisions of BR Act is silent the provisions of the Companies Act would be applicable to the banking companies. One of the essential criteria for a bank to carry on the business of banking is that it must be a company registered under the companies Act, 1956. Sections 7 B.R.Act, 1949 prohibits the use of the name bank, banker, banking or Banking Company by any firm or individual other than the banking companies. The Reserve Bank of India under Section 22 of the B.R.Act, 1949 grants licence to a company to carry on the business of banking. A distinction is made between a co-operative bank and other banking company in the sense that a co-operative bank is registered

the bank with the objective of determining whether, amongst other things, internal controls are well designed and properly operated. Management is responsible for ensuring that the internal audit function is adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities and who report to top management, and that timely and appropriate action is taken on their findings[31].

These responsibilities of the management are in no way diminished by the existence of a system for the supervision of-banks by central banks by a requirement for a bank's financial statements to be subject to audit by independent auditors or any special auditors appointed by the supervisory agencies.

(vi) Inspection: The supervisory methods/techniques on inspection and the degree of reliance placed on one or the other will vary from country to country. In essence, there are two main techniques, adopted by the supervisors viz. (i)on-site examinations; and (ii) the collection and interpretation of information and other statistical data.

In some countries, examination techniques tend to concentrate on the quality of the loan assets and the documentation supporting them and the adequacy of internal controls set by management. In other countries, examination focuses not only on loan assets but also on other types of exposure referred above. Where loan quality classification systems are in use, the inspectors will routinely examine a sample of loans to check whether they have been correctly classified. Inspecting officers will also

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first as a society under the respective State societies Act and moreover the provisions applicable to a co-operative bank are contained in Part V of the B.R.Act, 1949.

[31] A theory of bank regulation and management compensation, www3.oup.co.uk/revfin/hdb/volume_13/issue_01/130095.sgm.abs.html visited on 28.06.2000

pay attention to policies with regard to provisions for bad and doubtful debts and will judge whether provisions are adequate in the light of the perceived quality of the loan-book. In the case of banks with wide-ranging activities or complex networks, attention will also be focused on the extent to which control is exercised and the risk managed. In special circumstances, where the supervisory authority is already aware of particular problems, the examination would be more narrowly focused.

(vii) Audit: The examination of information (including the audited statement of accounts) and statistical data is less costly and the expense is shared more evenly between the banks (whose own internal information systems must be adapted to provide data) and the supervisory authority (which is responsible for designing the returns and interpreting the data). The reporting returns will normally provide a detailed breakdown of the composition of the balance sheet (including off-balance-sheet items) and of the profit and loss account. The information should, in principle, be sufficient to enable the supervisor to form a view of a bank's exposure to the various categories of risk.

Examination of the information and the data submitted at regular intervals allows the supervisor to monitor developments of the banks in a more frequent and timely manner than is the case with on-site inspection. However, these information and data have certain limitations that they are generally designed for completion by the banking system as a whole and may not capture adequately new types of risk or the particular activities of an individual institution, their usefulness in providing early warning to the supervisor depends on the quality of banks' own internal information systems and the accuracy with which the returns are completed; and even

with reliable, comprehensive data, experienced judgement is needed to interpret the results.

The concern of the auditor, is primarily with reporting on the financial position of the bank and on the results of its operations. In doing so, he also considers the bank's continuing viability (generally for a period not to exceed one year from the balance-sheet date). The auditor, in most situations, is concerned with the assessment of internal control to determine the degree of reliance he can place on the system in planning and carrying out his work; and the auditor is also concerned to obtain assurance that the accounting records from which financial statements are prepared have been properly maintained. On the basis of this information the supervisor is able to have a proper assessment of the bank and is able to take proper action in the interest of the bank.

Supervisors should continue to develop a more dynamic, risk-focused and process-oriented framework, reflecting the reality that banks and other financial institutions are increasingly able to alter their risk profiles at will. By "risk-focused" means that supervisory resources should be directed at the most material risks to which the institution and its capital are exposed, given its array of business activities. By "process-oriented" means that examiners and auditors should ascertain whether management processes and methodologies are sufficiently rigorous and effective, given the institution's identified risks. Institutions that demonstrate a sound control structure and effective management processes should be subject to less intrusive supervision than institutions that do not have this essential infrastructure in place[32].

[32] Speech by *Patricia J. Lerner*, Regional Director or US Agency for International Development Regional Services Center for Europe and the New Independent States, Budapest, Hungary

CHAPTER 3

ROLE OF CENTRAL BANK IN REGULATION AND SUPERVISION

3.1 The Role of the Central Bank

One of the fundamental responsibility of the Central Bank is to ensure monetary and financial stability in the country. Broadly, Central Bank has these two core objectives i.e. (i) Monetary stability, which involves stabilising the price level and the value of currency and (ii) the stability of financial markets, which has to do more with the institutions in the financial sector, the players, the structure and infrastructure of the financial markets and prices[33]. In order to implement the two objectives, Central Banks conduct range of functions, including that of supervision and regulation of banks. These functions have a direct impact on the financial market stability.

There is a possibility of a conflict between monetary policy objectives and concern about the stability of the banking system. The Central bank concentrates on tightening its policies adopting certain measures e.g. interest rates which have implications on the banking system as a whole. Therefore, the question that arises is whether or not monetary policy and regulation of banks be kept separate. The main function of the Central Bank ought to be that of laying down monetary policy rather than regulation and supervision of banks[34].

[33] Article by LARRY PREOMISEL in Robert C.Effros (editor), **Current Legal Issues Affecting the Central Banks**, Vol.4, International Monetary Fund : Washington, 1994 at Pp.307-309

[34] In some countries the regulation of banks is done by a separate authority other than that of the Central Bank. Central Bank concentrates on laying down monetary policy., The separate institutions for regulating and supervising the banks or monetary policy need not be universal. It may vary from country to country depending on their financial system and also the expertise needed to formulate and implement such objectives. However, the author is of the view that it would be desirable to have separate of monetary policy and regulation or supervision of banks since it undertakes function as that of a player instead of being a referee.

One of the other broader functions of the Central Bank is the management of the payment system[35]. The Central Bank at time provides credit for certain intra-day activities undertaken by the commercial banks. The Central Bank holds balances of these commercial banks and often transfers these balances from one account to another. Since the Central Bank has an infinite liquidity available with it and has a lesser or nil credit-risk, it offers certain degree of certainty to the financial system. It is beneficial for the financial system that Central Banks play a key-role in supervising such system. Since it knows the participants and is able to extend credit on very short notice and can take appropriate measures to maintain balance in the system. This would ensure maintenance of certain standards and principles that provides stability and certainty to the system.

The lender of last resort function is one of the key objectives of any Central Bank. It extends liquidity support to a bank that is in trouble. For this, it may adopt certain measures such as setting the discount rate and the other terms and conditions of the liquidity support.

One of the strongest arguments for the role of Central Bank is crisis management. Central Banks are necessarily involved in reducing systemic crisis and taking prompt action to rectify the same. The systemic crisis can arise from disturbances to financial market, political and legal uncertainties, economic slow-down, etc. The Central Banks involved in providing enough liquidity to deal with such systemic crisis. It has adequate information and experience to tackle such a crisis.[36]

There are those to argue for having an independent agency to supervise banks. One of the arguments is in the best interest of the depositors' safety and bank's

[35] Management of payment system may vary from country to country depending upon their financial system.

[36] In this context it would be seen that many banks are international in nature. A disturbance is much more likely to arise from the activities of a large, international bank than from a small bank, or even a large domestic bank, the likelihood of such disturbances that might spread from one country to another may develop into a global crisis.

efficiency and stability. Thus, it would be free for the Central Bank to concentrate on its main / core function i.e. monetary policy.

One of the main objective of banking supervision is that it must ensure the stability of the banking system, maintain the banking system's ability to function and protect the creditors against losses as far as possible. The protective purpose and the main goal of banking supervision are to ensure the functioning of the banking system in the interest of creditor protection.

3.2 There are two major models on banking supervision.

One is the Central Bank model where the banking supervision is conducted by the Central Bank, while on the other hand, where the functions have been entrusted to an authority separate from the Central Bank, either to a division of the Ministry of Finance or a Supervisory Authority under the Government.

Different countries have chosen different approaches to organising banking supervision. The main determining factor seem to be the history and structure of the particular country's banking system and the prevailing view of the Central Bank's mandate. Comparison has been made in this regard where these functions are undertaken by a separate agency or they are part of the wings of the government itself[37].

There is a school of thought that argues for Central Banks and others argue against the Central Banks undertaking the function of regulating and supervising the banks.

[37] See Appendix I enclosed in this paper where analysis of countries have been made in respect of the agency undertaking the role and function of regulation and supervision of banks.

3.3 Arguments for the Central Bank Model

The main argument for making the central bank the banking supervisor is that as the central bank is ultimately responsible for the payments system and the stability of the financial system and is also the lender of last resort and hence the central bank should be the banking supervisor. If banking supervision were to be administered outside the central bank, the central bank would still have to monitor the banks as a consequence of its responsibility for the payments system and the stability of the financial system. Most central banks have highly qualified and experienced staffs to analyse the performance of banks. The staffs of the Central Bank are also trained to understand banking risks and the implications of new systems and new financial products. To split resources between two or more entities would be ineffective and risk the maintenance of unnecessary bureaucracy cannot be ruled out[38].

Concentration of banking supervision in the central bank would effectively use the available resources. Concentration would also reduce the risk of overlapping supervision by two or more authorities; on the other side of the coin, it would reduce the risk of inadequate supervision in some areas[39].

Concentration of supervision in the central bank would also represent important advantages from the perspective of the banks. Because the central bank needs the information anyway, it would minimise the need to supply more or less the same information to more than one authority. If possible, the authorities should make every effort to reduce the costs of those supplying requested information.

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[38] *Supra note 33* at pp.347-349
[39] ibid

Banks are expanding by forming branches and subsidiaries in other countries. This development represents new challenges to all banking supervision. Banking supervision has to become international: it can no longer limit itself to activities within national borders.

Central banks have long been conducting close relationships with other central banks, for example, at the Bank for International Settlements[40]. Supervision often comprises confidential matters. Because central banks have a tradition of trusting each other with such information, it may be deemed appropriate to vest banking supervisory authority in them.

3.4 Arguments against the Central Bank Model

One argument is the difficulty or undesirability of separating banking supervision from the supervision of other credit and financial institutions and financial markets. Other institutions are entering the traditional banking areas while banks are expanding outside their traditional activities for eg. insurance companies in competition with banks and mutual funds are constantly developing new products to attract investors[41].

Another argument against the central bank model is the risk of conflict of interest that such a model may produce within the central bank. According to this

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[40] The BIS is an international organisation which fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability.
The BIS functions as:

- a forum for international monetary and financial cooperation where central bankers and others meet and where facilities are provided to support various committees, both standing and ad hoc;
- a bank for central banks, providing a broad range of financial services;
- a centre for monetary and economic research, contributing to a better understanding of international financial markets and the interaction of national monetary and financial policies;
- an agent or trustee, facilitating the implementation of various international financial agreements.

(Taken from the Home page of the Bank for International Settlement at www.bis.org)

[41] *Supra note 33 at Pp.350-352*

argument, such conflicts can occur if the central bank is entrusted with banking supervision, in addition to its monetary policy functions. The main creditor of the banks, which is one of its roles and the main counterpart in money and foreign exchange market transactions, which is another of its roles, should not simultaneously be the banking supervisor. In the latter capacity, it will have access to information that is unavailable to the other creditors and counterparts of the banks.

The banking supervisor is in some countries also responsible for consumer protection issues[42]. The central banks' assuming such responsibilities is another argument for making a separate entity the banking supervisor.

Lastly, if a central bank, whose main asset in executing monetary policy is its credibility, fails to supervise banks successfully, its credibility and thus its ability to execute monetary policy may be damaged as well[43]. A central bank's credibility when implementing monetary policy may consequently be harmed by possible banking supervision failures.

3.5 Conflict of interest between the different roles of the regulators

One more area of challenge that has emerged is whether there is a need for a super regulator or a mega regulator. As the businesses are getting diversified it is possible that such business would be subjected to the jurisdiction of those regulators. In this regard a considerable amount of debate has been generated about the conflict of interest that may arise between the different roles of the regulator. The classic example is that of the central bank being a prudential

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[42] In India, the Central Bank i.e. Reserve Bank of India does not undertake any function with any consumer as defined under the Consumer Protection Act, 1986, though the RBI Act, 1934 does not prohibit the Reserve Bank from doing any commercial activity. C.D.Deshmukh, the first Governor of the Reserve Bank of India had opened a saving account in the Reserve Bank to prove such a point.

regulator and the lender of the last resort. Quite clearly these roles of the central bank are in conflict because as a prudential regulator it has to report and take action against a financial crunch which a bank may face. On the other hand, as a lender of the last resort, the central bank has to provide the bank with liquidity to help it tide over the crunch[44].

While globally, the different players of the financial market are engaged in the provision of more than one form of service, in India, the scenario is different. There is clear functional differentiation between the various players of the financial market in India. As a result the global debate on the issue is concerned with how the conflict of interest can be sorted out in more complex situations as they exist in the developed economies of the world. The debate in India however is confined to the role of the government or a government agency as the regulator. This is because the institutions which are the players in the financial market are largely owned by the government and supervised by the government. Added to it, the role of the Reserve Bank of India as the lender of the last resort and the prudential regulator are in direct conflict here.

This situation of conflict does not seem to have caused any major problems in the Indian economy yet. However, the same may not be the case in the future as the government is divesting itself of its holding. The scope for conduct of the business has expanded making them amenable to various regulating authorities. It would be better to have a clear policy in this regard.

3.6 The case for a mega regulator

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[43] This is known as the contagion effect.

[44] Bank regulation: the case of the missing model, Gerard Caprio, Jr. [Feb 1996], www.worldbank.org/stml/dec/publications/workpapers/wps1574-abstract.html visited on 02.07.2000

One school of thought argues in favour of a single regulatory agency for the full range of financial services and markets. Such a mega-agency would be responsible for systemic, prudential and conduct of business regulation even though different considerations are involved in each case. The arguments in favour of such a structure are;

1. Economies of scale, with respect to skill requirements, sharing of resources and institutional costs. The compliance and structural costs of regulation however, are dependent on the kind regulation: they may rise if the regulation is inappropriate.
2. A simple structure that is readily understood and recognised by regulated firms and consumers is an advantage in itself.
3. A single agency would , in principle avoid the problems of competitive inequality, inconsistencies, duplication, overlap and gaps, all of which can arise in a regime based upon several regulatory agencies.
4. Accountability of regulation might be more certain with a simple structure.
5. The monitoring costs imposed on regulated firms might be reduced in so far as they would need to deal with only one agency.

3.7 The case against a 'mega regulator'

The reservations that may be made about a 'mega regulator' are :

1. The differentiated functioning of the players of the financial market warrants a differentiated approach to prudential regulation.
2. A single regulator might not have a clear focus on the objectives and rationale of regulation, and might not make the necessary differentiation between different types of institutions.
3. It is possible that significant cultural conflicts within the organisation could emerge if a single agency were responsible for all aspects of regulation and for all types of financial institutions.

4. There is risk that a large regulator of this sort would become bureaucratic in its processes.
5. There is merit in having a certain degree of competition and diversity in regulation so that lessons can be learnt from the experiences of different approaches.

There is no conclusive evidence to show that economies of scale will in fact be generated by having a mega regulator instead of many regulators that have clearly defined objectives.

However, in conclusion, it could be stated that it would always be ideal for the Central Bank to concentrate on its core function i.e. the monetary management, as it would be able focus itself entirely on the monetary management and also perform the same in a professional manner. The same cannot not be made as a general principle. As seen from the experience of certain countries as in those countries amongst other factors the laws have been made stricter. Unless the legal framework is strengthened it may not be possible to achieve the desired objectives. If separate agency were to be created the same would be able to concentrate and attain professionalism in regulating and supervising banks in the country.

CHAPTER 4

REGULATION AND SUPERVISION OF BANKS IN INDIA

4.1 Banking System in India

The major institutions in the financial system are banks (commercial, regional rural and co-operative) and non-banks (including developmental financial institutions and non-banking financial companies). Banking system in India can be broadly divided into Commercial banks and Co-operative banks. The indigenous bankers, especially in the rural areas, provide banking services banks in the unorganised sector. The primary task of the banks has been to mobilise savings and provide working capital to producing units in different segments of the economy. However, of late, as the financial markets are integrating to the reform process, they have begun rendering medium and long-term assistance.

Commercial banks, which include public sector banks[45], private sector banks[46] and foreign banks operating in India, are the predominant segment of the system. Co-operative banks occupy an important role in the banking system of the country. The co-operative banking structure represents a three-tier structure with State Co-operative Bank at the apex level in a State; Central Co-operative Banks at district levels and Primary credit Societies at grass root level. Besides, these there are State Land Development banks that provide long term agricultural credit, Primary Co-operative Banks, Farmers Service Societies and self-help Groups. The Primary Co-operative Banks commonly referred to as Urban Co-operative Banks (UCBs), are small sized co-operative organised banking units, which operate in metropolis, urban and semi-urban centres to cater to the needs of small borrowers. Commencing from March 1966, the UCBs have come under the regulatory and

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[45] Public sector banks are the State Bank of India, its 7 associate banks and 19 nationalised banks.

[46] Categorised as 'old' and 'new' private sector banks. 'old' private sector banks i.e. those which were in existence before the guidelines of RBI issued in 1993 for floating new private banks, foreign banks and Regional Rural Banks. .

supervisory umbrella of the RBI after certain provisions of the Banking Regulation Act, 1949 regarding matters relating to banking business were extended to co-operative banks following the amendment of the Banking Laws (as applicable to Co-operative Societies) Act 1965.

In India, banks comprise more than three-fourths of the total assets, and in turn, more than three-fourths of the assets of the banking system are held by the public sector (Government owned institutions)[47]. This is a very important facet of the institutional set up and certainly impacts the efficacy of the regulatory and supervisory set up of the financial system. The pre-dominance of the banking system assets also leads to the supervisory framework being pre-dominantly bank oriented, with that of the other institutions emerging as a corollary of this. Since the framework, in turn, is determined by the objectives of supervision of the particular institution, this could lead to the objective being carried over from banks to other supervised institutions by virtue of this common approach.

The Reserve Bank of India (RBI) as the central bank of the country has been continuously playing an active role in developing and strengthening the financial system. The preamble to the RBI Act, 1934, sets out the objectives of RBI[48]. RBI is entrusted as the sole responsible body for the regulation and supervision of banks, the dominant intermediary in the financial sector, under the Banking Regulation Act, 1949 with a specific objective to the promotion of financial

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[47] Government owns majority of the shares in these nationalised banks. As part of the financial reforms process Government of India in the year 1991 had set up a committee more commonly known as the Narasimham Committee which had suggested the Government shareholding to be reduced to 51%. Accordingly, an amendment was brought in 1994 in the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970 / 1980 bringing down the shareholding of the Government to 51%. Further there is a move to reduce the capital holding to 33% by way of amendment Bill which is pending in the Parliament.

[48] *See generally* the Preamble to the Reserve Bank of India Act, 1934 which amongst others states as 'to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

stability. It contributes to financial stability by promoting the development of the financial system and maintaining orderly conditions in financial markets.

The Indian banking system has gone through several phases starting from the fifties, the latest being the liberalisation era heralding the 'second generation' reforms process. The banking system in India is modelled on branch banking concept like England, Canada and Australia. Unlike US which is modelled on unit banking system. In branch banking system, a typical commercial bank is a large institution having a number of branches scattered over different State jurisdictions whereas in a unit banking system, bank's operations are confined to a single office.

4.2 Objectives of Regulation and Supervision in India

There are several agencies entrusted with the task of regulation and supervision of different institutions and market participants in the financial sector in India. While the specific objectives often vary from depositor protection to investor protection to market regulation, their broad concern remains that of maintaining financial stability.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 provide the legal framework for banking regulation and supervision in India. The Banking Regulation Act, 1949 has been reviewed and amended periodically. The regulation of banking system by the Reserve Bank of India had sought to ensure that the funds are placed with the financial intermediaries and that they deploy institutions in a prudent manner without jeopardising their safety and soundness. Requisite powers are vested with RBI in terms of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934, viz. power to determine policy, power to issue direction to banking companies in general or in particular, power to remove managerial and other persons from office of a banking company, if so

deemed necessary in the public interest, power to call for information from banking companies in general or in particular, sharing and publication of information obtained from banking companies, etc.

4.3 Regulatory and Supervisory Powers

An analysis has been made with regard to powers conferred upon the Reserve Bank of India in regulation and supervision of banks in India under the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The powers exercised in terms of the said Acts are given below which gives the RBI to exercise in regulating the banks in India.

i. Regulatory Powers of RBI

4.3.1 Licensing

The Banking Regulation Act, 1949 provides that a company intending to carry on banking business must obtain a licence from the Reserve Bank except such of the banks, which are established under specific enactments[49]. The licence is granted only after "tests of entry" are fulfilled[50]. These tests are listed under the Act which include minimum capital, ownership structure, bank's operating plans and controls, ability of the bank to pay its present and future depositors in full, quality of management and whether the licensing of the bank would be in the public interest[51].

RBI has been given powers under the Banking Regulation Act, 1949 to carry on inspection of the books of accounts of the company or otherwise to satisfy that

[49] The banks established under the Banking Companies(Acquisition and Transfer of undertakings) Act,1970 & 1980 (commonly known as the 'Nationalisation Act'), State Bank of India Act,1954 and the State Bank of India (Subsidiaries) Act,1955 do not require to obtain licence from the Reserve Bank.

[50] The licensing norms of new banks have been tightened since 1993 when guidelines allowing entry of banks in private banks were formulated. The fit and proper test of the promoters are ascertained from other banks, supervisory / regulatory departments and from Securities and Exchange Board of India (SEBI). Financial strength of the promoters and long-term viability are important factors.

condition for grant of licence are fulfilled before grant of the licence under the Act. The Act provides that before granting a licence to a branch of a company incorporated outside India, the Reserve Bank is to be satisfied that the conditions specified in the Act is fulfilled for the purposes of carrying on the banking business by such company. Before granting such licences it would satisfy itself as to whether it will be in the interest of the public, the Government or laws of the country where it is incorporated and does not discriminate in any way banking companies incorporated in India[52]. The Banking Regulation Act, 1949 prohibits a banking company from opening a new place of business or change the location of an existing place of business otherwise than within the same city, town or village. Similar restriction applies in respect of overseas operations of banking company incorporated in India[53]. However, branch licensing policy has been liberalised in recent years. Banks that have achieved prescribed capital adequacy ratio, have earned net profit for three consecutive years, have non-performing loans not exceeding 15 per cent of gross loans and have minimum owned funds of Rs 100 crore may be permitted to set up branches and update extension counters into full-fledged new branches. The policy in this regard is revised from time to time. The Act empowers RBI to cancel a licence granted to a banking company if the company ceases to carry on banking business in India, or company fails to comply

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[51] Section 22 of the Banking Regulation Act, 1949 empowers Reserve Bank to grant licence for a company or a co operative society to carry on the business of banking in India.

[52] Sub-sections (3) and (3A) of Section 22 of the Banking Regulation Act, 1949, empower the RBI to satisfy itself with respect to such factors as stipulated there under, before granting any license for carrying on banking business and for such purpose the RBI is also empowered to inspect the books of the company i.e. the applicant for grant of license under said Section 22.

[53] Section 23 of the Banking Regulation Act, 1949 restricts a bank from opening of new, and transfer of existing place of business without the prior approval of the Reserve Bank of India. As per sub-section (2) of Section 23 of the Banking Regulation Act, 1949, while considering an application of an existing banking company for opening of a new place of business or change of the location of its existing place of business, the RBI is empowered to undertake inspection of the books of the banking company as per Section 35 of the Act or otherwise, if so deemed necessary, for satisfying itself with respect to the financial condition, history of the company, the general character of its management, adequacy of its capital structure, its earning prospects and also that public interest will be served by the opening of such new place of business or change of the location of its existing place of business.

with any of the conditions imposed upon it under the Act[54]. Thus the 'tests of entry' laid down by the RBI while granting license to a company are continuing in nature i.e. the banking company must fulfill them on a continuous basis.

4.3.2 Capital Requirement

Section 11 of the Banking Regulation Act, 1949 provides for a statutory minimum level of Paid-up Capital and Reserves for a bank. Such of those banks which satisfy the minimum criteria viz. minimum paid-up capital of Rs.5 lakh and satisfy the Reserve Bank that their affairs are not being conducted in a manner detrimental to the interests of their depositors are included in the Second Schedule of the RBI Act and categorized as "scheduled banks". The scheduled commercial banks enjoy certain facilities such as refinance from RBI, access to Call/Notice Money Market, etc.

In pursuance of the Financial Sector Reforms initiated since 1991, new banks in the private sector were allowed to be set up. Accordingly, in terms of the guidelines for setting up banks in private sector issued in 1993, banks in the private sector were allowed to be set up subject to a minimum paid up capital of Rs.100 crore (now enhanced to Rs.200 crore) on prudential consideration and certain other conditions.

The minimum assigned capital requirement for a foreign bank desirous of opening branches in India is US $ 10 million for the first branch, additional US $ 10 million for the second branch and a further US $ 5 million for the third branch. The minimum Capital of 9% of risk-weighted assets has also to be maintained on an on-going basis.

[54] Section 22(4) of the Banking Regulation Act, 1949 empowers the Reserve Bank to cancel licence of a banking company or a co-operative bank.

4.3.3 Shareholding and Voting Rights

There is no legal restriction on holding of shares of a banking company by an individual or a group. However, banks have to obtain an acknowledgement from the Reserve Bank of India for transfer of shares where the total holdings of the transferee is equivalent to 5% and above of the total Paid-up Capital of the bank. Section 12(2) of the Banking Regulation Act,1949 (as amended in 1994) provides that the voting rights of a person in respect of any shares held by him in a banking company shall not exceed 10% of the total voting rights of all the shareholders of the banking company.

The participation of Non Resident Indians in the Equity Share Capital of a new bank set up in the private sector has been fixed at 40%. In the case of foreign banking companies or finance companies (including multilateral financial institutions) as technical collaborator or co-promoter, equity participation in a new private sector bank has been restricted to 20% of the Share Capital.

4.3.4 Reserve Requirements

For banks to carry out their deposit taking activities in India they must fulfil three basic regulatory requirements. These are meeting the (a) Cash Reserve Ratio (CRR) requirements[55], (b) Statutory Liquidity Ratio (SLR)[56] requirements and (c) Deposit Insurance requirements. These are the monetary control instruments through which the RBI exercises control over liquidity position of banks. Since 1990, RBI has deregulated interest rates of both deposit and lending.

[55] Section 42 of the Reserve Bank of India Act, 1934 requires the scheduled banks to maintain CRR which shall not be less than 3% of the net demand and time liabilities and a maximum of 20% which the Reserve Bank prescribes the requisite percentage of CRR to be maintained by the scheduled banks. Under Section 18 of the Banking Regulation Act, 1949, a non scheduled bank is required to maintain CRR.

[56] Section 24 of the Banking Regulation Act,1949 requires all the banks to maintain in the form of cash, gold or unencumbered approved securities (which are more or less government securities or such securities as authorised by the Central Government) not less than 25% and a maximum of 40% of its demand and time liabilities in India.

For the purposes of CRR, as per Section 42(1) of the Reserve Bank of India Act, 1934, every bank included in second schedule is required to maintain with the RBI an average daily balance the amount of which should not be less than 3 per cent of the total of the demand and time liabilities in India as on the last Friday of the second preceding fortnight. As per proviso to Section 42 (1) of the RBI Act, RBI has power to enhance rate of cash reserve ratio upto 20 per cent of total of the demand and time liabilities. Section 24 (2-A) of the Banking Regulation Act, 1949, requires every banking company to maintain in India in cash, gold or unencumbered approved securities an amount which should not be less than 25 per cent of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. The RBI is empowered to raise the statutory liquidity ratio upto 40 per cent of the demand and time liabilities. Thus, the pertinent objectives of regulation and supervision of the banking system may be enumerated as follows;

i. To protect interests of depositors of banks;
ii. To ensure orderly development and conduct of banking operations;
iii. To ensure liquidity and solvency of banks;
iv. To secure and ensure compliance with various provisions, directions, policies etc under various laws;
v. To prevent any systemic crisis through preventive and corrective measures.

4.3.5 Permissible Activities

The Banking Regulation Act, 1949 lists the permissible activities that a banking company may engage. Carrying on any business other than those specified is prohibited under the Act. Banks are permitted to set up subsidiaries only for undertaking activities that are permissible under the Act. Banks are not allowed to trade in commodities or become members of the stock exchange[57]. In India no

[57] Permissible activities of the bank are listed in Section 6(1) of the Banking Regulation Act, 1949.

company other than a company undertaking the business of banking is allowed to use the word 'bank', 'banker', or 'banking'. Further, 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[58].

4.3.6 Prudential Norms

(a) Capital Adequacy

In 1992, the Reserve Bank of India adopted the Weighted Risk Asset approach evolved by the Basle Committee[59]. These norms were introduced in a phased manner and initially banks were required to achieve a Capital Adequacy Norm of 8%. The time schedule prescribed for various categories of banks for achieving the norms are as follows :

(a) foreign banks operating in India – 8% by 31st March 1993.

(b) Indian banks having branches abroad – 8% by 31st March 1995;

(c) other banks – 4% by 31st March 1993 (Tier I capital should not be less than 50% of total capital) – 8% by 31st March 1996;

(d) with effect from 31st March 2000, banks are expected to maintain a minimum Capital of Risk Assets ratio (CRAR) of 9%.

The Tier I capital consists of paid-up capital, statutory reserves, other free disclosed reserves, if any, and capital reserves representing surplus arising out of sale proceeds of assets. However, equity investments in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods will be deducted from Tier I capital. As regards foreign banks Tier I capital would include :

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[58] Section 7 of the Banking Regulation Act, 1949.

[59] Reserve Bank of India has accepted the Basle Accord and has taken a decision to implement it in a phased manner and a detailed circular was issued to all scheduled commercial banks [DBOD No.BP.BC117/21.01.002. 92] on 22nd April 1992 which was followed by another circular [DBOD BP.BC.9/21.01.002/94] on 8th February 1994.

a) Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms;
b) Statutory reserves kept in Indian books
c) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India;
d) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India;
e) Interest free funds remitted from abroad for the purpose of acquisition of property and held in Indian books.

(b) Norms for Income Recognition and Provisioning

In terms of the Prudential Norms on Income recognition, Asset classification and Provisioning, introduced in 1992, income from Non-Performing Assets (NPAs) cannot be taken to Profit and Loss Accounts of banks unless the Income has been realized. An NPA has been defined as a credit facility in respect of which interest or instalment of principal has, remained "past due" for a period of two quarters in a financial year. Similarly, based on the status of an asset as NPA, it is required to be classified as Standard, Sub-Standard, Doubtful and Loss Assets and appropriate provisions made[60].

(c) Exposure Norms

Banks are subjected to certain exposure norms. The ceiling on exposure to a single borrower including funded and non-funded credit limits, underwriting and similar commitments should not exceed 15% of the bank's Capital Funds (Tier I and Tier

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[60] The data in respect of NPAs level of banking system available for countries like USA, Japan, Hongkong, Korea, Taiwan and Malaysia reveal that it ranged from 1% to 8.1% during 1993-94, 0.9% to 5.5% during 1994-95 and 0.85% to 3.9% during 1995-96 as against 23.6%, 19.5% and 17.3% respectively for Indian banks during these years.

II) effective from March 31, 2002.. The ceiling on exposure to a group of borrowers should not exceed 40% of the Capital Funds of the bank and 50% of the Capital Funds if the additional 10% relates to exposure to infrastructure projects (power, telecom, roads and ports).

The Tier II capital of Indian banks consists of :

(a) Undisclosed reserves provided they represent accumulations of post tax profits and are not encumbered by any known liability and are not routinely used for absorbing normal loan or operating losses;
(b) Cumulative perpetual preference shares which are fully paid up and do not contain clauses which permit redemption by the holder;
(c) Revaluation reserves arising out of revaluation of assets that are undervalued in the bank's book, typically bank premises and marketable securities. Such reserves will have to be reflected in the balance sheet as revaluation reserves. However, taking into account the deterioration in values of these assets in a forced sale, tax consequences of revaluation, etc. the revaluation reserves would be considered at a discount of 25 per cent for inclusion in Tier II capital. RBI has advised all commercial banks that from the financial year beginning April1, 1994 revaluation reserve may be discounted at 55 per cent when treated as part of Tier II capital.
(d) General provisions and loss reserve not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses will be admitted to a maximum of 1.25% of risk weighted assets.

(e) Hybrid debt capital instruments which combine characteristics of equity and debt provided they can support losses on an on-going basis without triggering liquidation.

(f) Subordinated debt where the instrument is fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and not redeemable at the initiative of the holders or without the consent of the banks' supervisory authorities. Subordinated debt instruments will be limited to 50% per cent of Tier I capital.

(g) Banks are permitted to issue subordinated debt instruments as Tier II capital. However, the Banks or a Financial Institution's investment in Tier II bonds issued by other banks be subject to a ceiling of 10% of the bank's or Financial Institution's total capital.

4.3.7 Loans & Advances

Section 21 of the Banking Regulation Act, 1949 lays down provisions relating to power of RBI to control advances by banking companies. Policy in relation to advances to be followed by banking companies generally or by any banking company in particular, is determined by RBI in exercise of its powers in terms of sub-section (1) of Section 21 of the Banking Regulation Act, 1949. Sub-section (2) of said Section 21 empowers RBI to issue directions to banking companies either generally to any banking company or group of banking companies in particular, in respect of (a) purposes for which advances may or may not be made; (b) the margins to be maintained in respect of secured advances; (c) the limit upto which advances or other financial accommodation may be made by that banking company to any one company, firm, association of persons or individual, having regard to its paid up capital, reserves and deposits. Policy and conditions relating to Selective Credit Control are laid down and enforced by RBI in terms of said provision.

4.3.8 Connected Lending

Section 20 of the Banking Regulation Act provides loans to Directors or to any firm or company in which Directors are interested. As regards loans to related companies i.e. the bank's own subsidiaries or joint ventures, the RBI has advised banks to maintain arms-length relationship in respect of all such transactions. The subsidiary company is treated as any other company and all loans to such companies have to be made at commercial rates and are subject to limits, which apply to similar companies. Similarly there is an aggregate ceiling fixed for such loans related to owned funds of the subsidiary.

4.3.9 Management

Under the Banking Regulation Act, 1949 the voting rights of a shareholder on poll in respect of any shares held by him are limited to 10 per cent[61] of the total rights of all the shareholders of the banking company[62].

The Banking Regulation Act, 1949 requires that not less than 51 per cent of the total number of members of the Board of Directors of a banking company shall consists of members who shall have knowledge or practical experience in subjects like accountancy, agriculture and rural economy, banking, co-operation, economics, finance, law, small-scale industry, any other matter useful to the banking company[63]. The Act provides that no banking company incorporated in

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[61] Section 12(2) of the Banking Regulation Act, 1949 restricts a person holding shares in a banking company, the right to exercise on poll upto a limit of 10%.

[62] An administrative circular was issued by the RBI under Section 35A of the Banking Regulation Act, 1949 which states that any transfer of share exceeding 5 per cent of the paid up capital of the banking company warrants acknowledgement of the RBI before the transfer of shares can be registered in the books of the banking company. The banking company has to furnish a declaration that the proposed transfer of shares would not result in the transferee acquiring either singly or jointly a controlling interest in the banking company.

[63] Section 10A (2) of the Banking Regulation Act, 1949 lays down the qualifications of a director in respect of the composition of the Board of directors of a banking company. If the conditions as required in this sub section is not fulfilled the Board of directors shall reconstitute the Board [sub section (3) of Section 10A].

India shall have as a director in its Board of Directors any person who is a director of any other banking company. The Act prohibits a banking company from granting any loans or advances on the security of its own shares, or any commitment for granting loans or advances on behalf of any of its directors, any firm or company or its subsidiary or holding company in which a director is interested or even to any individual for whom a director stands as a guarantor or with whom the director is a copartner in a firm[64]. Similarly, under the Banking Regulation Act, a banking company shall not, except with the prior approval of the RBI, remit in whole or in part any debt due to it by any of its directors, any firm or company or its subsidiary or holding company in which a director is interested or even to any individual for whom a director stands as a guarantor or with whom the director is a copartner in a firm[65].

Banks are allowed to set up subsidiaries to undertake businesses as specified under the Banking Regulation Act, 1949 to ensure that banks engage only in financial sector services. Setting up of a subsidiary requires prior approval of the RBI[66].

Section 36 of the Banking Regulation Act, 1949 empowers RBI to caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company. As per said Section 36, RBI may on request by the banking companies concerned and subject to their complying with the requisite conditions as stipulated under Section 44A of the Act, assist, as an intermediary or otherwise, in proposals for the amalgamation of such banking companies; and may also give assistance to any banking company by way of, purchase, sale or discount of bill of exchange or promissory note, and in relation to a State Co-operative bank and a Co-operative society, by way of making loans and

[64] See Proviso to sub section (4) of Section 10B of the Banking Regulation Act, 1949.
[65] Section 20A of the Banking Regulation Act, 1949

advances in accordance with provisions of Section 18 of the Reserve Bank of India Act, 1934.

As per said Section 36 of the Banking Regulation Act, 1949 RBI may;

(a) direct a banking company to call meeting of its Directors in relation to such matters or affairs of the bank as the RBI may specify in its direction;

(b) require a banking company to depute its officer to RBI to discuss such matter;

(c) depute one or more of its officers to watch the proceedings in the meeting of the Board of Directors of the banking company or of any other Committee or body of the banking company and may also require, if so necessary, the banking company to provide an opportunity to the officers of RBI deputed for the purpose to be heard at such meetings and direct such officers to send a report of such proceedings to RBI;

(d) require the Board of Directors or any other Committee or body of the banking company, to give in writing to any officer of the RBI specified for such purpose at his address all notices of, and other communications relating to, any meeting of the Board or such Committee or Body of the banking company;

(e) appoint one or more of its officers to observe the manner in which the affairs of the banking company or of its offices or branches are being conducted and to make a report in respect thereof;

(f) require the banking company to make changes in its management within such time and in such manner as specified by the RBI in this behalf; and

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[66] Section 19 (1) of the Banking Regulation Act, 1949

(g) to appoint such a staff at such places as RBI may consider necessary for the scrutiny of the returns, statements and information furnished by banking companies in pursuance of the provisions of the Banking Regulation Act, 1949.

The recent developments that have taken place in some of the private sector banks have brought to the fore the inadequacy of the legal provisions with regard to bringing about changes in the management of commercial banks. Section 36-AA (1) of the Banking Regulation Act, 1949 vests power in RBI to remove managerial and other persons from office of a banking company if it is in the public interest, or for preventing the affairs of the banking company being conducted in manner detrimental to the interests of the depositors or for securing the proper management of the banking company. In the light of these recent developments, a view emerged that powers need to be vested with RBI for superseding the entire Board, instead of a Director as at present. It was felt that RBI should have the powers to reconstitute the entire Board with professionals / experts who satisfy the 'fit and proper' norms stipulated by RBI.

Banking Regulation Act, 1949 vests power in RBI to remove managerial and other persons from office of a banking company if it is in the public interest, or for preventing the affairs of the banking company being conducted in manner detrimental to the interests of the depositors or for securing the proper management of the banking company[67]. In the light of these recent developments, Banking Regulation Act, 1949, empowers RBI to satisfy itself with respect to such factors as stipulated there under, before granting any license for carrying on the

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[67] See Section 36-AA (1) of the Banking Regulation Act, 1949. A need is felt in the wake of recent development that powers need to be vested with the Reserve Bank for superseding the entire Board, instead of a Director as at present. It was felt that the Reserve Bank should have the powers to reconstitute the entire Board with professionals / experts who satisfy the 'fit and proper' norms stipulated by the Reserve Bank.

business of banking and for such purpose the RBI is empowered to inspect the books of the company i.e. the applicant for grant of license under Section 22.

ii. Supervisory powers of RBI

4.3.10 Information & Audit

Under Section 27 (1) of the Banking Regulation Act every banking company is required to submit to the RBI details of its assets and liabilities as at the close of business of the last Friday of every month in the prescribed format. Section 27 (2) empowers the RBI to direct any banking company to furnish it within specified time with such statements and information relating to the business or affairs of the banking company. RBI has introduced the off-site surveillance returns in exercise of the powers under Section 27 (2) of the Banking Regulation Act. The off-site surveillance returns have been introduced by the RBI in exercise of the powers under Section 27 (2) of the Banking Regulation Act, 1949.

Section 28 of the Banking Regulation Act, 1949 gives power to the RBI to publish any information obtained by it under this Act in such consolidated form as it deems proper. Chapter IIIA of the RBI Act,1934 was inserted by Act 35 of 1962 with effect from 15.09.1962 and the provisions of said chapter under Sections 45A to 45E relate to; collection of credit information by the RBI from banking companies and furnishing of the same to the banking companies, and sharing of credit information by one banking company with another banking company . Such provision also provide the extent and scope of the power of the RBI in this regard, procedure for furnishing credit information to banking companies, prohibition as imposed with respect to disclosure of credit information contained in any statement submitted by a banking company or furnished by a bank to any banking company in pursuance of the provisions of said Chapter IIIA of the RBI Act and also stipulate the exceptions to such prohibition. As per Section 45-R of

the Banking Regulation Act, 1949, the RBI can require the liquidator of a banking company to furnish to it with any statement or information relating to or connected with the winding up of the banking company.

Section 29 of the Banking Regulation Act, 1949 requires every banking company to prepare their statement of accounts as prescribed in the Third Schedule of the said Act. With a view to moving towards greater transparency and bringing the disclosure standards of Indian banks on par with that of international banks, in addition to detailed schedules to their Balance Sheet, banks are to increase the level of disclosure covering vital aspects of their functioning by way of `Notes to Accounts'.

Section 30 of the Banking Regulation Act, 1949 empowers the RBI to conduct special audit in the public interest or in the interest of the banking company or the depositors.

4.3.11 Inspection

The main instrument of supervision in India has traditionally been on-site inspections of the affairs of banking companies and their books of accounts. Section 35 of the Banking Regulation Act, 1949 empowers the Reserve Bank to conduct on-site inspection of banks in India (including branches of foreign banks) and foreign branches of Indian banks. There is no enabling statutory power for permitting foreign supervisory authorities to carry out on-site inspection of banks in India having branches in the concerned foreign country. Off-site monitoring as an instrument of supervision has been introduced as recently as 1995 in order to continuously monitor the financial condition of banks in between annual inspections.

Since 1992 very far reaching developments had taken place in the Indian banking system in the form of financial and banking sector reforms leading to introduction of prudential norms on income recognition, asset classification and provisioning and introduction of capital adequacy standard. Consequent on the establishment of the Board for Financial Supervision (BFS) for dedicated supervision in 1994, a new approach to supervision was put in place. The Reserve Bank had set up a Working Group in 1995 to review its on-site supervision under the chairmanship of Shri S. Padmanabhan. The Working Group recommended that Annual Financial Inspection (AFI) should focus on statutory mandate viz., protection of depositors and concentrate on the core assessment structured on lines of the internationally adopted CAMEL model with an additional parameter of 'S' for systems and control.

Section 35 of the Banking Regulation Act, 1949 vests comprehensive powers in Reserve Bank of India (RBI) for inspection of books of any banking company at any time. The RBI has been vested with wide powers under Section 35A of the Banking Regulation Act, 1949 to issue directions to banking companies in general or to any banking company in particular, if it is satisfied that these are required in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or to secure the proper management of any banking company generally.

The focus of on-site inspection is on core assessments based on the CAMELS model. The areas that are covered in the course of on-site inspection includes internal control, credit management, overseas branch operations, profitability, compliance with prudential regulations, developmental aspects, proper valuation of assets / liability portfolio, investment portfolio, asset-liability management, treasury operations, risk management and the bank's role in social lending are

covered in the course of on-site inspection. As part of on-site inspection, domestic banks are rated based on the international CAMELS model and foreign banks are rated based on CALCS (Capital adequacy, Asset quality, Liquidity, Compliance and Systems) for discriminatory supervision based on financial and risk profile of banks. The frequency of inspection is generally annual which can be increased / reduced depending on the financial position, methods of operation and compliance record of the bank. The on-site inspection is based on primary records of selective cross section of branches, controlling offices and head office of the bank, pre-inspection feedback received from other departments of the RBI about specific aspects to be looked into, off-site surveillance feedback, market intelligence report, internal audit report, statutory audit report, concurrent audit report and reports / communications of the RBI nominee directors on Boards in case of public sector banks and old private banks.

In addition to provisions of Section 35 of the Banking Regulation Act, 1949, there are other provisions under the Act, which vest power in the RBI to conduct inspection/ scrutiny of banking companies. In terms of Section 45-Q of the Banking regulation Act, 1949, on being directed by the Central Government or by the High Court, the RBI is required to carry out an inspection of a banking company which is being wound up and make a report to the Central Government and the High Court.

Under Section 47-A of the Banking Regulation Act, 1949, the RBI has powers to impose penalty for contravention of the provisions of the Act or for default in complying with any requirement of the Act or of any order, rules or direction made or condition imposed.

4.4 Co-operative Banks

An important feature which distinguishes urban co-operative banking sector from commercial banks is its heterogeneity; chiefly, its uneven distribution. Co-operative banks play an important role in terms of deposit mobilisation in India.

4.4.1 Background

The usage of the terms 'Co-operation ' and 'Co-operatives' in India is century old. Co-operatives existed even in times of Kautilya and references abound in his treatise 'Arthashastra'. Though, United Kingdom is considered to be the origin of the 'consumer co-operation'begun by the Rochdale Pioneers, co-operative banking movement had its beginnings in Germany and its pioneers were individuals Herr Schulze and Herr F. W. Raiffeisen[68].

Urban credit movement in India made its presence only toward the close of the nineteenth century. Late Shri Vithal Laxman Kavthekar organised the first mutual aid society 'ANYONYA SAHAKARI MANDALI' in the then princely State of Baroda in 1889. However, the movement gathered momentum after the passing of the Co-operative Credit Societies Act, 1904. This enactment conferred legal status on credit societies and the first urban co-operative credit society was registered in October 1904 at Kanjeevaram in Madras Province. This was followed by organization of a few more credit societies in the erstwhile Mysore State and undivided Bombay Province[69].

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[68] In 1860, Raiffeisen founded his first loan society in his own native town. Raiffeisen experiment came to be known as 'Raiffeisen Model'. While, Raiffeisen banks served the rural areas; banks set-up by Schulze were meant for serving the urban population. The banks set-up under the Schulze Model were an association of artisans and petty-traders, to provide credit facilities for its members only. Funds were raised by means of share-capital contributed by members, by attracting deposits, and by means of re-discounts by an out-side bank.

[69] A paper on "urban Co-operative Banks" complied by Shri Pierrera, General Manager, Urban Banks Department, Reserve Bank of India, Mumbai.

4.4.2 First Phase of the development of the UCBs

In the Indian context the co-operative credit movement was nursed and nurtured by the State, which took initiative for establishment of credit dispensation institutions at micro level, essentially, to meet the growing credit requirements of agriculturists and poor urban masses, more particularly, those belonging to the lower strata of the society. The passage of the 1904 Act resulted in classification of the societies as rural and urban, and while the latter were left a choice, the former were bound to accept unlimited liability. They were given legal personality and authorized to raise funds to be lent to members only on personal and real security. Special exemptions from the provisions of Stamp Act, the Registration Act and the Income Tax Act were conceded. This also gave impetus to start other co-operative endeavours, such as societies for distribution and other purposes than credit, for which no legislative protection could be secured under the then existing Act. The Government of India re-examined the whole question and decided that the position could be best met by entirely fresh legislation. This ushered in the enactment of the Co-operative Societies Act, 1912. In 1914 the Government reviewed the situation and in the June of that year, issued a detailed resolution stating the progress made and laying down in general terms the practical lessons that could be drawn from experiences so far gained. Further, there was sizeable growth in the number of societies as well as funds invested and financial management, inspection and audit of these societies were becoming complicated. Thus necessity was felt to go into the entire gamut of the activities of the co-operative movement leading to the appointment of the Maclagan Committee. The Committee warned against the hasty registration of societies and laid down certain standards regarding their structure, financial management, maintenance of liquidity, inspection and audit, etc[70].

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[70] ibid

Upon the transfer of the subject of "co-operation" from central to Provincial Governments, as sequel to the constitutional reforms popularly known as "Montagu Chelmsford Reforms" and passing of the State Co-operative Act in 1925 "which not only gave the movement its size and shape but was a pace setter of co-operative activities and stressed the basic concept of thrift, self help and mutual aid". In the initial stages, urban co-operative credit societies restricted their activities on communal lines and business was carried out strictly with members primarily for sustaining consumptive purposes. Usage of the nomenclature "bank," "banker", was not strictly observed. In fact many of the credit societies set-up in the early part of the century later converted themselves into urban co-operative banks. It was left to the Joint Reorganisation Committee popularly known as Mehta Bhansali Committee (1939), which for the first time defined the urban co-operative bank as a credit society having a paid-up capital of Rs. 20,000 or more and which accepted deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order. It was only in 1966 when the Banking Regulation Act was made applicable to the co-operative banks that a formal definition of urban co-operative bank was laid out and this was defined as a primary co-operative bank not being a primary agricultural credit society[71]:

i. the primary object of which is to conduct the banking business;
ii. the paid-up share capital and reserves of which are not less than Rs. 1 Lakh and;
iii. the by-laws of which do not permit admission of any other co-operative society as a member.

4.4.3 Second Phase of development of Co-operative Banks

The second phase of the urban co-operative banking movement was between the periods 1966-93. The deposit insurance Scheme was extended to these banks in

India. Certain provisions of the Banking Regulations Act, 1949 were extended to these bank[72]. This marked a beginning of a new era in the history of the urban co-operative banking movement ushering in the concept of dual control. Reserve Bank controlled the banking related functions such as new bank licensing, branch licensing and area of operation, credit exposure norms, interest rates on deposits and advances etc. and State authorities in view of powers bestowed upon them by the respective State Co-operative Societies Acts looked after the functions such as incorporation and registration of co-operative banks, audit, management, liquidation, winding-up and amalgamation etc. This arrangement of shared supervision has not worked well and it is now a certainty that the dual control in fact has been the bane of all the vexatious issues confronting the urban bankers and the co-operators. The period between 1966-93 can be associated with extreme regulation by the Reserve Bank and the Bank followed the dictum of "one district-one bank", further restricting urban banks from operating beyond the municipal limits and not allowing them to function in rural areas etc[73].

The Reserve Bank appointed the Marathe Committee in 1993 to look into the regulatory issues confronting the urban co-operative banks. Amongst others, singularly, important recommendation of the Marathe Committee was to give-up hitherto policy of "one district-one bank" concept and recommended setting up of

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[71] ibid

[72] Prior to March 1966, co-operative societies carrying on banking business were not covered under the Banking Regulation Act,, 1949 and the RCS was the sole Regulator and Supervisor and all the Societies registered in the State including societies carrying on banking business by virtue of provisions of Co-operative Societies Act of respective States. With the passage of the bill *viz.,* Banking Laws (application to co-operative societies) Bill by the Parliament and after receiving the assent of the President in September 1965, the Act came into force from 1 March 1966. However, as mentioned above, in terms of the Co-operative Societies Act of the State the RCS was to have jurisdiction over the incorporation, registration, management, amalgamation, merger, liquidation etc; and the RBI was to have jurisdiction over the banking activities of the co-operative societies.
The RCS, however, continues to be the regulator and supervisor of co-operative institutions. This has thus given rise to the duality of control by the Reserve Bank and the RCS of respective States over such of the societies as are eligible to carry on banking business in terms of Section 22 of the Banking Regulation Act, 1949.

[73] Supra note 69.

the new urban banks on the basis of "need" and "potential" of the institution for raising the deposits and dispensation of credit. Reserve Bank accepted these recommendations and came out with its new licensing policy in May 1993. This lead to rapid growth in urban co-operative banks and till end March 1999 the Bank had issued as many as 537 licenses for setting up of new banks. There was considerable increase in opening of branches and number of new offices added was 2928. Urban co-operative banks were also to extend their area of jurisdiction encompassing the entire district without specific approval of the RBI and such of the banks with Rs. 50 crore deposits and above were permitted to operate beyond the State of their registration.

One aspect that needs special mention is the statute-induced expansion of the banks i.e., automatic conversion of Primary Credit Societies into UCBs. This essentially takes place when the owned funds of the primary credit society reach Rs. 1 Lakh, it has to then approach RBI for a license to carry on banking business. On account of this a large number of primary co-operative societies have come under the ambit of the Banking Regulation Act, 1949. In order to plug this automatic route Registrar of Co-operative Societies were advised in 1978 not to register any new primary credit society the object of which is to carry on banking business.

UCBs face certain challenges which restrict their performance and inhibit them from growing at their full potential. These are (i) dual control, (ii) highly unprofessional management cadre and (iii) growing instances of weak banks (even among Scheduled Urban Co-operative Banks).

4.5 Regulatory functions exercised by RBI over Urban Co-operative Banks

The scope of regulatory functions encompasses compliance with the provisions of B.R. Act, 1949 (As Applicable to Cooperative Societies) by Urban Co-operative Banks (UCBs). These functions are as follows:

4.5.1 Licence

(a) Licensing of new banks : New banks which are set up after 1 March 1966, could commence banking business only after obtaining a licence from RBI as per the provisions of Section 22 of B.R. Act, 1949 (As Applicable to Cooperative Societies). Before granting licence to any bank, RBI has to satisfy itself the requirements as stated in para 22(3) of the B.R. Act, 1949 (As Applicable to Cooperative Societies) which are :

that the co-operative bank is or will be in a position to pay its present or future depositors in full as their claims accrue;

- That the affairs of the co-operative bank are not being, or are not likely to be conducted in a manner detrimental to the interests of its present or future depositors;
- That the general character of the proposed management of the co-operative bank will not be prejudicial to the public interest or the interest of its depositors;
- That the co-operative bank has adequate capital structure and earning prospects;
- That the public interest will be served by the grant of a licence to the co-operative bank to carry on banking business in India;
- That having regard to the banking facilities available in the proposed principal area of operations of the co-operative bank, the potential scope for expansion of banks already in existence in the area and other relevant factors, the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;

- Any other condition, the fulfillment of which would, in the opinion of the Reserve Bank, be necessary to ensure that the carrying on of banking business in India by the co-operative bank will not be prejudicial to the public interest or the interests of the depositors.

(b) Licensing of existing Banks : The provisions of Banking Regulation Act, 1949 were made applicable to urban banks from 1 March 1966. In terms of Section 22 of the Act, the UCBs which were existing as on the above date were required to apply to the RBI for a licence to carry on banking business. Such banks were permitted to carry on banking business if licences were granted to them on fulfilling the prescribed norms, or until they were informed that licence cannot be granted to them.

As per the provisions of Section 23 of B.R. Act, 1949 (As Applicable to Cooperative Societies), UCBs are required to obtain licence from RBI for opening branches.

In terms of Section 22 of Banking Regulation Act, 1949 (As Applicable to Cooperative Societies) Reserve Bank can cancel a licence granted to a cooperative bank under this section:

- If the cooperative bank ceases to carry on banking business in India or
- If the cooperative bank at any time fails to comply with any of the conditions imposed upon it under sub-section (1) or
- If at any time, any of the conditions referred to in sub-section (3) is not fulfilled;

4.5.2 Capital Requirements

Under the provisions of Section 11 of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), no UCB can commence or carry on banking

business if the real or exchangeable value of its paid-up capital and reserves is less than Rs.1 lakh.

4.5.3 Restriction on holding shares in other cooperative societies

No cooperative Bank shall hold shares in any other cooperative society except to such an extent and subject to such conditions as the Reserve Bank may specify in that behalf under Section 19 of Banking Regulation Act, 1949 (As Applicable to Cooperative Societies). As per the present guidelines, the total investment of a cooperative bank in the shares of cooperative institutions (except those of Central/State Cooperative banks to which it is affiliated) should not exceed 2 per cent of its owned funds. When more than one cooperative bank contributes to the shares of a cooperative institution, then the overall ceiling is 5 per cent of the subscribed capital of the recipient institution.

4.5.4 Reserve Requirements

In terms of the provisions of Section 18 of Banking Regulation Act, 1949 (As Applicable to Cooperative Societies) non- scheduled UCBs are required to maintain in India by way of cash with itself or in form of balances in a current account with the RBI or the State Co-operative Bank of the state concerned or the Central Co-operative Bank of the district concerned or by way of net balances in current accounts with public sector banks, i.e. in one or more of the aforesaid ways, a sum equivalent to at least 3% of its total demand and time liabilities in India on day to day basis. In the case of scheduled UCBs, every bank is required to maintain with the RBI an average daily balance, the amount of which shall not be less than 6 per cent of its total demand and time liabilities in India in terms of Section 42 of the RBI Act, 1934.

In addition to the cash reserve, every UCB (scheduled / non-scheduled) is required to maintain liquid assets in the form of cash, gold or unencumbered approved securities which shall not be less than 25% of the total of its demand and time liabilities in accordance with provisions of Section 24 of the Banking Regulation Act,, 1949 (As Applicable to Cooperative Societies).

4.5.5 Loans and advances

RBI is empowered to regulate the interest rates of UCBs on deposits and advances by virtue of powers vested in it under provisions of Section 21 of Banking Regulation Act, 1949 (As Applicable to Cooperative Societies).

In terms of Section 21 of B.R. Act, 1949 Reserve Bank may give directions to cooperative banks, either generally or to any cooperative bank or group of cooperative banks in particular, as to:

- The purpose for which advances may or may not be made.
- The margins to be maintained in respect of secured advances
- The maximum amount of advances or other financial accommodation which having regard to the paid-up capital, reserves and deposits of a cooperative bank and other relevant considerations, may be made by the cooperative bank to any one party.
- The maximum amount upto which, guarantees may be given by a cooperative bank on behalf of any one party, and
- The rate of interest and other terms and conditions on which advances other financial accommodation may be made or guarantees may be given.

4.5.6 Prudential Norms

(a) Exposure Norms

The prudential loan exposure ceilings are based on the capital funds of the banks. The UCBs are now permitted to lend upto 20 per cent and 50 per cent of

their capital funds to individual borrowers and group respectively. The overall exposure of a bank by way guarantees should not exceed 10% of its resources. Investments in Non-Banking Finance Companies) NBFCs by UCBs is totally prohibited. They are also prohibited from lending to NBFCs except to Equipment Leasing and Hire Purchase Companies.

(b) Asset provisioning

Pursuant to the recommendations of the Committee on Financial System Reforms (Narasimham Committee), the UCBs were also advised to adopt norms on income recognition, asset classification and provisioning for NPAs, with effect from 31st March 1993.

The assets are broadly categorized into performing and non-performing assets. An asset is classified as non-performing, if repayment of interest and/or principal remains overdue for a period of more than 180 days from the date is was due to be paid.

A non-performing asset is further classified into three categories viz., substandard asset (non-performing for less than 18 months), doubtful asset (non-performing for more than 18 months) and loss asset where the entire advance is considered uncollectable. Once an asset has been classified as non-performing, banks are prohibited to take to the Profit and Loss Account the income due on such non-performing asset.

The provisioning requirements in respect of the non-performing assets which are applicable to all urban cooperative banks are as under:

- Sub-standard Assets: 10%
- Doubtful Assets: Between 20% to 50% of the secured portion depending on the age of NPA and 100% of the unsecured portion;

- Loss Assets: 100% of the outstanding should be provided for or the entire amount should be provided for or the entire amount should be written off.

In addition to the above, the banks have been advised to make provisioning in respect of standard assets @ 0.25%.

(c) Valuation of investments

Investments of banks in SLR securities should be bifurcated into 'current' and 'permanent', with the prescription that the 'current' investments are not less than 75% of the total SLR securities. The 'current' category of SLR investments and the entire portfolio of non-SLR investments should be marked to market. These guidelines have been modified and effective from 31 March 2002:

i. The banks are required to classify their entire investment portfolio as on 31 March 2002, under three categories viz. 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

ii. The investments under the 'Available for Sale' and 'Held for Trading' categories should be marked to market.

The investments under the 'Held to Maturity' category need not be marked to market as in the case of 'Permanent' securities at present.

4.5.7 Issue of Direction

Section 35A of the Banking Regulation Act, 1949 empowers the Reserve Bank to issue directions to banking companies including co-operative banks generally or to any banking company or a co-operative bank in particular. The criterion for exercise of such power is the satisfaction of the Reserve Bank about the need for issuance of such direction;

- In the public interest
- In the interest of banking policy

- To prevent the affairs of any cooperative bank being conducted in a manner detrimental to the interest of the depositors/cooperative bank.
- To secure proper management of the banking business of any cooperative bank.

4.6 Supervisory Functions exercised by the RBI

The supervisory powers exercised by RBI with regard to co-operative banks are as follows:

4.6.1 Inspection

Reserve Bank of India conducts the statutory inspection of urban co-operative banks in terms of the powers vested under Section 35 of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies). The main objective of inspection of urban banks is to safeguard the interests of depositors and to build up and maintain a sound banking system in conformity with the banking laws and regulations. Based on market reports or on the basis of complaints received against banks or to verify the position of compliance by banks to inspection reports, RBI may also carry out a scrutiny of the books of accounts of UCBs as per the provision of sub section (1A)(a) of Section 35 of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies).

4.6.2 Authority to caution banks

In terms of Section 36(1)(a) of the Banking Regulation Act, 1949(As Applicable to Co-operative Societies), the Reserve Bank may caution or prohibit co-operative banks generally or any co-operative bank in particular against entering into any particular transaction or class of transactions, and generally give advice to any co-operative bank.

4.6.3 Appointment of Observer

In terms of Sub-section (i) of Section 36(1)(d) of the said aforesaid Act the Reserve Bank may depute one or more of its officers to watch the proceedings of any meeting of the Board of Directors of the co-operative bank or of any other body constituted by it and require the co-operative bank to give an opportunity to the officer so deputed to be heard at such meetings and to offer such advice on such matters as the officer may consider necessary or proper for the organisation and expansion of co-operative credit on sound lines. Further, in terms of sub-section (ii) of the aforementioned Section of the Act, RBI may appoint one or more of its officers to observe the manner in which the affairs of the co-operative bank or its offices or branches are being conducted. However, it may be added that the Reserve Bank does not have any authority to appoint a Director on the Board of Directors of a co-operative bank.

The Banking Regulation Act, 1949 (As Applicable to Co-operative Societies) does not provide direct authority to the Reserve Bank for removal of the Board of Directors of urban co-operative banks. However, in pursuance to the provisions of Section 13 D of the Deposit Insurance and Credit Guarantee Corporation Act 1961, necessary provisions are incorporated in the Co-operative Societies Acts to the effect that, if so required by the Reserve Bank, the Registrar of Co-operative Societies shall issue an order for supersession of the Board of Directors of insured co-operative banks. Thus, power of removal of Board of Directors can be exercised only through Registrar of Cooperative Societies.

4.6.4 Power to call for Information

As per the provisions of Section 27(2) of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), RBI has been vested with necessary powers to direct a cooperative bank to furnish it with such statements and information relating to the business or affairs of the cooperative bank. Further, the Banking

Regulation Act, 1949 (As Applicable to Cooperative Societies) requires that cooperative banks should submit to the Reserve Bank the following important returns periodically:

4.6.5 Audit

Audit of urban cooperative banks is carried out by the State Governments by the Auditors appointed by them as per the provision of the Cooperative Societies Acts or the Central Registrar of Cooperative Societies, in case of Urban Co-operative Banks registered under Multi-State Co-operative Societies Act, 1984. Follow-up of these audit reports is also a function of the State Governments.

4.7 Dual Control : An area of tension between RBI and State Government

Regulating the activities of India's co-operative banks first came into sharp focus as an adjunct of the extension of deposits insurance to this sector of banking. Earlier the Banking Companies Act, 1949 which came into force from 16 March 1949 had specifically excluded co-operative banks, including urban co-operative banks from the purview of the Act as co-operative banks were registered under the Co-operative Societies Act of the respective States and an such could not be classified as "Companies".

In terms of Article 246 of the Constitution of India the exercise of the legislative powers is broadly divided into three areas (i) exclusively reserved for the Union of India and referred to as the "Union List" (ii) exclusively reserved for the States and referred to as the "State List" (iii) those left for both and referred to as the "concurrent List". These areas of legislation are indicated by Entries in List I, II and III respectively of the VII th Schedule to the Constitution of India. The Co-operative Credit Societies doing banking business in the area exclusively reserved for the Union and to a certain extent, in the area exclusively reserved for the State.

This results in the duality of jurisdiction over co-operative banks by the RBI in terms of Banking Regulation Act, 1949 and the RCS in terms of the Co-operative Societies Act of the State concerned. Entries 43 and 45 in the "Union List" refer to "banking" and the Entry 32 of the State list refers to "co-operative societies". Thus the authority of the State Government to legislate and control the co-operative credit societies doing banking business is derived from the above Constitutional provisions.

"Co-operation" being a state subject under the Constitution it is governed by the respective State Co-operative Societies Acts. The co-operatives are at present under the control of State Governments in all matters relating to Incorporation, Registration, Membership, Election, Audit, Management, Amalgamation, Merger Winding up, etc;. Certain aspect relating to banking activities are regulated/supervised by Reserve Bank of India under Banking Regulation Act 1949 (As Applicable to Co-operative Societies).

There has been interference by State Governments, even in the banking related functions of urban cooperative banks. A few instances of overlapping jurisdiction resulting in avoidable difficulties for UCBs are listed below[74]:

i) In terms of Section 23 of Banking Regulation Act,, 1949(AACS), the RBI has the authority to issue a branch licence to an urban cooperative bank and under the existing policy, RBI issues branch licence after satisfying itself about the financial strength of the UCB. However, in some states, the UCBs are required to obtain "No Objection Certificate" (NOC) from RCS of the concerned State even after the licence has been granted by the RBI.

ii) Another area of concern arising out of dual control is investment of surplus funds by UCBs. The "investment" is also a banking function within the meaning of Section 5 of Banking Regulation Act, 1949.Hence UCBs

should, subject to the guidelines issued by the Reserve Bank, have the freedom to choose the products in which they may invest. Yet, some Registrars of Cooperative Societies insist on their permission being taken for every investment decision. Due to limited avenues of profitable investments in the cooperative sector, the RBI has allowed UCBs to invest upto 10% of their surplus funds in the equity of All India Financial Institutions, units of UTI, and PSU bonds. However, in some of the States, this freedom is frustrated by the Registrars of Cooperative Societies.

4.8 Deposit Insurance

The protective form of regulation adopted by the regulator is protecting its depositors. Accordingly, the Deposit Insurance Corporation was established under the *Deposit Insurance Corporation Act, 1961* with effect from January 01, 1962. Subsequently, in pursuance of the provisions of the Deposit Insurance Corporation (Amendments and Miscellaneous Provisions) Act, 1978 (Act 21 of 1978) which provided, inter alia, for the acquisition by, and transfer to, the Deposit Insurance Corporation, of the undertaking of the Credit Guarantee Corporation of India (a Public Limited Company, promoted by the Reserve Bank) w.e.f. July 15, 1978, it took over the undertaking of the Credit Guarantee Corporation of India Ltd. With the incorporation of said two organisations, the Corporation was re-named as the Deposit Insurance and Credit Guarantee Corporation (DICGC).

The Corporation has twin objectives of giving insurance protections to a small depositors in banks and providing guarantee support to credit extended by banks and other approved financial institutions to certain categories of small borrowers, particularly, those belonging to the weaker and neglected sections of the Society as well as to a small scale industrial units.

[74] Supra note 69.

As per the provisions of said Chapter III (Sections 10, 11, 11A, 12, 13A and 13B) every existing banking company, regional rural bank and cooperative banks as defined under Section 2 (b) (ma) and (dd) of the DICGC Act, 1961 to be registered as an insured bank. Thus, it would appear that insurance of deposits held by every existing banking company, regional rural bank and cooperative banks, is compulsory.

There are provisions that relate to:

(b) liability of Corporation in respect of Insured Deposit,

(c) manner of payment by Corporation in case of winding up of an insured bank,

(d) manner of payment by Corporation in case of a scheme of compromise or arrangement or of reconstruction or amalgamation in respect of an insured bank,

(e) discharge of the liability of Corporation,

(f) obligations of the Corporation to make provisions for unpaid amounts,

(g) repayment of the amount to the Corporation by the Liquidator or the insured bank or the transferee bank as the case may be,

have been provided under the Sections 16, 17, 18, 19, 20 and 21 respectively.

As stated earlier that cooperative being the subject matter of State enactment, the cooperative banks are governed in each state also by their respective State Legislation's in addition to the provision of Banking Regulation Act, 1949 (as applicable to cooperative banks). However, Section 13D of the DICGC Act 1961, stipulates the circumstances in which the Bank may require winding up of cooperative banks.

The DICGC protects the interests of the depositors and their deposits are insured upto Rs. 1 lakh and also the creditors. Lots of reforms are underway to make the DICGC more strengthened including the charging of premiums at a risk based

method and making the DICGC as a liquidator in case of any bank being wound up so as to make the liquidation proceedings more speedily.

CHAPTER 5
REGULATION AND SUPERVISION OF BANKS IN OTHER COUNTRIES

World over supervisory approaches are being reviewed, particularly with regard to supervisory responsibilities, prudential standards, proper controls and qualitative factors of supervision. The roles of banking supervisors will continue to achieve in improving effectiveness of banks, promoting sound practices and to a certain extent diminishing the regulatory burden. Overviews of some countries where the regulation and supervision of banks are either performed by the central bank or other agency and some of the reforms undertaken by these countries are highlighted in this chapter.

5.1 FRANCE

In France, supervision is performed by the Banking Commission, a separate authority. The Board of Banking Commission is chaired by the Bank of France, (which is the Central bank of France), but it also has Board Members from the Treasury and from other sources, such as Court Judges and independent experts. However, the Banking Commission's authority is closely linked with the Bank of France; it uses central bank staff as a secretariat for its activities, including the examination of banks. Moreover, the head of the banking Commission has the status of a director of the Central Bank[75].

The Banking Commission includes the Governor of the Bank of France as Chairman, the Director of the Treasury and four members appointed by a decree of the Ministry of Economic Affairs and Finance for a period of six years. These four comprise a member of counsel and a judge from the Conseil d'Etat (the

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[75] *Supra note 33* at pp.356-358

highest administrative and civil jurisdictions, respectively, in France), and two members chosen for their competence in banking and financial matters. In case of a tie, the Chairman cast the deciding vote[76].

The Banking Commission is responsible for ensuring credit institution's compliance with the legal and regulatory provisions applying to them, and for taking disciplinary action. It also examines the way in which the credit institutions operate and monitors the soundness of their financial institution, ensuring that the rules of sound banking practice are observed.

The Banking Commission uses three supervisory procedures to ascertain credit institutions compliance with the laws and regulations applying to them and to monitor their activities[77]:

1) Examination of institutions financial accounting and statutory statements;
2) Inspection visits to the institutions; and
3) Data analysis.

The Banking Commission draws up a list of documents and data to be submitted to it and determines their forms and the filing dates. It may also ask the credit institution to provide additional information, and it may ask to send the auditor's report and other relevant documents.

The Banking Commission overseas the application of regulatory provisions by credit institutions. It verifies that each institution observes the prudential standards set by the Banking Regulation Committee, which can be stated as[78]:

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[76] ibid at pp.359-360
[77] ibid at pp.360

(a) The solvency ratios define the relationship between the own funds and assets, together with off balance sheet items, weighted by the credit risk that they entail.
(b) Risk distribution rules, which occupy a prominent position in the regulatory system, require credit institutions to limit their exposure. The aim of diversifying risks is an essential prudential precaution.
(c) Regulation on exchange rate position limits these positions to a portion of the credit institution's own funds; credit institutions must comply with the prescribed ratios. In addition, their aggregate short-term positions in all currencies must not exceed the prescribed limit of own funds.
(d) Liquidity ratios require credit institutions to measure their short-term maturity mismatch risks. They must show a liquidity ratio of at least 100 percent, the components of which are determined on the basis of the estimated degree of liquidity or payability of assets and liabilities.
(e) Own funds and long-term resources ratios require credit institutions to fund a minimum of 60% of their fixed or long-term assets, or those with a residual duration of more than five years out of own funds or resources in due in more than five years.

The Banking Commission is mandated to make inspection visits not only to supervise the credit institutions' compliance with the regulations but also to scrutinise their operations, monitor their financial health. This inspection is comparable to an external audit that emphasis the prudential requirements, the quality of the risks, and the profitability of the institutions. Inspection visits are even extended to a credit institutions subsidiary, the legal entities controlling it directly or indirectly and their subsidiaries[79].

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[78] ibid at pp.361-362
[79] ibid at p.361

The Banking Commission can take preventive measures when a credit institution is in breach of the rules of sound banking practice, the Banking Commission may issue a warning. It may also issue an injunction calling upon a credit institution to take all necessary measures to restore or strengthen its financial equilibrium or rectify its management method within a stipulated period. If a credit institution has contravened a law or regulation relating to its business or if it has not complied with an injunction or ignored a warning, the Banking Commission may impose one of the following disciplinary action: caution, reprimand, prohibition on the execution of certain operations, temporary suspension of the persons responsible for the effective management of the institution, compulsory suspension of these same persons, or withdraw of the institutions authorisation. The Commission is also empowered to impose a fine not exceeding the minimum capital requirement and to appoint a provisional administrator[80].

When imposing a disciplinary sanction, the Banking Commission acts as an administrative Court, such decisions can be appealed only to the Conseil d'Etat.

The Banking Commission has three other tasks: First, it is responsible for enforcing compliance with the industry's rule of good conduct. Second, under the 1984 Act, the Commission has one month in which to contest proposed appointments by credit institutions of statutory auditors. Finally, several legislative and regulatory tests have been adopted recently to issues like money laundering[81].

5.2 Germany

[80] ibid at p.363
[81] ibid at p.363

In Germany, the concept of banking suspension is implemented through an 'independent supervisory authority that co-operates with the Bundes Bank (the Central Bank of Germany). Since 1961, the Federal Supervisory Office (FSO), working in co-operation with the Deutsche Bundes Bank has carried out banking supervision. The Banking Act assigns the central role in banking supervision to the FSO, which directly reports to the Federal Minister of Finance. The Federal Supervisory Office has no substructure of its own, hence the participation of the Bundes Bank becomes necessary. It is only the Bundes Bank system, with its main and branch offices, that permits efficient and cost-effective supervision at the local level of the over 4,000 credit institutions in Germany[82].

Banking supervisory functions are clearly divided between the Banking Supervisory Office and the Bundes Bank. To name a few[83]:

(i) Sovereign functions such as issuing of administrative acts, are responsibilities of the FSO.

(ii) Before issuing general regulations, the FSO must confer with the Bundes Bank. For e.g. when issuing principles concerning capital and liquidity, the FSO is required to reach agreement with the Bundes Bank while, in other cases, the Bundes Bank may be merely consulted.

(iii) The Bundes Bank is fully involved in the regular surveillance of the credit institutions; it also analyses the annual reports and other documents of these institutions.

(iv) The Bundes Bank maintains the credit register of loans of DM 3 Million or more, which is an important source of information both

[82] *Ibid at pp.338-339*

for the banking supervisory authorities and for lenders. This clause stipulated that credit institutions and insurance enterprises must report loans of DM 3 Million or more to the Bundes Bank, which adds together the loans be individual borrowers and subsequently notifies the lenders of the total indebtedness of their borrowers and the number of lenders involved.

(v) To enable the banking supervisory authorities to analyse regularly the credit institutions business who have to submit monthly returns and provides its comments to the Federal Supervisory Office.

Although both the supervisory office and the Bundes Bank are authorised to examine banks, they almost exclusively rely on the reports of the external auditors. The supervisory office formally establishes guidelines for the contents of these audit reports. These reports are routinely submitted to the State Central banks, which review them and prepare summaries. The reports and summaries are provided to the supervisory office; the Bundes Bank normally receives only the summary report[84].

5.3 USA

The National Bank Act, the Federal Reserve Act, and the Glass-Steagall Act have defined *what* a banking organization is permitted to do and what it is forbidden to do. The McFadden Act, the Douglas amendment, and other legislation have determined the place of business and defined the corporate form required to do it. The national and state banking authorities, deposit insurance agencies, and Federal

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[83] ibid at pp.340-343
[84] ibid at p.343

Reserve System have defined *how* to do it. Banking supervisors and examiners have tried to ensure that it was done that way.

Historically, in the USA, the regulatory framework segmented the financial industry into three major groupings: (1) depository institutions, (2) securities underwriting and sales, and (3) insurance underwriting and sales. Each major group was further subdivided in ways with which we are all familiar.

The Federal Reserve has statutory authority to conduct on-site examinations of all member banks, Edge Act and agreement corporations, and bank holding companies. The Comptroller of the Currency has primary responsibility for supervising and examining member banks that are nationally chartered, and the Federal Reserve fulfills its responsibilities for these banks chiefly through reviewing financial reports from the banks and from the OCC. The Federal Reserve System exercises primary supervisory responsibility and examines only those member banks that are chartered by the states. This supervisory role derives from the Federal Reserve's statutory responsibility for admission of state-chartered banks to membership in the Federal Reserve System. The Federal Reserve and the various state supervisory agencies share authority to examine state chartered member banks and must approve applications for new branches. However, the Federal Reserve conducts joint examinations with state agencies, or alternates annual examinations with those agencies, and cooperates with the states in other areas to reduce duplication and overlap in the examination and supervision of state-chartered banks[85].

The examination of a depository institution generally entails (1) an appraisal of the soundness of the institution's assets; (2) an evaluation of internal operations,

[85] Regulatory competition in the US Federal system: Banking and financial services, www4.law.cornell.edu/workingpapers/open/macey/yalebank.html visited on 28.06.2000

policies, and management (3) an analysis of key financial factors such as capital, earnings, liquidity, and interest rate sensitivity; (4) a review for compliance with all banking laws and regulations; and (5) an overall determination of the institution's solvency. In addition to these examinations for the general safety and soundness of state member banks and bank holding companies, the Federal Reserve conducts special examinations of state member banks in certain areas such as consumer affairs; activities of trust departments, stock transfer agents, and municipal securities dealers; and electronic data processing[86].

The Federal Reserve also is the primary supervisor for bank holding companies under the Bank Holding Company Act of 1956, as amended. Because most large commercial banks are owned by bank holding companies, this statutory authority accords the Federal Reserve supervisory responsibility for banking organisations that at the end of 1983 controlled about 84 percent of the total deposits of U.S. commercial banks. To ensure the safety and soundness of these institutions, the Federal Reserve conducts on-site inspections of parent bank holding companies and their significant nonbank subsidiaries. The inspections include a review of nonbank assets and funding activities, an evaluation of policies and procedures for managing the holding company and its subsidiaries, and a review for compliance with the Bank Holding Company Act and other relevant banking statutes[87].

If in the process of an examination, or by any other means, the Federal Reserve determines that the condition of a bank or a bank holding company is not satisfactory, the Federal Reserve is responsible for requiring that the organisation take steps to correct the situation. In most cases, when the condition is not too serious, the Federal Reserve will enter into an informal agreement or memorandum of understanding with the bank and its directors concerning the

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[86] ibid at p.2

appropriate actions to be taken; in more serious instances a written agreement or cease-and-desist order is issued to direct the bank to take the necessary corrective measures.

When the weakness of an individual bank reach a critical level, the Federal Reserve may play significant role to provide financial and managerial assistance. Under the emergency provisions of the Bank Holding Company Act and the Bank Merger Act, the Board of Governors can approve the immediate acquisition of a failed or problem bank by a bank holding company or a state member bank. The Federal Reserve works closely with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and state banking agencies to facilitate these transactions. Occasionally, liquidity assistance may need to be provided through the discount window to problem institutions before their acquisition by another depository institution or liquidation by the insurance authority.

The Federal Reserve has been authorised by the Congress to implement a number of statutes designed to ensure that consumers, including bank customers, have sufficient information and are treated fairly in credit and other financial transactions. To help them carry out its responsibilities for consumer protection, the Board is advised by a Consumer Advisory Council, which meets three times a year and is composed of representatives of consumers, creditors, and others concerned with these issues.

The Federal Reserve is responsible for writing and implementing regulations to carry out many of the major statutes protecting consumers in financial transactions. Its responsibilities for enforcement of these laws generally extend only to state-chartered banks that are members of the Federal Reserve System.

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[87] ibid at pp.2-4

However, the Board or the Federal Reserve Banks will accept complaints about the policies or practices of any bank and refer them to the appropriate bank regulators.

The Federal Reserves responsibility for supervising and regulating the activities of depository institution in the U.S. include[88] :

i) Supervision and regulation of State - Chartered banks that are members of the Federal Reserve System, all bank holding companies and agreement corporations;
ii) Supervision and regulation of the U.S. activities of foreign banking organisations under the International Banking Act of 1978;
iii) regulation of the U.S. Commercial banking structure through administration of the Bank Holding Company Act of 1956 as amended and along with other federal agencies the Bank Merger Act of 1960 and the change in Bank Control Act of 1978 ; and
iv) regulation of the foreign activities of all U.S. Commercial banking operations that are members of the Federal Reserve System or that conduct their foreign activities through a Corporation[89].

The Congress has also assigned to the Federal Reserve Regulatory responsibilities for a number of Consumer Protection Statutes, whose coverage often extends well beyond banks to other Financial Institutions and Creditors.

5.4 ISRAEL

[88] ibid at pp.3-4
[89] referred also as the 'Edge Corporations'.

Banking supervision is Israel is part of the Bank of Israel (the central bank) and has two main objectives (i) the stability of the banking, and (ii) proper banker-customer relationships. The Banking Supervision Authority attempts to maintain a balance between increasing competition within the financial system and safeguarding bank stability. These goals are achieved by monitoring bank activities, by collecting extensive information on the banking system, by exerting efforts to improve and expand reporting practices of banks – both to the public and to the Bank of Israel. Many of the directives to the banks issued by the supervisor of banks are based on the Basle Committee recommendations and on standard U.S. accounting principles.[90]

The Banking Supervision Authority consists of several units. The Financial Reporting and Information Unit is responsible for processing data received from the banks and initiating improvements in the guidelines for preparing reports to the public. The purpose is to enable the public to obtain comprehensive information about the banks, their performance, and their risks.

The Inspection Unit and the Institutional Evaluation Unit carry out ongoing supervisory activities such as the analysis of periodic data, credit inspection, review of decisions of banks' boards of directors, examination of bank profitability and risk, inspection of the head offices' supervision of branches and offices outside Israel.

The Customer Relations Unit deals with inquiries by the public and monitors bank charges and contracts as well as relations between banks and customers. The Regulation Unit is responsible for preparing legislative proposals and directives for the proper conduct of the banking business. The Research Unit studies and

[90] Taken from the Journal of the Central Bank of Israel

analyzes topics related to the banking system and follows the development of banking throughout the world.

Recently the Supervision of Banks has focused on the issues relating to risk management banks mainly the market risks. In the light of the introduction of innovative financial instruments and the liberalization of financial markets, banks (in Israel and elsewhere) are more exposed to market risks. A directive on risk management has been issued for risk management and control. Another issue that has been focused is that of the banker-customer relationship. Steps have been taken to simplify, speed up, and reduce the costs involved in customer transfer between banks.

5.5 ENGLAND

The Banking Act of 1979, which for the first time provides a statutory basis for banking supervision within the United Kingdom. The Act imposes on the Bank of England primary responsibility for regulating and supervising deposit-taking business and for this purpose established to two categories of institution: recognised banks and licensed deposit-takers. This two-tier system (which is not required by the EEC Directive) enables the Bank to maintain its traditional approach to the supervision of recognised banks based on direct contracts with management, while adopting more formal regulatory procedures in relation to licensed deposit-takers[91].

Bank of England, recognises that the primary objective of its supervision over the financial system including banks is "to fulfil the responsibilities, relating to the safety and soundness of individual authorised banks placed on it by the Banking

[91] Richard Dale, **The Regulation of International Banking**, Cambridge: Woodhead, Faulkner, 1984 at pp.126- 127

Act, 1987 with the aim of strengthening, but not ensuring the protection of depositors in authorised banks". The Banking Act, 1987 accepts the possibility of bank failures and does not aim to deliver a guarantee of bank deposit liabilities. The intention of Banking Act, 1987 is that effective supervision should be in place in order to reduce the risk of capital loss to depositors and to instil depositor's confidence.

Bank of England has prescribed for itself the following standards of supervision[92]:

a) Discharging legal responsibilities;

The Bank will ensure discharging all responsibilities as called for by the banking Act, 1987. This includes Bank's responsibilities in relation to offences under the Act and for keeping under review the operation of the Act.

b) Discharging policy responsibilities:

The Bank intends to define appropriate supervisory policies and guidelines as a basis for consistent and transparent supervisory action. Such policies and guidelines are developed in consultation with the banking industry and their interest parties and with the Board of banking Supervision.

c) Working to raise international standards of banking supervision and developing effective relations with other regulators and supervisory authorities both in UK and overseas.

d) Assessing bank's business, their risk profiles and the microeconomic concept.

The Bank of England is interested to understand and assess the relevant strategies, activities, organisation structure, quality and style of management, risk and earnings profile and systems and controls of supervised institutions.

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[92] Gangopadhyay D.R, *Review of Banking Supervision: U.K. South Africa and India,*. Vol.68, No.2 April-June 1997, The Journal of the Indian Institute of Bankers, at pp 52-54

e) Designing effective supervisory plan and supervisory tools:

Supervisory plans and tools should address effectively more material risks to which a bank is exposed so that appropriate supervisory action can be taken.

f) Reliance on other regulators:

There should be proper understanding and knowledge of other supervisor's legal framework and working practices for proactive co-operation with them.

g) Taking prompt and consistent supervisory actions:

Supervisors should take prompt and consistent supervisory action where a bank has failed to comply with supervisory requirement.

h) Optimal resource allocation based on risk assessment:

In order to achieve this objective of supervision, optimal allocation of resources including people, skills, training, information technology, support services, access to adequate information has to be ensured based on perceived level of risk.

i) Communicating the supervisory framework, approach, policy and decisions:

It is objective of Bank of England to ensure that the supervisory approach is communicated to the supervisory staff to the authorised banks and to the general public.

5.6 SINGAPORE

The Singapore banking system separates local banking business from international and offshore operations. This dual structure enables the authorities to promote Singapore's role as an international financial centre while avoiding excessive competition in the domestic market. Accordingly, within the commercial banking

sector foreign-owned banks are in general prevented from engaging freely in local currency business, the precise limitations depending on whether the bank has a full, restricted or offshore licence. On the other hand any commercial bank can apply for an Asian Currency Unit (ACU) licence enabling it to set up a separate book-keeping unit authorised to participate in the Asian dollar market[93].

Foreign-owned commercial banks are confined to branch form on the grounds that a branch enjoys the full support of the group to which it belongs. There is, however, a separate category of locally incorporated merchant banks which are not permitted to accept deposits from the public but which can (and typically do) set up their own ACUs[94].

Under the Monetary Authority of Singapore Act 1970 the Authority (MAS) fulfils all the functions of a central bank, other than the issue of currency, and is also responsible for supervising the banking system within the framework of the 1970 Banking Act. In carrying out its supervisory function the MAS has recently adopted a policy of deregulation in the sense that detailed supervision of individual institutions is being replaced by generally applicable guidelines, and greater reliance is being placed on external auditors in lieu of extensive prudential returns. At the same time responsibility for the supervision of foreign-owned banks is being shifted more to the parent institutions and their home supervisory authorities[95].

All the banks licensed by the MAS and for this purpose they have to meet certain statutory capital requirements. The MAS also authorise to impose mandatory

[93] supra note at p. 121
[94] ibid at p.121
[95] ibid at p.122

capital ratios and issue any general norms in this regard. As part of reserved requirements, each bank has to maintain minimum cash balance with the MAS[96]

[96] ibid at p.123

CHAPTER 6

COMMITTES REVIEWING REGULATION AND SUPERVISION OF BANKS

6.1 BASLE COMMITTEE CORE PRINCIPLES

The Basle Committee on Banking Supervision, is a Committee of Banking Supervisory Authorities that had drawn up 25 "Core Principles for effective Banking Supervision"[97] which are in the nature of minimum requirements intended to guide Supervisory Authorities which are seeking to strengthen their supervisory function. In 1997, in consultation with the supervisory authorities of a few non G-10 countries including India, it drew up the Core Principles.

In this chapter analysis have been made in respect of the core principles as to whether or not the present legislation in India pertaining to banking supervision has incorporated these core principles. As many countries adopt these principles and businesses becoming more global the necessity of the aforesaid principles in India is more relevant and pertinent so as to make it competitive internationally.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety

[97] Also referred to as "the core principles"

and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Reserve Bank of India has been entrusted the sole responsibility of regulation and supervision of banks in India. The Reserve Bank of India carries out various inspections to supervise and regulate banks in India.

- RBI is entrusted with the sole responsibility of regulation and supervision of banks under the Banking Regulation Act, 1949 (Sections 35 relating to Inspection of Books and 35A relating to issue of direction to banking companies in general or to any banking company in particular).
- The Regulatory and Supervisory functions of RBI were earlier carried out through its Dept. of Banking Operations and Development (DBOD) till December, 1993, when a separate Dept. entitled Dept. of Supervision (DOS) was formed to take over the supervisory function leaving regulatory function to DBOD[98].
- In 1994 RBI constituted the Board for Financial Supervision (BFS) under RBI (BFS) Regulations, 1994.
- DOS bifurcated into the Dept. of Banking Supervision (DBS) and Dept. of Non-Banking Supervision (DNBS).
- DBS is responsible for the supervision of commercial banks and their merchant banking subsidiaries, regulation and supervision of the Development Financial Institutions (DFI) are handled by the Financial Institution Division (FID) of the DBS.
- Power of RBI to apply for winding up of a banking company that is unable to meet its commitments. The RBI can intervene in the bank's management if Director/Management are not found to be fit and proper.
- Cancellation of licence by RBI for non-fulfillment of Section 22 (3) of Banking Regulation Act, 1949.

- Section 7 of RBI Act provides for operational independence to RBI with the Central Govt. also issuing directions from time to time in public interest.
- Section 53 (2) of the RBI Act provides for submission of an annual report on the working of the RBI.
- Section 43 of the RBI Act requires RBI to publish fortnightly consolidated statement containing aggregate liabilities and assets for all scheduled commercial banks.

Principle 2 : The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

- Permissible banking activities are listed under S.6(1) of the Banking Regulation Act,1949. S.6(2) prohibits a banking company from carrying on any form of business other than those referred in S.6(1)
- The scope of the supervision of BFS is currently limited to all commercial banks other than the RRB's.
- S.19 Banking Regulation Act,1949 Restriction on the nature of subsidiary companies. Here banks are not allowed to trade in commodities or become members of the stock exchange.
- S.7 Banking Regulation Act,1949 prohibits the use of the word 'bank', 'banker' or 'banking' to any person other than a banking company as part of its name .

Principle 3 : The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its

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[98] *See generally* RBI Newsletter, Vol.26 No.8, April 30,2000 at p.1

capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

- S.22 of Banking Regulation Act,1949 requires a company intending to carry on banking business to obtain a license from RBI and S.22(3) of Banking Regulation Act,1949 provides for an inspection of bodies to the satisfaction of the RBI.
- S.22(4) of Banking Regulation Act,1949 provides for cancellation of license if it ceases to carry on the business.
- S.10 A(2) of Banking Regulation Act,1949 requires 51% of the Board of Directors to have special knowledge or practical experience.
- Prior approval for opening of new branches of banks from the RBI.

Principle 4 : Banking supervisors must have the authority to review and reject any proposals to transfer ownership or controlling interests in existing banks to other parties.

- S.12(2) of Banking Regulation Act,1949 restricts shareholders in a banking company from exercising voting rights on poll in excess of 10% of total voting rights.

Principle 5 : Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investment by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

- S.19(1) of Banking Regulation Act,1949 requires approval of RBI to form subsidiaries by a bank. S.19(2) of the said Act restricts other investments by banks which should not to exceed 30% of its paid-up capital.
- Insistence of RBI to maintain arm length relationship between a bank and a subsidiary.

Principle 6 : Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Base Capital Accord.

- 9% of CAR as prescribed by RBI to be maintained by banks.
- Compliance with CAR is monitored through quarterly prudential reporting and on-site inspection of banks.

Principle 7 : An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

- S.21 of the Banking Regulation Act,1949, places a responsibility of determining the policy relating to advances by banks and giving directions to them.
- On site examination, the policies, practices, procedures, operations of the scheme, classification of assets, loan loss providing for loans and investments, concentration of risk, adherence to prudential exposure norm, scope and adequacy of audit and loan review functions and compliance with laws and regulations.
- Guidelines by RBI on Risk management systems in Banks.

Principle 8 : Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

- On site inspection for appraisal of asset quality, prudential norm on income recognition , erosion of the issue of assets and the impairment in the value of assets.

Principle 9 : Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

- Prudential norms have been prescribed by RBI. The banks are to fix certain limits for exposure to different sectors as part of the loan policy.
- As per the instructions of RBI, banks are required to report their top twenty borrowers with balances exceeding 15% of their capital funds.

Principle 10 : In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

- S.20 prohibits loans and advances to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor.
- Banks are requested to maintain arms length relationship with promoter companies and cannot extend finance for acquisition of shares except for acquiring shares in overseas wholly owned subsidiaries or joint ventures.

Principle 11 : Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

- Suitable steps are being taken by Reserve Bank in ensuring that banks have proper risk assessment systems.

Principle 12 : Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

- Power of RBI under S.35A of the BR Act to impose specific limits and/ or specific capital charge on market risk exposures as part of the general powers to issue directions to banks on any aspect of their functioning.
- The ratio of marking to market has been fixed at 75% of approved securities with effect from 31st March, 2000.
- Banks revalue their foreign exchange portfolios on monthly basis. The investment in securities are valued quarterly.

Principle 13 : Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

- RBI has issued guidelines to banks for putting in place Asset-Liability Management(ALM) system with efffect from 1st April, 1999. Every bank has an Asset-Liability Committee (ALCO), headed by the Chief Executive Officer/Chairman and Managing Director or the Executive Director of the bank.
- All banks are required to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) as per S.42(1) of RBI Act and S.24(2A) of the BR Act. The RBI has power to modify CRR between 3 to 20% and SLR between 25 to 40% by notification in the official gazettee.

- Banks are required to submit a quarterly return on interest rate sensitivity for exposures in Rupee as well as in foreign currencies to RBI with effect from June, 1999.
- Banks are required to assign 100% risk weight to their open position in foreign exchange with effect from March 31, 1999. The RBI has recently issued guidelines on management of overall risk management covering the major risks faced by banks.

Principle 14 : Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliations of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

- Examination and evaluation of the adequacy and effectiveness of the internal control system in the banks form one of the important aspects during on-site inspection by the RBI.
- All domestic banks have been advised to name the General Manager in-charge of Audit and Inspection function as compliance officer, who should ensure ongoing compliance with instructions issued by the RBI and Government of India.
- RBI is vested with powers to remove managerial persons under S.36AA and S. 36-AB of the BR Act.

Principle 15 : Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector

and prevent the bank being used, intentionally or unintentionally, by criminal elements.

- RBI maintains a database of frauds and their modus operandi and this information is shared with banks to enable them to prevent occurrence of such frauds.

Principle 16 : An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

- On-site inspections are done through CAMELS (Capital Adequacy, asset quality, management earning, liquidity and systems and controls) model.
- Domestic banks are rated on CAMELS model while foreign banks are rated on CACS model (capital adequacy, asset quality, compliance and systems).

Principle 17 : Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operation.

- Meetings are held with banks for various purposes. Banks are often consulted before introduction of major reporting changes and senior bank officers are often associated with the working groups and committee set up by the RBI to examine/ deliberate on regulatory/ supervisory activities.

Principle 18 : Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

- In terms of Section 27 of the Banking Regulation Act, 1949, RBI has powers to call for information from a banking company relating to their affairs.
- RBI also conducts inspections from time to time for the purpose of reviewing and analysing reports submitted by the banks.

Principle 19 : Banking supervisors must have a means of independent validation of supervisory information either through on-site examination or use of external auditors.

- In terms of Section 30 (1B) of the Banking Regulation Act, 1949, RBI has been empowered to conduct special audit in the interest of banking companies or its depositors.
- In terms of Section 30(1A) of the Banking Regulation Act, 1949, every banking company shall, before appointing or reappointing or removing any auditor, obtain previous approval of the RBI.

Principle 20 : An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.[99]

- In terms of Section 27 of the Banking Regulation Act, 1949, RBI is empowered to collect information from the banks. However, RBI does not have power to call for any information in case the bank is owned by any institution / non-banking company; if there is any apprehension that the decision or control exercised by such non-banking company have an adverse interest in such banking company.

Principle 21 : Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

[99] Supervision of the banking group on a consolidated basis goes beyond accounting consolidation. It implies that there is a group-wide approach to supervision whereby all risks run by a banking group are taken into account, wherever they are booked. It is important to note that both accounting consolidation and consolidated supervision are key aspects of the supervision of banking groups.

- In terms of Section 29 of the Banking Regulation Act , 1949 banks are required to prepare statement of accounts in the form as may be prescribed by the Reserve Bank from time to time. Certain disclosures are also required to be made by the bank in its annual statement such as capital adequacy ratio, return on assets, etc.
- In terms of Section 31 of the Banking Regulation Act, 1949, banks are required to publish their balance sheet and profit and loss account together with the auditor's reports in any leading newspaper in circulation at the place where the bank's head office is situated.

Principle 22 : Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

- In terms of Section 35 A of the Banking Regulation Act, 1949, RBI may issue specific directions to the bank in the interest of banking company, banking policy, depositor's interests or in the interest of public.
- In terms of Section 46 of the Banking Regulation Act, 1949, RBI may impose penalty on the banks for any violations of the guidelines issued by them or violations of any provisions of the Banking Regulation Act, 1949.

Principle 23 : Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

- RBI has powers to call for information from banks incorporated in India but having branches outside the country.

Principle 24 : A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

- Forums like Bank for International Settlements where the Central Banks are members have understanding in sharing information. On request from other Central Banks to information is parted on a consolidated form in terms of Section 28 of the Banking Regulation Act,1949.

Principle 25 : Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

- The directions issued by the RBI for e.g. in terms of Section 35A of the Banking Regulation Act,1949 are equally applicable to all the banks

From the above principles and the steps taken by RBI or that which is already existing in the provisions of the Banking Regulation Act, 1949 one could safely conclude that much of the principles are already been incorporated. The area that would require focus is that of consolidated supervision for which the RBI must have powers to advise the companies which are non banks holding control or ownership of the banking company and also to call for such information as it may require for taking suitable steps for the purposes of supervision.

As the permissible activities undertaken by the banks are expanding, some of the activities often fall under the jurisdiction of other regulators. In this connection it

is felt necessary that proper co-ordination and information sharing between these regulators would become a necessity.

6.2 Report of the Narasimham Committee on Banking Sector Reforms

The Narasimham Committee II was appointed to review the progress made in the banking sector since the Committee made their set of recommendation in 1991[100]. The Narasimham Committee II made their recommendation to further strengthen the banking system in India. Amongst others, the major recommendations, which have a direct bearing in the regulation and supervision of banks, have been listed below:

- Action for strengthening the foundations of the system would involve improving the quality of bank assets.
- Continuation of the reform process would involve the reduction of higher level of NPA.
- To find ways to regulate the business done by NBFC.
- Few large banks to have an international character. There is also need to impart greater competition between Public and Private sector banks.
- Mergers between strong banks can be a means of strength, providing greater opportunities for competition. Mergers to be meaningful should yield benefits in terms of staff and branch network rationalisation.
- Technological upgradation both at the level of central office and branch retail offices be given top priority.
- High degree of professionalism is needed in the banks.
- Regulation should be concerned with formulation of policy with regard to the prudential norms, capital adequacy and like, while the function of supervision

[100] Also known as the First Narasimham Committee set up by the Government of India in 1991 to strengthen the banking system and make it internationally competitive.

should be regarded as the instrumentality for ensuring that the regulatory norms are compiled with.

- A Board of Financial supervision be established as an autonomous body.
- There are host of banking sector laws like the RBI Act, BR Act, SBI Act, Nationalisation Act and so on which are in urgent need of review and amendments to bring some of the provisions in line with the current needs of the banking industry in the country.
- The emphasis for banking and financial sector reform should be to enhance the inherent strength of banks, review the structure of the system, the internal organisation of banks and streamlining the procedures taking into account institutional and technological dimensions. An analysis of the banking policy in the new milieu would also be required.
- Reserve Bank should be made the Primary agency for regulation. The supervisory function over banks and financial institutions should, however, be given off to a separate authority to operate as quasi-autonomous body, under the Reserve Bank, but should be separate from the other Central Banking functions of the Reserve Bank.
- There is a need for constant review of prudential norms, governing bank's operations.

The RBI has accpeted the recommendation of the Narasimham Committes recommendation and has taken adequate care to phase out in a manner that reduces risk exposures of banks, strengthens financial soundness and contributes to improved profitability outlook.

CHAPTER 7

CONCLUSIONS

Changes in the financial services industry present new challenges as to how supervision is to be carried out most effectively. It is clear that the fundamental approach, scope and methodologies of supervision must evolve in line with the way financial institutions manage their activities keeping in view the overall legal framework . Good banking supervision is a balancing act. It is important for the banking supervisor to identify prevailing risks and take proper remedial action. The banking supervisor needs to understand the functioning of the markets, existing and future financial products and current bank practices. Furthermore, the supervisor must be well-informed about each institution and understand fully the accounts so as to be able to make proper analyses.

The fundamental aspect for any banking supervisors and regulators is to remain focused on their principal tasks. First, to ensure that the banking system remains sufficiently safe and sound, posing little risk to the federal safety net and adequately protected against systemic risk. Second, banking services are made available to the public at a competitive price (e.g. interest rates on borrowings) and conform to legislative standards. Perhaps more than before, achieving these goals requires us to adapt our practices to changing circumstances within the banking sector and to take full advantage of the technologies that exist.

The supervisors must maintain a steady flow of relevant information and review the same for any institution's exposures and to be satisfied that risk management system is in order so as to reduce the time-consuming and burdensome process that are often associated with traditional examination and oversight techniques. Periodic review of management reports should not only enhance the knowledge of specific exposures and events, but also provide insights into a bank's control

process and about what information management is deemed to be important. Information sharing and co-ordination with other supervisors are key elements of to successful supervision of large institutions. The system should provide supervisors with both public and confidential information about an institution in a simpler way. The system should prove particularly helpful in monitoring and evaluating conditions at the largest institutions.

Of late there has been a shift away from the supervisors or regulators imposing prudential standards on banks by defining the minimum reserve assets that they must hold (e.g. in government securities or in readily realisable assets). Instead, the trend has been towards defining minimum, capital-adequacy ratios and by requiring banks to disclose more of their financial details. This self-discipline within prudent standards is supposed to operate more neutrally than the previous order. Historically, the purpose of the central banks of supervision is to provide liquidity, maintaining inflation by using various methods rather then to interfere in the management of particular institutions. Of late these thing have beginning to show a change specially after the financial scams that has took place in the recent past and due to the mismanagement of individual banks. The closer the supervision of banks, the less discretion is affected to those responsible for the management of banks, which may increasingly rely on direction from the supervisor as to how to run a banking business. But banking supervision are not engaged in commercial decision making necessary for a successful banking business and are unlikely to spot all the opportunities and the day to day affairs of the banking company.

In this context, the fundamental tenet of supervision is that the nature of a bank's risk management process must be consistent with the level of underlying risk. In a properly working banking system, risks are balanced and managed. To do that, it

is necessary to create a framework of laws and regulations within which banks conduct their operations, but leave it to bank management to operate the bank within that framework. It is thus also essential to have bank management with the know-how, skills and experience and the systems to measure risks and keep them under control. This is one of the greatest challenge to the supervisors who should be skilled to monitor and also to facilitate the growth of the services provided by the banks which in turn would depend on the legal and regulatory framework of individual countries.

Again the supervisory systems of the individual countries depend on the institutional framework, which differ considerably across countries and are based on the particular political, legal and administrative traditions of the countries; their varying banking structures; and their differing approaches to the theory and practice of banking supervision.

In developed economies, there is a general tendency among central banks to retreat from supervisory function. This was exemplified recently in the UK by the breakaway of the supervisory functions from the Bank of England in May 1997 and the establishment of the Financial Services Authority (FSA), a mega financial supervisory authority. Several reasons have been advanced for this trend. First, banking is becoming increasingly complex business and less clearly defined. Leading banks are active in several jurisdictions as providers of a gamut of financial services. Linked to this are new developments in financial supervision, which increasingly stresses the role of self regulation and internal risk management in financial institutions. Finally, there is growing acceptance that bank failures are increasingly becoming expensive, going beyond the sums that banks can provide from its own resources.

At present the role of RBI as a regulator of banks needs to be strengthened. It would be better if RBI is made as a constitutional authority to give the dimension of autonomy. The central banks in countries like Sri Lanka and South Africa are part of the Constitutional framework. This need is more felt in a developing country like India where the monetary management plays a significant role in the development of the economy. Operational independence helps to take prudent decisions and in a democratic set up like India, autonomy is more necessary for prudent decision making and ensuring greater transparency in the policies as a whole.

This leads us to the issue i.e. should there be a separation of monetary management and supervisory role of the central bank ?. Ideally, it is better if the central bank is able to concentrate on its core objectives i.e. monetary management and maintaining financial stability in the system. It will be able to concentrate solely on these important aspects. A close co-ordination between the two will ensure a better functioning and attaining a fair amount of expertise in the respective area. The case of Bundes Bank is a good example where there is a separation of the regulation and supervisory function. France too has a similar structure. The Governor of the central bank is ex officio chairman in the supervisory board, which reduces overlapping of functions, and close co-ordination is maintained. Information is necessary for the purposes of effective regulation and supervision. When there is flow of information it becomes easier for the agency to take decisions.

Another aspect towards separation is that RBI as a regulator or referee of money market often seems to be assuming the role of a player in the market. This leads to an apprehension of its role as a referee which is only to act as an independent agent divested of any interest in the game except that its concern only should be

whether or not the rules of the game are properly followed. Hence there is overlap of regulatory functions of RBI.

The Narasimham Committee had emphasised the need for separation of the functions of regulation and supervision. Though the RBI has created a separate Board for Supervision but the function carried out by them are similar. Separation of supervisory functions for instance like NABARD for rural banks have given it a competitive edge in terms of achieving a professional approach in supervising these rural banks. Though, setting up a separate institution will increase the cost of exchequer but over the period of time it may prove fruitful.

Another area of challenge for the central banks role is with regard to the changes and diversifying of businesses by the banks. The banks may be subjected to the jurisdiction of different regulators. This brings us to the point as to whether a 'mega regulator' is necessary, possible or feasible to introduce into the Indian financial market. To examine this properly one needs to analyse the existing structure of the financial sector and the regulators that are already in place.

Building up from the arguments advanced above of the various models of supervision and the case for and against a mega regulator, the analysis of the feasibility of the structure of a mega regulator within the Indian scenario becomes necessary.

The RBI has under its control the function of monitoring the health of individual banks and NBFCs. This is done by means of prescribing prudential norms and keeping a strict check of all these parameters. The RBI carries on both on-site and off-site surveillance for this purpose. Under the Banking Regulation Act, the RBI is also vested with the powers to issue directions to banks whenever it considers it necessary. The power to grant licenses to banking companies is also vested solely

in the RBI. Therefore, the RBI controls the entry into the banking sector, operations and health within it and also the exit point. There is a large element of control by the Central Government built into the Banking Regulation Act, 1949 and the Reserve Bank of India Act,1934 by virtue of its overriding powers and the factum of its ownership of the largest chunk of the Banking sector, thereby making the Central Government and the RBI joint regulators of the banking sector. There is a move, however, to separate the government's role and have RBI as the sole regulator of the Indian banking sector. There is debate internationally, about the possible conflict between the roles of the central bank as a regulator and as the lender of the last resort. If the autonomy of the central bank is to be maintained then it must be given a free hand to take the decision in the overall interest of the banks.

The regulatory measures have important lessons for India. In the context of banks adopting the universal banking model, there will be need for evolving proper supervisory structure by bringing multiple supervisors like RBI, SEBI, IRA, BFS etc. under a single umbrella. The suggestion of the Narasimham Committee (1998) to establish the Board for Financial Regulation and Supervision (BFRS) is quite valid. However, closer coordination between the multiple regulators may not be sufficient. It would be useful to designate a primary regulator who will also jointly supervise other subsidiaries/parts of the financial system intermediaries. The supervisory structure will have to allow financial diversification while attempting to contain risks within individual financial affiliates and preferably prevent any spillage of financial difficulties originating in a non-bank affiliate overflowing into the bank entity. Suggestion for construction of fire walls within the corporate structure of the financial conglomerate may be worth examining. The fire walls may please restrictions on intra-group transactions, or they may seek separate identity of the bank and its affiliates or they may call for separate management. While the solo supervisors could pursue their supervision of the

relevant entity, designating a primary regulator would facilitate taking a holistic view of the activities as a whole.

Though, time may not be ripe at this stage to go in for a mega regulator in India as the other regulators like Securities Exchange Board of India (regulating the capital markets), Insurance Regulatory Authority (IRDA) and other bodies where banks are seemingly playing an important role in expanding their businesses. However, the need would be felt in the future when their role may seemingly become indifferent. The policy, cost for setting up such an institution and the legal framework also need to be considered for having a mega regulator

Presently, there are hosts of laws pertaining to banks in India. The Banking Regulation Act, 1949, Reserve Bank of India Act, State Bank of India Act, Nationalisation Act, Negotiable Instruments Act, Bankers Books of Evidence Act, Regional Rural Banks Act etc. It is rather high time that these laws are unified. Necessity is felt with regard to having a unified self contained code relating to banking which will contain all aspects relating to banking from deposit taking activity, banker customer relationship, loans and advances, collection of credit information, negotiable instruments etc. This would give a sense of direction and certainty to the laws and the policies thereof in India.

Ever since the reforms in 1991 the Indian banks seem to be moving towards universal banking and many foreign players have also entered the fray in the wake of these reforms. This is a good sign of development for the banking industry as a whole and also for the customers who avail off such services would have better facilities offered to them due to the competitive atmosphere. To stay in the competition it requires that the bank be managed prudently and soundly. Need for expertise to run the bank is felt more. As in the case of public sector banks where the government holding and control, the question of management has not been

considered much. But of late this scenario is changing as the government is realising the need for maintaining a sound system and thereby taking initiatives to divest its shareholding.

The introduction of prudential norms in India is a welcome move. Banks are compelled to make their statements in accordance with these norms. Though to some extent the introduction of prudential norms has affected the profitability of banks and made the bank management overcautious while sanctioning the loans. These norms, which are based on international standards are not in consonance with the recovery atmosphere prevailing in the country. The recovery process needs to be strengthened and steps like formation of Asset Management Companies and securitisation is a step ahead to reduce the NPA levels in the banks.

The core principle on banking supervision and the compliance in the system is a healthy sign of the Indian banking system. Areas like consolidated supervision and reporting have not yet been incorporated. This will be of relevance when there are mergers and amalgamations taking place or where the ownership or control is vested in an entity, which is not a banking company. It will be difficult for the regulator of the bank i.e. RBI to supervise or give direction to the holding company which may be a non bank and hence will frustrate the very action desired to be taken by the RBI in the interest of the bank, banking policy, depositors interest or in public interest. The consolidation will facilitate greater flexibility to RBI in regulating the banks.

Other challenge that RBI may face is with regard to the multiple regulators. As the banks are diversifying their business, some of which may not fall under the jurisdiction of RBI, it may become necessary that proper sharing of information be

there between the regulators for maintaining the stability and health of the financial system.

The co-operative banking sector has been a great challenge to RBI. It may be stated that the dual control regime, per se, need not cause any hindrance to the growth of the urban banking movement. It is the absence of a clear-cut demarcation between functions of RBI and that of the State Governments that adversely affects the smooth functioning of Urban Cooperative Banks. It is interesting to take a case of supervision and regulation of banking companies. Although they are registered as companies under the Companies Act 1956 by the Registrar of Companies, they carry on the banking business under the sole Supervision of RBI. This is because the Registrar of Companies does not interfere in the field covered by the Banking Regulation Act. Once a company registered under the Companies Act, gets licence from Reserve Bank, its activities are regulated by its Memorandum and Articles of Association and the provisions of the Banking Regulation Act, 1949. Since the provisions of Banking Regulation Act have an overriding effect on the Memorandum and Articles of Association, the RBI becomes the sole regulatory-authority in relation to business activity of banking companies.

One of the suggestions, repeatedly put forth by the cooperators is that excesses of dual control regime can be contained by transferring the item "cooperative society" to Union List or to Concurrent List so as to enable the Union Parliament to legislate on the subject of cooperative banks. Given the federal polity of our country, it is unlikely that the State Governments would agree to such a transfer. Earlier Committees like Madhavadas Committee, Marathe Committee and quite recently Narasimham Committee have all suggested that there is need to address the issue of `duality of control', by carrying out necessary statutory amendments. However, nothing substantial has been done till date. Perhaps the only effective

way to solve the problem of dual control is to carry out amendments in the respective State Cooperative Societies Act, the Multi State Cooperative Societies Act, 1984 and also the Banking Regulation Act to clearly demarcate the banking-related functions which are to be regulated solely by RBI and those related to establishment of cooperative societies and their cooperative character which shall remain within the domain of the RCS of concerned state. Thus for banking related functions, the RBI would become the sole regulator.

The Committee on the Financial System 1991 (Narasimham Committee I) had strongly recommended that the "duality of control over the banking system between the Reserve Bank and the banking division of the Ministry of Finance (in case of Commercial Banks) should end and that the Reserve Bank should be the primary agency for the regulation of the banking system[101]". The concept of a Super Regulator was raised in the Report of the Working Group for Harmonising the role and operations of DFIs and banks (Chairman: S.H. Khan). The Group recommended as one of the options, the establishment of a Super Regulator to supervise and coordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment. Report of the Committee on Banking Sector Reforms (April 1998) (Narasimham Committee II) recommended that integrated system of regulation and supervision be put in place to regulate and supervise the activity of the banks, financial institutions and NBFCs. The Report of the Advisory Group on Banking Supervision, September 2000[102] made some elaborations on the subject and observed that overlap needs to be regulated so that RBI can perform its regulatory/supervisory roles without any hindrance.

With the setting up of National Bank for Agriculture and Rural Development (NABARD) in 1982 responsibility of overseeing the functioning and supervision

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[101] Committee on Financial Sector Reforms, M.Narasimham, 1991 at p.130
[102] under the Chairmainship of Shri M.s.Verma

of co-operative banking structure other than Urban Co-operative Banks has been shifted from RBI to NABARD under Section 35(6) of the Banking Regulation Act,1949. NABARD has made efforts at streamlining and upgrading its supervision arrangements on the basis of recommendations of internal committees set up by it since 1991 towards improving the quality and content of bank inspections. The U.K. Sarma Committee was set up by NABARD in 1998 to review the entire range of supervisory activities of NABARD and suggest appropriate measures to streamline the supervisory mechanism. The Committee's recommendations included a suggestion to introduce off-site surveillance system aimed at continuous monitoring of the performance of banks. The Committee also recommended setting up of a separate Board for Supervision within NABARD.

To overcome the issue of duality some suggestions has been made i.e. to shift the regulatory and supervisory role of RBI in co-operative banks to NABARD. This has come in the wake of scams that has highlighted certain failures by the regulator to monitor the UCBs on a continuous basis. Given the wide coverage of branches spread over India and the RBI having most of its offices in the State capitals it is rather difficult for them to supervise on a continuous basis. The number of commercial banks and other private banks are also large making it rather difficult to put onus on RBI. The co-operatives being distinct in nature and being partly supervised by RBI it would be better to shift the same to NABARD as NABARD is already exercising its role as a regulator in case of Regional Rural Banks and other small co-operative banks. Given there wide network of offices and specialised staff in supervising the rural banks it would be able to undertake the supervisory aspect in a better way. This would also be reducing the regulatory costs even if suggestion is mooted to set up another specialised supervisory body like NABARD for UCBs. However, these suggestions will not be an ideal solution as the main problem with regard to UCBs has been that of dual control. Whosoever be the regulator or supervisor unless the issue of dual control is

addressed, the problem will persist. An amendment to the respective Co-operative Societies Act, Multi State Co-operative Act,1984 is much needed so as to give the regulatory and supervisory powers to RBI or any other regulator(NABARD or any other body created for the purposes of regulating UCBs). Though this is an uphill task since most of the members in UCBs are politicians or having a political clout, who exercise control over these banks, it would rather be difficult to bring concurrence in all the states.

Finally, the role of protecting the depositors is an important segment of any regulators. The role of the deposit insurance corporation needs to be strengthened. The banks have been defaulting in paying premiums to the corporation more so the co-operative banks that are the major defaulters. In case of liquidation or winding up of banking companies, it is often seen that the process of liquidation takes a longer time. A fast track liquidation mechanism on the lines of US Chapter 11 code will help the depositors and creditors to recover the money at the earliest. In this regard the amendment to the Deposit Insurance and Credit Guarantee Corporation Act, 1961 becomes necessary.

A sound banking system calls for appropriate infrastructure to support efficient conduct of banking business and a stable macro economic environment. The on going reforms in the banking sector are a healthy sign for positive development of banking system in the country. Creating a favourable legal environment wherein less interference from regulators may help the banking sector to move further. Indian banking system is here to stay and may in future become more competitive internationally and set a standard to which others can look into.

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ANNEXURE I
Supervision and Surveillance Across Central Banks

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
	2	3	4
. Australia	Australian Prudential Regulation Authority; all banks are also subject to the Corporations Law administered and enforced by the Australian Securities and Investment Commission	Statutory Responsibility to Protect Depositors	Authorisation and Oversight of Foreign Exchange Market
2. Austria	Ministry of Finance	Receives statistics for off-site analysis and inspections. Produces expert opinions on adherence with certain regulations	No explicit oversight of markets. Supervises foreign exchange bureaus
3. Belgium	Banking and Finance Commission	Validation of statistics. Member of Board of Bank is a member of Board of the Commission	First line surveillance of market for certain securities
4. Brazil	Central Bank of Brazil	Authorisation of domestic banks, inspections, compliance	Central bank supervises non-banks, but their operations in the market is overseen by Securities and Exchange Commission.
5. Canada	Office of Superintendent of Financial Institutions (OSFI)	Advisory Role, Governor is member of supervisory committees, Bank acts as	No statutory responsibility for oversight of markets, though interest in stability

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
	2	3	4
		Lender-of-Last Resort (LLR), Bank may require OSFI to carry out special inspections	of financial system.
6. China	People's Bank of China		Financial market surveillance other than securities markets. Also supervises non-bank financial intermediaries.
7. Czech Republic	Banking supervision with Czech National Bank		Czech Securities Commission for securities activities
8. Denmark	Danish Financial Supervisory Authority (under Ministry of Economic Affairs)	Bank maintains close relation with supervisory body and participates in primary legislative work	Macro oversight
9. Egypt	Central Bank of Egypt		Regulation of capital markets and insurance are conducted by separate agencies
10. Finland	Financial Supervision Authority (micro supervision), Bank of Finland (macro prudential oversight)	Bank carries out analysis, participates in development of legislation, participates in development of financial market infrastructure, monitors liquidity of banks	Interest in oversight of systemic risk. Interest of efficiency of money market, because of monetary policy role
11. France	Commissioner Bancaire	Bank provides staff and	Commission supervises

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
	2	3	4
	(supervision), separate licensing committee (staffed by Bank)	resources for Commission; Governor of the Bank is Chairman of Commission	investment firms, also financial holding companies (which consist of credit institutions); monitoring and analysis of financial markets
2. Germany	Federal Banking Supervisory Office; Bundesbank has primary responsibility for surveillance of credit institutions, in task of credit register with regard to loans of DEM 5 mn. or more	For regulations, involvement of Bundesbank differs according to the extent to which the regulations affect its functions; this is specified. Bundesbank is fully involved in regular surveillance of credit institutions and analyses of their annual and other reports.	None
13. Ghana	Bank of Ghana		Insurance sector is regulated by a separate agency, *National Insurance Commission*
14. Greece	The banking supervision division of Bank of Greece is responsible for supervision of banks	Bank of Greece acts in close co-ordination with insurance and securities regulators. Exchange of confidential information between the Bank of Greece	Regulation of securities market is conducted by Capital Market Commission, an independent decision making body under the

;ountry	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
	2	3	4
		and the aforesaid supervisors is permitted by legislation and informal cooperation takes place, whenever necessary.	supervision of Ministry of National Economy
5. Hong Kong	With Hong Kong Monetary Authority (HKMA)		HKMA oversees inter-bank market and conduct of authorised institutions in Government debt market. Chairs Foreign Exchange and Money Market Practices Committee
.6. Hungary	Hungarian Banking and Capital Market Supervision (HBCMS); Central Bank of Hungary (CBH)	Bank consulted over licensing; it also carries out on-site and off-site supervision to ensure compliance with its regulations. Data exchanges between CBH and HBCMS	NBH supervises range of financial intermediaries, other than insurance. General oversight of inter-bank and foreign exchange market.
17. Iceland	The Financial Supervisory Authority (funded entirely by the supervised institutions) is the supervisor of banking, insurance and securities markets.		
18. India	Reserve Bank of India		Supervision of insurance is

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
	2	3	4
			conducted by Insurance Regulatory and Development Authority (IRDA); regulation of securities market is conducted by Securities and Exchange Board of India (SEBI).
9. Indonesia	Bank Indonesia	Bank Indonesia is also responsible for promoting a sound development of the credit and banking business and exercising supervision over the credit business	Regulation of Securities market is conducted by Capital Market Supervisory Agency
20. Ireland	Bank has primary responsibility for all aspects of authorised deposit-taking institutions (other than Post Office Savings Bank and credit unions)	Regulation, inspection and analysis	Bank has responsibility for all financial institutions, except insurance companies
21. Israel	Bank of Israel		Regulation of securities market and insurance are conducted by two separate agencies, of which the latter is under Ministry of Finance
22. Italy	Bank of Italy	Bank is responsible for	Bank responsible for

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
1	2	3	4
		application of competition law for the banking sector	supervision of some banks; for investment firms, this is with Companies and Stock Exchange Commission.
23. Japan	Financial Supervisory Agency (FSA) is the sole supervisor of banks	Bank conducts on-site examinations and off-site monitoring	On-site examinations of major securities companies with accounts at the bank. Consulted about changes in codes of practice for money market
24. Kenya	Central Bank of Kenya		The Capital Markets Authority, established in 1989 under an Act of Parliament regulates the securities market
25. Korea	Financial Supervisory Commission (banks, securities and insurance)		Securities and Futures Commission (securities market)
26. Malaysia	*Bank Negara Malaysia* is responsible for supervision of banking and insurance business		Regulation of securities is conducted by a separate securities regulator, *Suruhanjaya Sekuiti*.
27. Mexico	National Banking and Securities Commission	Bank carries out off-site inspection of financial institutions. Also research and analysis	Oversight of money, forex, local Government debt securities and derivative market
28. Netherlands	De Nederlandsche Bank	Coordination with Dutch	Bank supervises investment

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
1	**2**	**3**	**4**
	NV	supervisory institution for combined banks/insurance companies	institutions which attract money from the public, also exchange agencies
29. New Zealand	Reserve Bank of New Zealand		The Securities Commission is the regulator of the securities market
30. Nigeria	Central Bank of Nigeria	The Central Bank is responsible for overseeing financial stability	The securities market is regulated by the Securities and Exchange Commission
31. Norway	Banking, Insurance and Securities Commission	Bank does some surveillance work, including early warning indicators and quarterly reports on prospects for financial stability	Bank responsible for smooth functioning of financial markets
32. Philippines	Central Bank of Philippines		Separate regulatory agencies are responsible for regulation of securities (Securities and Exchange Commission) and insurance (Insurance Commission).
33. Poland	General Inspectorate (organizationally autonomous body within the structure of National Bank of Poland) responsible for banking		Securities and Exchange Commission (securities market); State Agency for Insurance Supervision (insurance). Bank in general oversees supervision of

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
1	**2**	**3**	**4**
	supervision		forex and derivatives market
34. Singapore	Monetary Authority of Singapore responsible for authorisation, licensing, inspection, requesting information, give direction and suspend operations of all institutions (banks, merchant banks and securities and insurance companies)		
35. South Africa	South African Reserve Bank	Responsible for supervision of mutual funds as well	The Financial Services Board, a non-governmental independent institution established by statute in 1990 to supervise the South African financial services industry (excluding banks and medical schemes) regulates securities and insurance activities
36. Spain	Banco de Espana (central bank)		Separate regulatory agencies are responsible for supervision of securities and insurance activities
37. Sweden	Financial Supervisory	Rules for each bank	

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
1	**2**	**3**	**4**
	Authority (FSA)	established and enforced by FSA, while Bank undertakes general supervision of financial markets	
38. Switzerland	Federal Banking Commission	National Bank shares data with Banking Commission	Swiss National Bank is responsible for conduct of monetary policy, promoting efficiency of the payment system and ensuring financial stability
39. Thailand	Bank has primary responsibility for supervision of all aspects of supervision of all commercial banks. Ministry of Finance supervises three specialised Government banks	Bank makes use of internal and external audits. Responsibility shared for certain business activities	Bank responsible for supervision of finance companies, finance and securities companies and credit fonciers. Bank oversees forex and derivative market
40. Turkey	Responsibility of Banking Supervision is vested with *Banking Regulation and Supervision Agency*, a separate agency established in 1999		Regulation of securities (Capital Market Board of Turkey) and insurance (Under Secretariat of Turkey) are with two separate agencies
41. United	Financial Services		Bank responsible for

Country	Prime Responsibility for Supervision of Banks	Responsibilities of Central Bank if Supervision is Shared	Responsibilities for Supervisors of markets /other institutions
1	**2**	**3**	**4**
Kingdom	Authority		financial stability
42. United States	Federal Reserve has supervisory authority for all state-chartered banks that are members of Federal Reserve, also for branches and agencies of foreign banking organisations with operations in the US		Federal Reserve supervises bank holding companies

Source: Annual Reports, various banks; BIS websites of central banks and Courtis (1999).

Annexure II

BANKING REGULATION ACT, 1949

Key provisions pertaining to regulation & supervision of banks in India.

Section 6. Form and business in which banking companies may engage

(1) In addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely,-

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; and drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts, bill of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, travellers' cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others; the negotiating of loan and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) acting as agents for any government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a [30][Managing Agent or Secretary and Treasurer] of a company;

(c) contracting for public and private loans and negotiating and issuing the same;

(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

(e) carrying on and transacting every kind of guarantee and indemnity business;

(f) managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) undertaking and executing trusts;

(i) undertaking the administration of estates as executor, trustee or otherwise;

(j) establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts, and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pension and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent object or for any exhibition or for any public, general or useful object;

(k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purpose of the company;

(l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(m) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

(2) No banking company shall engage in any form of business other than those referred to in sub-section (1).

Section 7. Use of words "bank", "banker", "banking" or "banking company"

(1) No company other than a banking company shall use as part of its name [15][or, in connection with its business] 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.

(2) 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".

(3) Nothing in this section shall apply to-

(a) a subsidiary of a banking company formed for one or more of the purposes mentioned in sub-section (1) of section 19, whose name indicates that it is a subsidiary of that banking company;

(b) any association of banks formed for the protection of their mutual interests and registered under section 25 of the Companies Act, 1956 (1 of 1956).]

Section 10A. Board of Directors to include persons with professional or other experience

(1) Notwithstanding anything contained in any other law for the time being in force, every banking company-

(a) in existence on the commencement of section 3 of the Banking Laws (Amendment) Act, 1968, or

(b) which comes into existence thereafter,

shall comply with the requirements of this section:

PROVIDED that nothing contained in this sub-section shall apply to a banking company referred to in clause (a) for a period of three months from such commencement.

(2) Not less than fifty-one per cent of the total number of members of the Board of Directors of a banking company shall consist of persons, who-

(a) shall have special knowledge or practical experience in respect of one or more of the following matters, namely,-

(i) accountancy,

(ii) agriculture and rural economy,

(iii) banking,

(iv) co-operation,

(v) economics,

(vi) finance,

(vii) law,

(viii) small-scale industry,

(ix) any other matter the special knowledge of, and practical experience, which would, in the opinion of the Reserve Bank, be useful to the banking company:

PROVIDED that out of the aforesaid number of Directors, not less than two shall be persons having special knowledge or practical experience in respect of agriculture and rural economy, co-operation or small-scale industry; and

(b) shall not-

(1) have substantial interest in, or be connected with, whether as employee, manager or managing agent-

(i) any company, not being a company registered under section 25 of the Companies Act, 1956 (1 of 1956), or

(ii) any firm,

which carries on any trade, commerce or industry and which, in either case, is not a small-scale industrial concern, or

(2) be proprietors of any trading, commercial or industrial concern, not being a small-scale industrial concern.

[15][(2A) Notwithstanding anything to the contrary contained in the Companies Act, 1956 (1 of 1956), or in any other law for the time being in force,-

(i) no Director of a banking company, other than its Chairman or whole-time Director, by whatever name called, shall hold office continuously for a period exceeding eight years;

(ii) a Chairman or other whole-time Director of a banking company who has been removed from office as such Chairman, or whole-time Director, as the case may be, under the provisions of this Act shall also cease to be a Director of the banking company and shall also

not be eligible to be appointed as a Director of such banking company, whether by election or co-option or otherwise, for a period of four years from the date of his ceasing to be the Chairman or whole-time Director, as the case may be.]

(3) If, in respect of any banking company, the requirements, as laid down in sub-section (2), are not fulfilled at any time, the Board of Directors of such banking company shall re-constitute such Board so as to ensure that the said requirements are fulfilled.

(4) If, for the purpose of re-constituting the Board under sub-section (3), it is necessary to retire any Director or Directors, the Board may, by lots drawn in such manner as may be prescribed, decide which Director or Directors shall cease to hold office and such decision shall be binding on every Director of the Board.

(5) Where the Reserve Bank is of opinion that the composition of the Board of Directors of a banking company is such that it does not fulfil the requirements of sub-section (2), it may, after giving to such banking company a reasonable opportunity of being heard, by an order in writing, direct the banking company to so re-constitute its Board of Directors as to ensure that the said requirements are fulfilled and, if within two months from the date of receipt of that order, the banking company does not comply with the directions made by the Reserve Bank, that Bank may, after determining, by lots drawn in such manner as may be prescribed, the person who ought to be removed from the membership of the Board of Directors, remove such person from the office of the Director of such banking company and with a view to complying with provisions of sub-section (2), appoint a suitable person as a member of the Board of Directors in the place of the person so removed whereupon the person so appointed shall be deemed to have been duly elected by the banking company as its Director.

(6) Every appointment, removal or reconstitution duly made, and every election duly held, under this section shall be final and shall not be called into question in any court.

(7) Every Director elected or, as the case may be, appointed under this section shall hold office until the date up to which his predecessor would have held office, if the election had not been held, or, as the case may be, the appointment had not been made.

(8) No act or proceeding of the Board of Director of a banking company shall be invalid by reason only of any defect in the composition thereof or on the ground that it is subsequently discovered that any of its members did not fulfil the requirements of this section.

Section 11. Requirement as to minimum paid-up capital and reserves

(1) Notwithstanding anything contained in [section 149 of the Companies Act, 1956], no banking company in existence on the commencement of this Act, shall, after the expiry of three years from such commencement or of such further period not exceeding one year as the Reserve Bank, having regard to the interests of the depositors of the company, may think fit in any particular case to allow, carry on business [11][in India], and no other banking company shall, after the commencement of this Act, commence or carry on business [11][in India], unless it complies with such of the requirements of this section as are applicable to it.]

[(2) In the case of a banking company incorporated outside India-

(a) the aggregate value of its paid-up capital and reserves shall not be less than fifteen lakhs of rupees and if it has a place or places of business in the city of Bombay or Calcutta or both, twenty lakhs of rupees; and

(b) [the banking company shall deposit and keep deposited with the Reserve Bank either in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities-

(i) an amount which shall not be less than the minimum required by clause (a); and

(ii) as soon as may be after the expiration of each [40][***] year, an amount calculated at twenty per cent of its profit for that year in respect of all business transacted through its branches in India, as disclosed in the profit and loss account prepared with reference to that year under section 29:]

PROVIDED that any such banking company may at any time replace-

(i) any securities so deposited by cash or by any other unencumbered approved securities or partly by cash and partly by other such securities, so however, that the total amount deposited is not affected;

(ii) any cash so deposited by unencumbered approved securities of an equal value.]

[(2A) Notwithstanding anything contained in sub-section (2), the Central Government may, on the recommendation of the Reserve Bank, and having regard to the adequacy of the amounts already deposited and kept deposited by a banking company under sub-section (2), in relation to its deposit liabilities in India declare by order in writing that the provisions of sub-clause (ii) of clause (b) of sub-section (2) shall not apply to such banking company for such period as may be specified in the order.]

(3) In the case of any banking company to which the provisions of sub-section(2) do not apply, the aggregate value of its paid-up capital and reserves shall not be less than -

(i) if it has places of business in more than one State, five lakh of rupees, and if any such place or places of business is or are situated in the city of Bombay or Calcutta or both, ten lakhs of rupees;

(ii) if it has all its places of business in one State none of which is situated in the city of Bombay or Calcutta, one lakh of rupees in respect of its principal place of business, plus ten thousand rupees in respect of each of its other places of business, situated in the same district in which it has its principal place of business, plus twenty-five thousand rupees in respect of each place of business situated elsewhere in the State otherwise than in the same district:

PROVIDED that no banking company to which this clause applies shall be required to have paid-up capital and reserves exceeding an aggregate value of five lakhs of rupees:

PROVIDED FURTHER that no banking company to which this clause applies and which has only one place of business, shall be required to have paid-up capital and reserves exceeding an aggregate value of fifty thousand rupees:

[PROVIDED FURTHER that in the case of every banking company to which this clause applies and which commences banking business for the first time after the commencement of the Banking Companies (Amendment) Act, 1962 (36 of 1962), the value of its paid-up capital shall not be less than five lakhs of rupees;]

(iii) if it has all its places of business in one State, or more of which is or are situated in the city of Bombay or Calcutta, five lakhs of rupees, plus twenty-five thousand rupees in respect of each place of business situated outside the city of Bombay or Calcutta, as the case may be:

PROVIDED that no banking company to which this clause applies shall be required to have paid-up capital and reserves exceeding an aggregate value of ten lakhs of rupees.

Explanation: For the purposes of this sub-section, a place of business situated [42][in a State] other than that in which the principal place of business of the banking company is situated shall, if it is not more than twenty-five miles distant from such principal place of business, be deemed to be situated within the same State as such principal place of business.

(4) Any amount deposited and kept deposited with the Reserve Bank under [43][*subsection (2) by any banking company incorporated [44][outside India] shall, in the event of the company ceasing for any reason to carry on banking business [11] [in India], be an asset of the company on which the claims of all the creditors of the company [11][in India] shall be a first charge.

(5) For the purposes of this section-

(a) "place of business" means any office, sub-office, sub-pay office and any place of business at which deposits are received, cheques cashed or moneys lent;

(b) "value" means the real or exchangeable value, and not, the nominal value which may be shown in the books of the banking company concerned.]

(6) If any dispute arises in computing the aggregate value of the paid-up capital and reserves of any banking company, a determination thereof by the Reserve Bank shall be final for the purposes of this section.

Section 12. Regulation of paid-up capital, subscribed capital and authorised capital and voting rights of shareholders

(1) No banking company shall carry on business in India, unless it satisfies the following conditions, namely,-

(i) that the subscribed capital of the company is not less than one-half of the authorised capital and the paid-up capital is not less than one-half of the subscribed capital and that, if the capital is increased, it complies with the conditions prescribed in this clause, within such period not exceeding two years as the Reserve Bank may allow;

(ii) that the capital of the company consists of ordinary shares only or of ordinary shares or equity shares and such preferential shares as may have been issued prior to the lst day of July, 1944:

PROVIDED that nothing contained in this sub-section shall apply to any banking company incorporated before the 15th day of January, 1937.

(2) No person holding shares in a banking company shall, in respect of any shares held by him, exercise voting rights [28][on poll] [45][in excess of [46][ten per cent]] of the total voting rights of all the shareholders of the banking company.

(3) Notwithstanding anything contained in any law for the time being in force or in any contract or instrument no suit or other proceeding shall be maintained against any person registered as the holder of a share in a banking company on the ground that the title to the said share vests in a person other than the registered holder:

PROVIDED that nothing contained in this sub-section shall bar a suit or other proceeding-

(a) by a transferee of the share on the ground that he has obtained from the registered holder a transfer of the share in accordance with any law relating to such transfer ; or

(b) on behalf of a minor or a lunatic on the ground that the registered holder holds the shares on behalf of the minor or lunatic.

(4) Every Chairman, Managing Director or Chief Executive Officer by whatever name called of a banking company shall furnish to the Reserve Bank through that banking company returns containing full particulars of the extent and value of his holding of shares, whether directly or indirectly, in the banking company and of any change in the extent of such holding or any variation in the rights attaching thereto and such other information relating to those shares as the Reserve Bank may, by order, require and in such form and at such time as may be specified in the order.]

Section 19. Restriction on nature of subsidiary companies

(1) A banking company shall not form any subsidiary company except a subsidiary company formed for one or more of the following purposes, namely.-

(a) the undertaking of any business which, under clause (a) to (o) of sub-section (1) of section 6, is permissible for a banking company to undertake, or

(b) with the previous permission in writing of the Reserve Bank, the carrying on of the business of banking exclusively outside India, or

(c) the undertaking of such other business, which the Reserve Bank may, with the prior approval of the Central Government, consider to be conducive to the spread of banking in India or to be otherwise useful or necessary in the public interest.

Explanation: For the purpose of section 8, a banking company shall not be deemed, by reason of its forming or having a subsidiary company, to be engaged indirectly, in the business carried on by such subsidiary company.]

(2) Save as provided in sub-section (1), no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid-up share capital under reserves, whichever is less:

PROVIDED that any banking company which is on the date of the commencement of this Act holding any shares in contravention of the provisions of this sub-section shall not be liable to any penalty therefor if it reports the matter without delay to the Reserve Bank and if it brings its holding of shares into conformity with the said provisions within such period, not exceeding two years, as the Reserve Bank may think fit to allow.

(3) Save as provided in sub-section (1) and notwithstanding anything contained in sub-section (2), a banking company shall not, after the expiry of one year from the date of the commencement of this Act, hold shares, whether as pledge, mortgagee or absolute owner, in any company in the management of which any Managing Director or Manager of the banking company is in any manner concerned or interested.

Section 20. Restrictions on loans and advances

(1) Notwithstanding anything to the contrary contained in section 77 of the Companies Act, 1956 (1 of 1956), no banking company shall-

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of-

(i) any of its Directors,

(ii) any firm in which any of its Directors is interested as Partner, Manager, Employee or Guarantor, or

(iii) any company (not being a subsidiary of the banking company or a company registered under section 25 of the Companies Act, 1956 (1 of 1956), or a government company, of which [15][or the subsidiary or the holding company of which] any of the Directors of the banking company is a Director, Managing Agent, Manager, Employee or Guarantor or in which he holds substantial interest, or

(iv) any individual in respect of whom any of its Directors is a partner or guarantor.

(2) Where any loan or advance granted by a banking company is such that a commitment for granting it could not have been made if clause (b) of sub-section (1) had been in force on the date on which the loan or advance was made or is granted by a banking company after the commencement of section 5 of the Banking Laws (Amendment) Act, 1968 (58 of 1968), but in pursuance of a commitment entered into before such commencement, steps shall be taken to recover the amounts due to the banking company on account of the loan or advance together with interest, if any, due thereon within the period stipulated at the time of the grant of the loan or advance, or where no such period has been stipulated, before the expiry of one year from the commencement of the said section 5:

PROVIDED that the Reserve Bank may, in any case, on an application in writing made to it by the banking company in this behalf, extend the period for the recovery of the loan or advance until such date; not being a date beyond the period of three years from the commencement of the said section 5, and subject to such terms and conditions, as the Reserve Bank may deem fit:

PROVIDED FURTHER that this sub-section shall not apply if and when the Director concerned vacates the office of the Director of the banking company, whether by death, retirement, resignation or otherwise.

(3) No loan or advance, referred to in sub-section (2), or any part thereof shall be remitted without the previous approval of the Reserve Bank, and any remission without such approval shall be void and of on effect.

(4) Where any loan or advance referred to in sub-section (2), payable by any person, has not been repaid to the banking company within the period specified in that sub-section, then, such person shall, if he is a Director of such banking company on the date of the expiry of the said period, be deemed to have vacated his office as such on the said date.

Explanation : In this section-

(a) "loan or advance" shall not include any transaction which the Reserve Bank may, having regard to the nature of the transaction, the period within which, and the manner and circumstances in which, any amount due on account of the transaction is likely to be realised, the interest of the depositors and other relevant considerations, specify by general or special order as not being a loan or advance for the purpose of this section;

(b) "Director" includes a member of any board or committee in India constituted by a banking company for the purpose of managing, or for the purpose of advising it in regard to the management of, all or any of its affairs.

(5) If any question arises whether any transaction is a loan or advance for the purposes of this section, it shall be referred to the Reserve Bank, whose decision thereon shall be final.]

Section 20A. Restrictions on power to remit debts

(1) Notwithstanding anything to the contrary contained in section 293 of the Companies Act, 1956 (1 of 1956), a banking company shall not, except with the prior approval of the Reserve Bank, remit in whole or in part any debt due to it by-

(a) any of its Directors, or

(b) any firm or company in which any of its Directors is interested as Director, Partner, Managing Agent or Guarantor, or

(c) any individual if any of its Directors, is his Partner or Guarantor.

(2) Any remission made in contravention of the provisions of sub-section(1)shall be void and of no affect.]

Section 21. Power of Reserve Bank to control advances by banking companies

(1) Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest [86][or in the interests of depositors] [12][or banking policy] so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy as so determined.

(2) Without prejudice to the generality of the power vested in the Reserve Bank under sub-section (1), the Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies in particulars, [9][as to-

(a) the purposes for which advances may or may not be made;

(b) the margins to be maintained in respect of secured advances;

(c) the maximum amount of advances or other financial accommodation which, having regard to the paid-up capital, reserves and deposits of a banking company and other relevant considerations, may be made by that banking company to any one company, firm, association to persons or individual;

(d) the maximum amount up to which, having regard to the considerations referred to in clause (c), guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual; and

(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.]

(3) Every banking company shall be bound to comply with any directions given to it under this section.

Section 21A. Rate of interest charged by banking companies not to be subject to scrutiny by courts

Notwithstanding anything contained in the Usurious Loans Act, 1918 (10 of 1918), or any other law relating to indebtedness in force in any State, a transaction between a banking company and its debtor shall not be reopened by any court on the ground that the rate of interest charged by the banking company in respect of such transaction is excessive.

Section 22. Licensing of banking companies

(1) Save as hereinafter provided, no company shall carry on banking business in India unless it holds a licence issued in that behalf by the Reserve Bank and any such licence may be issued subject to such conditions as the Reserve Bank may think fit to impose.] .

(2) Every banking company in existence on the commencement of this Act, before the expiry of six months from such commencement, and every other company before commencing banking business [11] [in India], shall apply in writing to the Reserve Bank for a licence under this section:

PROVIDED that in the case of a banking company in existence on the commencement of this Act, nothing in sub-section (1) shall be deemed to prohibit the company from carrying on banking business until it is granted a licence in pursuance of [55][this section] or is by notice in writing informed by the Reserve Bank that a licence cannot be granted to it:

PROVIDED FURTHER that the Reserve Bank shall not give a notice as aforesaid to be a banking company in existence on the commencement of this Act before the expiry of the three years referred to in sub-section (1) of section 11 or of such further period as the Reserve Bank may under that sub-section think fit to allow.

(3) Before granting any licence under this section, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that [56][***] the following conditions are fulfilled, namely:-

(a) that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;

(b) that the affairs of the company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors;

(c) that the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors;

(d) that the company has adequate capital structure and earning prospects;

(e) that the public interest will be served by the grant of a licence to the company to carry on banking business in India;

(f) that having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;

(g) any other condition, the fulfillment of which would, in the opinion of the Reserve Bank, be necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.]

(3A) Before granting any licence under this section to a company incorporated outside India, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that the conditions specified in sub-section (3) are fulfilled and that the carrying on of banking business by such company in India will be in the public interest and that the government or law of the country in which it is incorporated does not discriminate in any way against banking companies registered in India and that the company complies with all the provisions of this Act applicable to banking companies incorporated outside India.]

(4) The Reserve Bank may cancel a licence granted to a banking company under this section:

(i) if the company ceases to carry on banking business in India; or

(ii) if the company at any time fails to comply with any of the conditions imposed upon it under sub-section (1); or

(iii) if at any time, any of the conditions referred to in sub-section (3) [15] [and sub-section (3A)] is not fulfilled:

PROVIDED that before cancelling a licence under clause (ii) or clause (iii) of this sub-section on the ground that the banking company has failed to comply with or has failed to fulfil any of the conditions referred to therein, the Reserve Bank, unless it is of opinion that the delay will be prejudicial to the interests of the companys depositors or the public, shall grant to the company on such terms as it may specify, and opportunity of taking the necessary steps for complying with or fulfilling such condition.

(5) Any banking company aggrieved by the decision of the Reserve Bank cancelling a licence under this section may, within thirty days from the date on which such decision is communicated to it, appeal to the Central Government.

(6) The decision of the Central Government where an appeal has been preferred to it under sub-section (5) or of the Reserve Bank where no such appeal has been preferred shall be final.

Section 23. Restrictions on opening of new, and transfer of existing, places of business

(1) Without obtaining the prior permissions of the Reserve Bank-

(a) no banking company shall open a new place of business in India or change otherwise than within the same city, town or village, the location of an existing place of business situated in India; and

(b) no banking company incorporated in India shall open a new place of business outside India or change, otherwise than within the same city, town or village in any country or area outside India, the location of an existing place of business situated in that country or area:

PROVIDED that nothing in this sub-section shall apply to the opening for a period not exceeding one month of a temporary place of business within a city, town or village or the environs thereof within which the banking company already has a place of business, for the purpose of affording banking facilities to the public on the occasion of an exhibition, a conference or a mela or any other like occasion.

(2) Before granting any permission under this section, the Reserve Bank may require to be satisfied by an inspection under section 35 or otherwise as to the financial condition and history of the company, the general character of its management, the adequacy of its capital structure and earning prospects and that public interest will be served by the opening or, as the case may be, change of location, of the place of business.

(3) The Reserve Bank may grant permission under sub-section (1) subject to such conditions as it may think fit to impose either generally or with reference to any particular case.

(4) Where, in the opinion of the Reserve Bank, a banking company has, at any time, failed to comply with any of the conditions imposed on it under this section, the Reserve Bank may, by order in writing and after affording reasonable opportunity to the banking company for showing cause against the action proposed to be taken against it, revoke any permission granted under this section.

[57][(4A) Any Regional Rural Bank requiring the permission of the Reserve Bank under this section shall forward its application to the Reserve Bank through the National Bank which shall give its comments on the merits of the application and send it to the Reserve Bank:

PROVIDED that the Regional Rural Bank shall also send an advance copy of the application directly to the Reserve Bank.]

(5) For the purposes of this section "place of business" includes any sub-office, pay office, sub-pay office and any place of business at which deposits are received, cheques cashed or moneys lent.]

Section 24. Maintenance of a percentage of assets

(1) After the expiry of two years from the commencement of this Act, every banking company shall maintain [in India] in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount which shall not at the

close of business on any day be less than 20 per cent of the total of its [demand and time liabilities] [in India].

Explanation : For the purposes of this section, "unencumbered approved securities" of a banking company shall include its approved securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.]

(2) In computing the amount for the purposes of sub-section (1), the deposit required under sub-section (2) of section 11 to be made with the Reserve Bank by a banking company incorporated outside India and any balances maintained in India by a banking company in current account with the Reserve Bank or the State Bank of India or with any other bank which may be notified in this behalf by the Central Government, including in the case of a scheduled bank the balance required under section 42 of the Reserve Bank of India Act, 1934 (2 of 1934), to be so maintained, shall be deemed to be cash maintained in India.]

(2A) (a) Notwithstanding anything contained in sub-section (1) or in sub-section(2), after the expiry of two years from the commencement of the Banking Companies (Amendment) Act, 1962 (36 of 1962):-

(i) a scheduled bank, in addition to the average daily balance which it is, or may be, required to maintain under section 42 of the Reserve Bank of India Act, 1934 (2 of 1934), and

(ii) every other banking company, in addition to the cash reserve which it is required to maintain under section 18,

[106][shall maintain in India-

(A) in cash, or

(B) in gold valued at a price not exceeding the current market price or in unencumbered approved securities valued at a price determined in accordance with such one or more of, or combination, of the following methods of valuation, namely, valuation with reference to cost price, market price, book value or face value, as may be specified by the Reserve Bank from time to time, an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not exceeding forty per cent as the Reserve Bank may, from time to time, by notification in the Official Gazette, specify, of the total of its demand and time liabilities in India, as on the last Friday of the second preceding fortnight;

(b) in computing the amount for the purposes of clause (a)-

(i) the deposit required under sub-section (2) of section 11 to be made with the Reserve Bank by a banking company incorporated outside India;

(ii) any cash or balances maintained in India by a banking company other than a scheduled bank with itself or with the Reserve Bank or by way of net balance in current

account in excess of the cash or balance or net balance required to be maintained under section 18;

(iii) any balance maintained by a scheduled bank with the Reserve Bank in excess for the balance required to be maintained by it under section 42 of the Reserve Bank of India Act, 1934 (2 of 1934);

(iv) the net balance in current accounts maintained in India by a scheduled bank;

(v) any balance maintained by a Regional Rural Bank in call or fixed deposit with its sponsor bank,

shall be deemed to be cash maintained in India.

Explanation : For the purposes of clause (a) of this sub-section, the market price of an approved security shall be the price as on the date of the issue of the notification or as on any earlier or later date as may be notified from time to time by the Reserve Bank in respect of any class or classes of securities.

(2B) The Reserve Bank may, by notification in the Official Gazette, vary the percentage referred to in sub-section (2A) in respect of a Regional Rural Bank

(3) For the purposes of ensuring compliance with the provisions of this section, every banking company shall, not later than twenty days after the end of the month to which it relates, furnish to the Reserve Bank in the prescribed form and manner a monthly return showing particulars of its assets maintained in accordance with this section, and its demand and time liabilities in India at the close of business on each alternate Friday during the month, or if any such Friday is a public holiday, at the close of business on the preceding working day:

PROVIDED that every Regional Bank shall also furnish a copy of the said return to the National Bank.

(4)(a) If on any alternate Friday or, if such Friday is a public holiday, on the preceding working day, the amount maintained by a banking company at the close of business on that day falls below the minimum prescribed by or under clause (a) of sub-section (2A), such banking company shall be liable to pay to the Reserve Bank in respect of that day's default, penal interest for that day at the rate of three per cent per annum above the bank rate on the amount by which the amount actually maintained falls short of the prescribed minimum on that day; and

(b) If the default occurs again on the next succeeding alternate Friday, or, if such Friday is a public holiday, on the preceding working day, and continues on succeeding alternate Fridays or preceding working days, as the case may be, the rate of penal interest shall be increased to a rate of five per cent per annum above the bank rate on each such shortfall in respect of that alternate Friday and each succeeding alternate Friday or preceding working day, if such Friday is a public holiday, on which the default continues.

(5)(a) Without prejudice to the provisions of sub-section (3), the Reserve Bank may require a banking company to furnish to it a return in the form and manner specified by it showing particulars of its assets maintained in accordance with this section and its demand and time liabilities in India, as at the close of business on each day of a month; and

(b) Without prejudice to the provisions of sub-section (4), on the failure of a banking company to maintain as on any day, the amount so required to be maintained by or under clause (a) of sub-section (2A) the Reserve Bank may, in respect of such default, require the banking company to pay penal interest for that day as provided in clause (a) of sub-section (4) and if the default continues on the next succeeding working day, the penal interest may be increased as provided in clause (b) of sub-section (4) for the concerned days.

(6)(a) The penalty payable under sub-section (4) and sub-section (5) shall be paid within a period of fourteen days from the date on which a notice issued by the Reserve Bank demanding payment of the same is served on the banking company and in the event of failure of the banking company to pay the same within such period, the penalty may be levied by a direction of the principal civil court having jurisdiction in the area where an office of the defaulting banking company is situated, such direction to be made only upon an application made by the Reserve Bank in this behalf to the court; and

(b) When the court makes a direction under clause (a), it shall issue a certificate specifying the sum payable by the banking company and every such certificate shall be enforceable in the same manner as if it were a decree made by the court in a suit.

(7) When under the provisions of clause (b) of sub-section (4) penal interest at the increased rate of five per cent above the bank rate has become payable by a banking company, if thereafter the amount required to be maintained on the next succeeding alternate Friday, or if such Friday is a public holiday, the next preceding working day, is still below, the prescribed minimum, every Director, Manager or Secretary of the banking company, who is knowingly and wilfully a party to the default, shall be punishable with fine which may extend to five hundred rupees and with a further fine which may extend to five hundred rupees for each subsequent alternate Friday or the preceding working day, as the case may be, on which the default continues.

(8) Notwithstanding anything contained in this section, if the Reserve Bank is satisfied, on an application in writing by the defaulting banking company, that the banking company had sufficient cause for its failure to comply with the provisions of clause (a) of sub-section (2A), the Reserve Bank may not demand the payment of the penal interest.

Explanation : In this section, the expression, "public holiday" means a day which is a public holiday under the Negotiable Instruments Act, 1881 (26 of 1881).

Section 27. Monthly returns and power to call for other returns and information

(1) Every banking company shall, before the close of the month succeeding that to which it relates, submit to the Reserve Bank a return in the prescribed form and manner showing its assets and liabilities [102][in India] as at the close of business on the last Friday of every

month or if that Friday is a public holiday under the Negotiable Instruments Act, 1881 (26 of 1881), at the close of business on the preceding working day.

(2) The Reserve Bank may at any time direct a banking company to furnish it within such time as may be specified by the Reserve Bank, with such statements and information relating to the business or affairs of the banking company (including any business or affairs with which such banking company is concerned) as the Reserve Bank may consider necessary or expedient to obtain for the purposes of this Act, and without prejudice to the generality of the foregoing power may call for information every half-year regarding [104][the investments of a banking company and the classification of its advances in respect of industry, commerce and agriculture].]

(3) Every Regional Rural Bank shall submit a copy of the return which it submits to the Reserve Bank under sub-section (1) also to the National Bank and the powers exercisable by the Reserve Bank under sub-section (2) may also be exercised by the National Bank in relation to the Regional Rural Banks.]

Section 28. Power to publish information

The Reserve Bank or the National Bank, or both, if they consider it in the public interest so to do, may publish any information obtained by them under this Act in such consolidated form as they think fit.

Section 29. Accounts and balance-sheet

(1) At the expiration of each calendar years or at the expiration of a period of twelve months ending with such date as the Central Government may, by notification in the Official Gazette, specify in this behalf,] every banking company incorporated in India], in respect of all business transacted by it, and every banking company incorporated outside India], in respect of all business transacted through its branches [102][in India], shall prepare with reference to that year or period, as the case may be,] a balance-sheet and profit and loss account as on the last working day of [120][the year or the period, as the case may be,] in the Forms set out in the Third Schedule or as near thereto as circumstances admit:

PROVIDED that with a view to facilitating the transition from one period of accounting to another period of accounting under this sub-section, the Central Government may by order published in the Official Gazette, make such provisions as it considers necessary or expedient for the preparation of, or for other matters relating to, the balance-sheet or profit and loss account in respect of the concerned year or period, as the case may be.

(2) The balance-sheet and profit and loss account shall be signed-

(a) in the case of a banking company incorporated [in India], by the manager or the principal officer of the company and where there are more than three Directors of the company, by at least three of those Directors, or where there are not more than three Directors, by all the Directors, and

(b) in the case of a banking company incorporated [outside India] by the Manager or Agent of the principal office of the company [122][in India].

(3) Notwithstanding that the balance-sheet of a banking company is under subsection (1) required to be prepared in a form other than the form [123][set out in Part I of Schedule VI to the Companies Act, 1956 (1 of 1956)1, the requirements of that Act relating to the balance-sheet and profit and loss account of a company shall, in so far as they are not inconsistent with this Act, apply to the balance-sheet or profit and loss account, as the case may be, of a banking company.

(3A) Notwithstanding anything to the contrary contained in sub-section (3) of section 210 of the Companies Act, 1956 (1 of 1956), the period to which the profit and loss account relates shall, in the case of a banking company, be the period ending with the last working day of the year immediately preceding the year in which the annual general meeting is held.

Explanation : In sub-section (3A), "year" means the year or, as the case may be, the period referred to in sub-section (1).

(4) The Central Government after giving not less than three months' notice of its intention so to do by a notification in the Official Gazette, may from time to time by a like notification amend the Forms set out in the Third Schedule.

Section 30. Audit

[(1) The balance-sheet and profit and loss account prepared in accordance with section 29 shall be audited by a person duly qualified under any law for the time being in force to be an Auditor of companies.]

1A) Notwithstanding anything contained in any law for the time being in force or in any contract to the contrary, every banking company shall, before appointing, re-appointing or removing any Auditor or Auditors, obtain the previous approval of the Reserve Bank.

(1B) Without prejudice to anything contained in the Companies Act, 1956 (1 of 1956), or any other law for the time being in force, where the Reserve Bank is of opinion that it is necessary in the public interest or in the interests of the banking company or its depositors so to do, [128][it may at any time by order direct that the special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an Auditor of companies or direct the Auditor of the banking company himself to conduct such special audit] and the Auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company.

(1C) The expenses of, or incidental to, [129][the special audit] specified in the order made by the Reserve Bank shall be borne by the banking company.]

(2) The Auditor shall have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed of Auditors of companies by [130][section 227 of the Companies Act, 1956 (1 of 1956)] [131][and Auditors, if any, appointed by the law establishing, constituting or forming the banking company concerned].

(3) In addition to the matters which under the aforesaid Act the Auditor is required to state in his report, he shall, in the case of a banking company incorporated [102][in India], state in his report:-

(a) whether or not the information and explanations required by him have been found to be satisfactory;

(b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;

(c) whether or not the returns received from branch officers of the company have been found adequate for the purposes of his audit;

(d) whether the profit and loss account shows a true balance [132][of profit or loss] for the period covered by such account;

(e) any other matter, which he considers should be brought to the notice of the shareholders of the company.

Section 35. Inspection

(1) Notwithstanding anything to the contrary contained in [section 235 of the Companies Act, 1956 (1 of 1956),] the Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.

[(1A) (a) Notwithstanding anything to the contrary contained in any law for the time being in force and without prejudice to the provisions of sub-section (1), the Reserve Bank, at any time, may also cause a scrutiny to be made by any or more of its officers, of the affairs of any banking company and its books and accounts; and

(b) A copy of the report of the scrutiny shall be furnished to the banking company if the banking company makes a request for the same or if any adverse action is contemplated against the banking company on the basis of the scrutiny.]

(2) It shall be the duty of every Director or other officer [140][or employee] of the banking company to produce to any officer making an inspection under sub-section (1) [134][or a scrutiny under sub-section (1A)1 all such books, accounts and other documents in his custody or power and to furnish him with any statements and information relating to the affairs of the banking company as the said officer may require of him within such time as the said officer may specify.

(3) Any person making an inspection under sub-section(1) [or a scrutiny under sub-section (1A)] may examine on oath any Director or other officer [or employee] of the banking company in relation to its business, and may administer any oath accordingly.

(4) The Reserve Bank shall, if it has been directed by the Central Government to cause an inspection to be made, and may, in any other case, report to the Central Government on any inspection [or scrutiny] made under this section, and the Central Government, if it is

of opinion after considering the report that the affairs of the company are being conducted to the detriment of the interests of its depositors, may, after giving such opportunity to the banking company to make a representation in connection with the report as, in the opinion of the Central Government, seems reasonable, by order in writing-

(a) prohibit the banking company from receiving fresh deposits;

(b) direct the Reserve Bank to apply under section 38 for the winding up of the banking company:

PROVIDED that the Central Government may defer, for such period as it may think fit, the passing of an order under this sub-section, or cancel or modify any such order, upon such terms and conditions as it may think fit to impose.

(5) The Central Government may, after giving reasonable notice to the banking company, publish the report submitted by the Reserve Bank or such portion thereof as may appear necessary.

Explanation: For the purposes of this section, the expression "banking company" shall include-

(i) in the case of a banking company incorporated outside India, all its branches in India; and

(ii) in the case of a banking company incorporated in India-

(a) all its subsidiaries formed for the purposes of carrying on the business of banking exclusively outside India; and

(b) all its branches whether situated in India or outside India.]

[110][(6) The powers exercisable by the Reserve Bank under this section in relation to Regional Rural Banks may (without prejudice to the exercise of such powers by the Reserve Bank in relation to any Regional Rural Bank whenever it considers necessary so to do) be exercised by the National Bank in relation to the Regional Rural Banks, and accordingly, sub-sections (1) to (5) shall apply in relation to Regional Rural Banks as if every reference therein to the Reserve Bank included also a reference to the National Bank.]

Section 35A. Power of the Reserve Bank to give directions

(1) Where the Reserve Bank is satisfied that-

(a) in the [142][public interest]; or

(aa) in the interest of banking policy; or]

(b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositor or in a manner prejudicial to the interests of the banking company; or

(c) to secure the proper management of any banking company generally;

it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

(2) The Reserve Bank may, on representation made to it or on its own motion, modify or cancel any direction issued under sub-section (1), and in so modifying or cancelling any direction may impose such conditions as it thinks fit, subject to which the modification or cancellation shall have effect.

Section 35B. Amendments of provisions relating to appointments of Managing Directors, etc., to be subject to previous approval of the Reserve Bank

(1) In the case of a banking company-

(a) no amendment of any provision relating to [124][the maximum permissible number of Directors or] the appointment or re-appointment or termination of appointment,or remuneration of a Chairman, [a managing Director or any other Director, whole-time or otherwise] or of a Manager or a Chief Executive Officer by whatever name called, whether that provision be contained in the company's Memorandum or Articles of Association, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or by its Board of Directors shall have effect unless approved by the Reserve Bank;

[1](b) no appointment or re-appointment or termination of appointment of a Chairman, a Managing or whole-time Director, Manager or Chief Executive Officer by whatever name called, shall have effect unless such appointment, reappointment or termination of appointment is made with the previous approval of the Reserve Bank.

Explanation : For the purposes of this sub-section, any provision conferring any benefit or providing any amenity or perquisite, in whatever form, whether during or after the termination of the term of office [of the Chairman or the Manager] or the Chief Executive Officer by whatever name called or the Managing Director, or any other Director, whole-time or otherwise, shall be deemed to be a provision relating to his remuneration.]

(2) Nothing contained in sections [268 and 269, the proviso to sub-section (3) of section 309, sections 310 and 311, the proviso to section 387, and section 388] (in so far as section 388 makes the [provisions of sections 269, 310] and 311 apply in relation to the Manager of a company) of the Companies Act, 1956 (1 of 1956), shall [apply to any matter in respect of which the approval of the Reserve Bank has to be obtained under sub-section (1)].

(2A) Nothing contained in section 198 of the Companies Act, 1956 (1 of 1956) shall apply to a banking company and the provisions of sub-section (1) of section 309 and of section 387 of that Act shall, in so far as they are applicable to a banking company, have effect as if no reference had been made in the said provision to section 198 of that Act.]

(3) No act done by a person [as Chairman or a Managing or whole-time Director] or a Director not liable to retire by rotation or a Manager or a Chief Executive Officer by whatever name called, shall be deemed to be invalid on the ground that it is subsequently discovered that his [appointment or re-appointment] has not taken effect by reason of any of the provisions of this Act; but nothing in this sub-section shall be construed as rendering valid any act done by such person after his [appointment or re-appointment] has been shown to the banking company not to have had effect.]

Section 36. Further powers and functions of Reserve Bank

(1) The Reserve Bank may:

(a) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company;

(b) on a request by the companies concerned and subject to the provisions of section 44A, assist, as intermediary or otherwise, in proposals for the amalgamation of such banking companies;

(c) give assistance to any banking company by means of the grant of a loan or advance to it under clause (3) of sub-section (1), of section 18 of the Reserve Bank of India Act, 1934 (2 of 1934)

[(d) at any time, if it satisfied that in the public interest or in the interest of banking company or its depositors it is necessary so to do,] by order in writing and on such terms and conditions as may be specified therein:

(i) require the banking company to call a meeting of its Directors for the purpose, of considering any matter relating to or arising out of the affairs of the banking company, or require an officer of the banking company to discuss any such matter with an officer of the Reserve Bank.

(ii) depute one or more of its officers to watch the proceedings at any meeting of the Board of Directors of the banking company or of any committee or of any other body constituted by it; require the banking company to give an opportunity to the officers so deputed to be heard at such meetings and also require such officers to send a report of such proceedings to the Reserve Bank;

(iii) require the Board of Directors of the banking company or any committee or any other body constituted by it to give in writing to any officer specified by the Reserve Bank in this behalf at his usual address all notices of, and other communications relating to, any meeting of the Board, committee or other body constituted by it;

(iv) appoint one or more of its officers to observe the manner in which the affairs of the banking company or of its officers or branches are being conducted and make a report thereon;

(v) require the banking company to make, within such time as may be specified in the order, such changes in the management as the Reserve Bank may consider necessary

(2) The Reserve Bank shall make an annual report of the Central Government on the trend and progress of banking in the country, with particular reference to its activities under clause (2) of section 17 of the Reserve Bank of India Act, 1934 (2 of 1934), including in such report its suggestions, if any, for the strengthening of banking business throughout the country.

(3) The Reserve Bank may appoint such staff at such places as it considers necessary for the scrutiny of the returns, statements and information furnished by banking companies under this Act, and generally to ensure the efficient performance of its functions under this Act.

Section 36A. Certain provisions of the Act not to apply to certain banking companies

(1) The provisions of section 11, sub-section (1) of section 12, and sections 17, 18, 24 and 25 shall not apply to a banking company-

(a) which, whether before or after the commencement of the Banking Companies (Amendment) Act, 1959 (33 of 1959), has been refused a licence under section 22, or prohibited from accepting fresh deposits by a compromise, arrangement or scheme sanctioned by a court or by any order made in any proceeding relating to such compromise, arrangement or scheme, or prohibited from accepting deposits by virtue of any alteration made in its memorandum; or

(b) whose licence has been cancelled under section 22 whether before or after the commencement of the Banking Companies (Amendment) Act, 1959 (33 of 1959).

(2) Where the Reserve Bank is satisfied that any such banking company as is referred to in sub-section (1) has repaid, or has made adequate provision for repaying all deposits accepted by the banking company, either in full or to the maximum extent possible, the Reserve Bank may, by notice published in the Official Gazette, notify that the banking company has ceased to be a banking company with in the meaning of this Act,and there upon all the provisions of this Act applicable to such banking company shall cease to apply to it, except as respects things done or omitted to be done before such notice.]

[PART IIA :- CONTROL OVER MANAGEMENT

Section 36AA. Power of Reserve Bank to remove managerial and other persons from office

(1) Where the Reserve Bank is satisfied that in the public interest or for preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors or for securing the proper management of any banking company it is necessary so to do, the Reserve Bank may, for reasons to be recorded in writing, by order, remove from office, with effect from such date as may be specified in the order, [any

Chairman, Director], Chief Executive Officer (by whatever name called) or other officer or employee of the banking company.

(2) No order under sub-section (1) shall be made [151][unless the Chairman, Director] or Chief Executive Officer or other officer or employee concerned has been given a reasonable opportunity of making a representation to the Reserve Bank against the proposed order:

PROVIDED that if, in the opinion of the Reserve Bank, any delay would be detrimental to the interests of the banking company or its depositors, the Reserve Bank may, at the time of giving the opportunity aforesaid or at any time thereafter, by order direct that, pending the consideration of the representation aforesaid, if any ,the Chairman or, as the case may be, Director or Chief Executive Officer] or other officer or Employee, shall not, with effect from the date of such order-

(a) act as such Chairman or Director] or Chief Executive Officer or other officer or employee of the banking company;

(b) in any way, whether directly or indirectly, be concerned with, or take part in the management of, the banking company.

(3)(a) Any person against whom an order of removal has been made under sub-section (1) may, within thirty days from the date of communication to him of the order, prefer an appeal to the Central Government.

(b) The decision of the Central Government on such appeal, and subject thereto, the order made by the Reserve Bank under sub-section (1), shall be final and shall not be called into question in any court.

(4) Where any order is made in respect of [a Chairman, Director] or Chief Executive Officer or other officer or employee of a banking company under sub-section (1), he shall cease to be [a Chairman or, as the case may be, a Director,] Chief Executive Officer or other officer or employee of the banking company and shall not, in any way, whether directly or indirectly, be concerned with, or take part in the management of, any banking company for such period not exceeding five years as may be specified in the order.

(5) If any person in respect of whom an order is made by the Reserve Bank under subjection (1) or under the proviso to sub-section (2) contravenes the provisions of this section, he shall be punishable with fine which may extend to two hundred and fifty rupees for each day during which such contravention continues.

(6) Where an order under sub-section (1) has been made, the Reserve Bank may, by order in writing, appoint a suitable person in place of [156][the Chairman or Director] or Chief Executive Officer or other officer or employee who has been removed from his office under that sub-section, with effect from such date as may be specified in the order.

(7) Any person appointed as [Chairman, Director or Chief Executive Officer] or other officer or employee under this section, shall-

(a) hold office during the pleasure of the Reserve Bank and subject thereto for a period not exceeding three years or such further periods not exceeding three years at a time as the Reserve Bank may specify;

(b) not incur any obligation or liability by reason only of his being a [Chairman, Director or Chief Executive Officer] or other officer or employee or for anything done or omitted to be done in good faith in the execution of the duties of his office or in relation thereto.

(8) Notwithstanding anything contained in any law or in any contract, memorandum or articles of association, on the removal of a person from office under this section, that person shall not be entitled to claim any compensation for the loss or termination of office.

Section 38. Winding up by High Court

(1) Notwithstanding anything contained in section 391, section 392, section 433 and section 583 of the Companies Act, 1956 (1 of 1956), but without prejudice to its powers under sub-section (1) of section 37 of this Act, the High Court shall order the winding up of a banking company-

(a) if the banking company is unable to pay its debts; or

(b) if an application for its winding up has been made by the Reserve Bank under section 37 or this section.

(2) The Reserve Bank shall make an application under this section for the winding up of a banking company it is directed so to do by an order under clause(b) of sub-section (4) of section 35.

(3) The Reserve Bank may make an application under this section for the winding up of a banking company-

(a) if the banking company-

(i) has failed to comply with the requirements specified in section 11; or

(ii) has by reason of the provisions of section 22become disentitled to carry on banking business in India; or

(iii) has been prohibited from receiving fresh deposits by an order under clause (a) of sub-section (4) of section 35 or under clause (b) of sub-section (3A) or section 42 of the Reserve Bank of India, Act, 1934 (2 of 1934); or

(iv) having failed to comply with any requirement of this Act other than the requirements laid down in section 11, has continued such failure, or, having contravened any provision of this Act has continued such contravention beyond such period or periods as may be specified in that behalf by the Reserve Bank from time to time, after notice in writing of such failure or contravention has been conveyed to the banking company; or

(b) if in the opinion of the Reserve Bank-

(i) a compromise or arrangement. Sanctioned by a court in respect of the banking company cannot be worked satisfactorily with or without modifications; or

(ii) the returns, statements or information furnished to it under or in pursuance of the provisions of this Act disclose that the banking company is unable to pay its debts; or

(iii) the continuance of the banking company is prejudicial to the interest of its depositors.

(4) Without prejudice to the provisions contained in section 434 of the Companies Act, 1956 (1 of 1956), a banking company shall be deemed to be unable to pay its debts if it has refused to meet any lawful demand made at any of its offices or branches within two working days, if such demand is made at a place where there is an office, branch or agency of the Reserve Bank, or within five working days, if such demand is made elsewhere, and if the Reserve Bank certifies in writing that the banking company is unable to pay its debts.

(5) A copy of every application made by the Reserve Bank under sub-section (1) shall be sent by the Reserve Bank to the Registrar.]

Section 45Q. Power to inspect

(1) The Reserve Bank shall, on being directed so to do by the Central Government or by the High Court, cause an inspection to be made by one or more of its officers of a banking company which is being wound up and its books and accounts.

(2) On such inspection, the Reserve Bank shall submit its report to the Central Government and the High Court.

(3) If the Central Government, on consideration of the report of the Reserve Bank, is of opinion that there has been a substantial irregularity in the winding up proceedings, it may being such irregularity to the notice of the High Court for such action as the High Court may think fit.

(4) On receipt of the report of the Reserve Bank under sub-section (2) or on any irregularity being brought to its notice by the Central Government under subsection (3), the High Court may, if it deems fit, after giving notice to and hearing the Central Government in regard to the report, give such directions as it may consider necessary.

Section 46. Penalties

(1) Whoever in any return, balance-sheet or other document [202][or on any information required or furnished] by or under or for the purpose of any provision of this Act, wilfully makes a statement which is false in any material particular, knowing it to be false, or wilfully omits to make a material statement, shall be punishable with imprisonment for a term which may extend to three years and shall also be liable to fine.

(2) If any person fails to produce any book, account or other documents or to furnish any statement or information which under sub-section (2) of section 35 it is his duty to produce or furnish, or to answer any question relating to the business of a banking company which he is asked by [250][an officer making inspection or scrutiny under that section] he shall be punishable with fine which may extend to [251][two thousand rupees] in respect of each offence, and if he persists in such refusal, to further fine which may extend to [252][one hundred rupees] for every day during which the offence continues.

(3) If any deposits are received by a banking company in contravention of an order under clause (a) of sub-section (4) of section 35, every Director or other officer of the banking company, unless he proves that the contravention took place without his knowledge or that he exercised all due diligence to prevent it, shall be deemed to be guilty of such contravention and shall be punishable with a fine which may extend to twice the amount of the deposits so received.

[253][(4) If any other provision of this Act is contravened or if any default in made in,-

(i) complying with any requirement of this Act or of any order, rule or direction made or condition imposed thereunder, or

(ii) carrying out ' the terms of, or the obligation under, a scheme sanctioned under sub-section (7) of section 45,

by any person, such person shall be punishable with fine which may extend to [254][fifty thousand rupees or twice the amount involved in such contravention or default where such amount is quantifiable, whichever is more, and where a contravention or default is a continuing one, with a further fine which may extend to two thousand and five hundred rupees for every day, during which the contravention or default continues.

(5) Where a contravention or default has been committed by a company, every person who at the time the contravention or default was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the contravention of default and shall be liable to be proceeded against and punished accordingly:

PROVIDED that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act if he proves that the contravention or default was committed without his knowledge or that he exercised all due diligence to prevent the contravention or default.

(6) Notwithstanding anything contained in sub-section (5), where a contravention or default has been committed by a company, and it is proved that the same was committed with the consent or connivance of, or is attributable to any gross negligence on the part of, any Director, Manager, Secretary or other Officer of the company, such Director, Manager, Secretary or other Officer shall also be deemed to be guilty of that contravention or default and shall be liable to be proceeded against and punished accordingly.

Explanation : For the purposes of this section,-

(a) "company" means any body corporate and includes a firm or other association of individuals; and

(b) "Director", in relation to a firm, means a partner in the firm.]

Section 47. Cognizance of offences

No court shall take cognizance of any offence punishable under [216][sub-section (5) of section 36AA or] section 46 except upon complaint in writing made by an officer of [256][the Reserve Bank or, as the case may be, the National Bank], generally or specially authorised in writing in this behalf by [255][the Reserve Bank or, as the case may be, the National Bank], and [257][no court other than that of a Metropolitan or a Judicial Magistrate of the first class or any court superior thereto] shall try any such offence.