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Critical Analysis of Role of Indian Government in Banking Management: with Special Reference to Foreign Banks

Prepared under the guidance and supervision of

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DECLARATION

I, **Himanshu Chandra**, do hereby declare that this dissertation titled as **"Critical Analysis of Role of Indian Government in Banking Management: with Special Reference to Foreign Banks"** is a result of research undertaken by me in partial fulfillment of LL.M. programme at National Law School of India University, Bangalore, under the guidance and supervision of **Prof. Dr. O.V. Nandimath**

I further declare that this dissertation is my original work and the relevant material taken from other sources has been cited at appropriate places and for which necessary acknowledgements have been made. I declare that this work has not been submitted either in part or in whole for any other degree, diploma or other course at any University or Institute.

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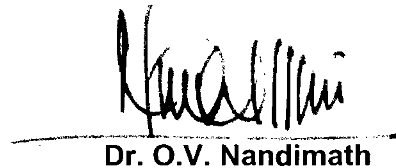
CERTIFICATE

This is to certify that this dissertation titled as **"Critical Analysis of Role of Indian Government in Banking Management: with Special Reference to Foreign Banks",** submitted by Mr. Himanshu Chandra (I. D. No. 726) for LL.M. Degree for the academic session 2016-17 at National Law School of India University, Bangalore, is the result of bonafide research satisfactorily carried on by him under my guidance and supervision. This dissertation or any part thereof has not been submitted elsewhere for any other degree.



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Though I have tried my best, but at the same time, I know there is nothing called perfection; so, I would like to have all valuable suggestions for the future.

Himanshu Chandra

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RESEARCH METHODOLOGY

Aims and Objectives of Research

India with a huge base for providing banking services is a great market for Domestic as well as Foreign Banks. In this sense, it would be imperative to analyze the working of Indian Government in managing, regulating and supervising the activities of this industry. Starting with the inception of Bank of India to the present globalized banking facilities, the government has evolved through its policies both in terms of expansion and management of Banks. International practices like adoption of Basel norms; SWIFT and CAMELS procedures have further helped India to expose its commitments. Analyzing the various provision given in the Banking regulation Act 1949, Reserve Bank of India Act 1934, Foreign exchange management Act 1999, the researcher has attempted to compare and look into the general practice of the government in lieu such regulations. Apart from this, Various RBI circulars has been looked into the understand its role in banking management. The aim is to comprehensively co-relate the functioning of Commercial Banks, RRBs and Co-operative Banks in India with the interoperability of regulations and rules by Executive and Reserve bank of India.

Research Problem

The understanding of the Social control exercised by the government in Banking Sector with various international practices to be adhered to by the banks in India. How do Department of Banking Supervision works and what are the existing framework and the laws governing the sector and lastly what could be possible entryways for the Commercial presence of Foreign Banks in India.

Hypothesis

Governments generally wish to retain control over banking systems because of the high costs and negative political repercussions of bank failures. [1] Governments, and related agencies such as central banks, typically have lender of last resort responsibility for banks operating within their borders.[2] If a bank has insufficent liquid funds to meet payments demands from depositors, the national government, through its central bank, may lend funds to the banks to meet these demands. There is also a considered view that bank supervision function can provide the central bank with far more information from and control over the insitutions and markets and thus assist in maintaining finacial stability.

[1] Dobson &hufbauer,supra note 2 , at 101-102

[2] Supra note at 4

[3] Bank of International Settlement, Basel committee on Banking Supervision, "*Core Principles for Effective Banking Supervision*", September 2012, available at http://www.bis.org/publ/bcbs213.pdf (last visited 23rd May 2017)

[4] Tannan, M.L.,*Banking Law and Practice*, 23rd (Nagpur: Lexis Nixies Butterworth Wadhwa,

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[4] Tannan, M.L.,*Banking Law and Practice*, 23rd (Nagpur: Lexis Nixies Butterworth Wadhwa,

In simple terms government plays crucial role in supervision and management of banks by helping them financially.

Scope and Limitations

The scope of this study is confined only to the understanding and analysis of government's role in Banking, while the role of judiciary has not been touched upon because of the page limit and time-constraint. The efforts have been made to put forth the existing practical framework with the literature available on the understanding of the banking structure.

Nature of Dissertation

The Research Methodology adopted for this research is "analytical" and "doctrinal" in nature. This dissertation has relied upon both primary and secondary sources of data. The dissertation is divided into 6 chapters all dealing with the specific subject area. The last chapter is a summary of the entire precious chapter and analyzes the scope of government's role and its impact.

Mode of Citation

A uniform mode of citation is followed throughout in this dissertation. The researcher has used footnoting method/style of citation throughout this project.

LITERATURE REVIEW

The pre-1969 system of working of banks and post it, has been drasticsally different. Regulation and supervision of the business activities, pertaining to the banking industry units will be essential for their effective functioning. Generally, the concept of banking regulation and supervision is defined as control over the creation, operation, and liquidation of banks. The most general definition of the concept of banking regulation and supervision is control over the creation, operation, and liquidation of banks.[3] Such control is very diverse, carried out by specialized banking supervisory authorities. Supervision over the bank's operational activities aims to protect the interests of depositors and to ensure effective functioning of the banking industry units. This supervision is the most important and essential part of the functions of banking supervisory authorities, which are carried out in the name of a sound banking system. Supervision is performed continuously throughout the whole operating process of the bank. Furthermore, banking supervision is required in order to monitor and assist in the early detection of problems in the banking institutions, taking all necessary measures, such as liquidation, with the aim of overcoming and limiting the

[3] Bank of International Settlement, Basel committee on Banking Supervision, "*Core Principles for Effective Banking Supervision*", September 2012, available at http://www.bis.org/publ/bcbs213.pdf (last visited 23rd May 2017)

adverse effects within the affected bank. Banking supervision should be seen as dynamic function, responding to market changes.

List of Abbreviations

ADR-	American Depository Receipt
AML-	Anti Money Laundering
ANZ-	Australia and New Zealand Bank
Art. -	Article
BCBS -	Basel Committee on Banking Supervision
BFS-	Board for Financial Supervision
BIS-	Bank for International Settlement
BO Scheme-	Banking Ombudsman Scheme
BR Act 1949	Banking Regulation Act 1949
DBS-	Department of Banking Supervision
DNBS-	Department of Non-Banking Supervision
DRI-	Differential Rate of Interest
Ed. -	Edition

FATF-	Financial Action Task Force
FDI-	Foreign Direct Investment
FEMA-	Foreign Exchange Management Act
FI-	Foreign Investment
FII -	Foreign Institutional Investor
FSA-	Financial Services Agreement
FTA-	Free Trade Agreement
G-10-	Group 10
GDR-	Global Depository Receipt
IMF	International Monetary Fund
Mag. -	Magazine
MFN-	Most Favored Nation
No. -	Number
NRI-	Non-Residents Indians
p-.	Page

PDS	Protected Disclosure Scheme
PI	Persons of Indian Origin
PIS -	Portfolio Investment Scheme
PMLA-	Preventive of Money Laundering
pp.-	Pages
QFB-	Qualifying Full Banking
RBI -	Reserve Bank of India
SCL -	SEBI and Corporate Law
SEZ-	Special Economic Zones
SS	Social Science Research Network
Vol. -	Volume
WOS-	Wholly Owned Subsidiary
WTO-	World Trade Organization

List of Statutes - Primary Source

- Banking Regulation Act 1949
- Reserve Bank of India Act,1934
- Banking Ombudsman Scheme 2006
- Foreign Exchange Management(establishment in India of branch or office or other place of business)Regulation,2000
- Foreign Management Act 1999
- Foreign Exchange Regulation Act 1973
- Protected Disclosure Scheme 2007
- Securities Board of India (foreign institutional investors) regulations, 1995
- Basel Accord on Banking Supervision 2004
- Foreign Exchange Management(Transfer or issue of any foreign security) Regulation, 2004
- Foreign Exchange Management (Transfer or issue of Security) Regulations, 2000
- General Agreement on Trade in Services 5th Protocol on Financial Services Agreement.

Chapter I - Introduction to Role of Government in Banking Management

1.1 Introduction

Word "Bank" derived from the word "bancus" or "banque" i.e. a bench[4]. In the medieval Europe, moneylenders and money exchangers, who can be called as early bankers, used to display their coins and transact business on the Bench, That time money-changing was considered important function of Bank. Then word "Bank" is used in respect of business of banking[5]. In ancient people use the business of banking & money lending. In modern times they still exists both the organized & unorganized segments of money market. Organized money market have made sufficient progress& replaying a growingly important role. Amongst the institutions in the organized sector the money market, commercial banks and Co-operative have been there for many decades. Banking is typically one of the most regulated industries within a nation's economy because it serves as the economy's payment mechanism, gathering financial assets and redeploying them for productive purposes through loans and other types of credit[6]. Because banking and its payment function are so crucial to an economy's operations,

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[4] Tannan, M.L.,*Banking Law and Practice*, 23rd (Nagpur: Lexis Nixies Butterworth Wadhwa, 2010)
[5] Singh, Avtar, *Banking and Negotiable Instruments*, 2nd ,(Lucknow:Eastern Book of India, 2011)
[6] See Robert E. Krainer, Banking in a Theory of Business Cycle: A Model and Critique of the Basle Accord on Risk-Basel Capital Requirements for Banks, 21 INT'L REV.L.& ECON.413,414(2001)

national governments tend to regulate this industry heavily and occasionally even own banks[7]. As international trade has grown, each nation's banking system has likewise become more international. National governments have been very hesitant to enter into international agreements that involve ceding regulatory control of banks incorporated or operating within their jurisdictions. They tend to view any transfer of regulatory control over their banking systems as akin to a surrender of soverign power.[8] Governments generally wish to retain control over banking systems because of the high costs and negative political repercussions of bank faikures.[9] Governments, and related agencies such as central banks, typically have lender of last resort responsibility for banks operating within their borders.[10] If a bank has insufficent liquid funds to meet payments demands from depositors, the national government, through its central bank, may lend funds to the banks to meet these demands. There is also a considered view that bank supervision function can provide the central bank with far more information from and control over the insitutions and markets and thus assist in maintaining finacial stability. In simple terms government plays crucial role in supervision and management of banks by helping them financially. The pharse "The Business of

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[7] See WENDY DOBSON & GARY CLYDE HUFBAUER, WORLD CAPITAL MARKETS 95, 103-04(2001); Richard Dale, international banking regulations, in INTERNATIONAL FINANCIAL MARKERT REGULATION 193-94(Benn steil ed.,1994); Rolf H.Weber, Challenges for the New Financial Architecture,31 H.K.L.J.246(2001).

[8] Richard dale,international banking regulation, in international financial market regulation 193-94(benn steil.,1994), at 187

[9] Dobson &hufbauer,supra note 2 , at 101-102

[10] Supra note at 4

Banking" has been interpreted by various courts. All courts have based their analysis of permissible bank powers on the assumption that a bank has no power except those either expressly granted by statute or incidental to the powers granted by the express statutory language.[11] Fro this assumption, two views have emerged regarding the interpretation of statutes garnting powers to banks.

Under the narrow view, based on the rule of "expressio unius est exclusio alterius" National banks are prohibited from engaging in any activites that have been expressly approved by congress. Under broad view, the phrase "the business of banking" is considered a seprate express grant of power by congress. Neither the narrow nor the broad view of bank powers is wholly satisfactory. The narrow view suggests a static, mechanical view of banking activites that does not provide a principled framework for evaluating the permissibility of new and unforseen activities. The broad view has no principled base or limits, beyond proposing that a bank's activites cannot substantially risk loss of its assets. India being devloping country, most of its financial institutions are controlled by government alone. The legal and institutional framework for bank supervision in India is provided under the Banking Regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks, non-banking financial companies and financial

[11] See californication bank vs kennedy, 167 U.S. 362,366(1897); logan. Nat'l bank vs townsend,139 U.S.67,73(1891)

institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the board for Financial Supervision was set up under the aegis Reserve Bank under Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector. Prior to 1993, the supervision and regulations of commercial banks was handled by the Department of Banking Operations & Development (DBOD). In December 1993, the department of supervision was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI.

1.2 Supervision & Control of Banking Management

Regulation and supervision of the business activities, pertaining to the banking industry units will be essential for their effective functioning. Generally, the concept of banking regulation and supervision is defined as control over the creation, operation, and liquidation of banks. The most general definition of the concept of banking regulation and supervision is control over the creation, operation, and liquidation of banks.[12] Such control is very diverse, carried out by

[12] Bank of International Settlement, Basel committee on Banking Supervision, "*Core Principles for Effective Banking Supervision*", September 2012, available at http://www.bis.org/publ/bcbs213.pdf (last visited 23rd May 2017)

specialized banking supervisory authorities. Supervision over the bank's operational activities aims to protect the interests of depositors and to ensure effective functioning of the banking industry units. This supervision is the most important and essential part of the functions of banking supervisory authorities, which are carried out in the name of a sound banking system. Supervision is performed continuously throughout the whole operating process of the bank. Furthermore, banking supervision is required in order to monitor and assist in the early detection of problems in the banking institutions, taking all necessary measures, such as liquidation, with the aim of overcoming and limiting the adverse effects within the affected bank. Banking supervision should be seen as dynamic function, responding to market changes. Therefore, National supervisory authorities and international departments should periodically adapt their policies and practices to the changes in economic environment. The legal framework in each country, concerning the banking system, should be flexible enough to allow national supervisors to make those changes.[13] The effective operation of future authority for banking supervision depends on: institutionalization of banking supervision; defining its rights and obligations; creating links with each other participants in the banking and insurance network; the presence of laws regulating the creation, ownership, right, and responsibilities of business organizations, property laws, insolvency and bankruptcy law; the application of

[13] http:www.centralbanksguide.com/banking+industry+regulation (last visited 23th May 2017)

the accounting world standards, practices and system; the presence of an independent external audit and public disclosure of financial audits. All these conditions create a healthy business environment which reduces the risk in the banking industry[14].

1.3 History of Government's Role in Banking Management

Up to 1935, Government of India retained all the powers of a central bank, including powers of note-issue in its own hands. But, it never operated consciously to influence the rate of interest in the money market, by the standard methods used by modern central banks. In 1926, Hilton Young Commission recommended the creation of separate bank, to be called Reserve Bank of India[15]. It was to perform central banking functions, so as to leave Imperial Bank entirely free to continue and extend its commercial banking activates. With establishment of RBI in 1935, the Imperial Bank ceased to be the government's banker. RBI came into existence by enactment of Reserve Bank of India Act 1934. Under the said act RBI has been entrusted with the numerous powers of issuing bank licenses, acting as banker to other bankers.

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[14] Id

[15] Roy T. Englert, "Bank Supervision in historical perspective", 34 Bus Law.1659 1978-1979, available at:www.heinonline.org;A.J.Saunders, "The Indian Reserve Bank and Sir Basil Blackett's work in India", The Economic Journal,Vol.38, No.151(sep.,1928),pp. 405-413, available at http://www.jstor.org/stable/2224317 (last visited 24th May 2017)

1.3.1 Social Control and Nationalization of Banks

The government of India concedes the important role of financial services in promoting its economic growth and gives added emphasis to improving services[16]. India is particularly concerned with the extension of banking services to remote geographical areas and the increase of mobilization of savings. After independence the Government of India (GOI) adopted planned economic development for the country (India). Accordingly, five year plans came into existence since 1951. This economic planning basically aimed at social ownership of the means of production. However, commercial banks were in the private sector those days. In 1950-51 there were 430[17] commercial banks. The Government of India had some social objectives of planning. These commercial banks failed helping the government in attaining these objectives. Thus, the government decided to nationalize 14 major commercial banks on 19th July, 1969. All commercial banks with a deposit base over Rs.50 crores were nationalized. It was considered that banks were controlled by business houses and thus failed in catering to the credit needs of poor sections such as cottage industry, village industry, farmers, craft men, etc. The second dose of

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[16] Report by the government of India, in: WTO, trade policy review India1998(WTO,Geneva,1998)p.237(India review 1998)

[17] Tannan, M.L.,*Banking Law and Practice*, 23rd (Nagpur: Lexis Nixies Butterworth Wadhwa, 2010)

nationalization came in April 1980 when banks were nationalized. Objectives behind Nationalization of Banks in India

The nationalization of commercial banks took place with an aim to achieve following major objectives.

- **Social Welfare**
- **Controlling Private Monopolies**
- **Expansion of Banking**
- **Reducing Regional Imbalance**
- **Priority Sector Lending**
- **Developing Banking Habits**

1.3.2 Basel committee on Banking Supervision

The governors of the G-10 countries had by the early 1970 have developed a highly sophisticated but essentially personal network of consultation and cooperation. This had, however rationally been based on contact in relation to purely monetary and economic matters. Bank supervision until then has been ignored at the governors meetings while national supervisory and regulatory authorities considered developments unfolding in international financial markets to be irrelevant. It was only in 1974 with the establishment of Basel committee

that the bank supervisory issues would be elevated to being an issue of international as well as of national concern. The committee possesses only an informal supervisory power and does not intend the Basel Accords to have legal force.[18] The Basel Committee on Banking Supervision (BCBS)[19] is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1974[20]. It provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The Committee frames guidelines and standards in different areas - some of the better known among them are the international standards on capital adequacy, the Core Principles for Effective Banking Supervision and the Concordat on cross-border banking supervision[21].

1.3.3 Core principal of effective Banking Supervision

Basel committee eventually develops more substantive standards for bank regulation. Rather than focusing merely on the coordination of the International

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[18] Ethan B.Kapstein, supervising international banks: origins and implications of the Basle Accords185(DEC-1991).

[19] Bank for International Settlement, Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision,2012, available at: http://www.bis.org/publ/bcbs230.pdf (last visited On 25th May 2017)

[20] See the "History of the Basel Committee and its Membership" in http://www.bis.org/bcbs/history.pdf(last visited 25th May 2017)

[21] About:Basel Committee on Banking Supervision

bank supervision, the basal committee provided comprehensive minimum standards for bank supervision when it published the core principal in 1997.[22]

The Core Principles define 29 principles that are needed for a supervisory system to be effective. Those principles are broadly categorized into two groups: the first group (Principles 1 to 13) focuses on powers, responsibilities and functions of supervisors, while the second group (Principles 14 to 29) focus on prudential regulations and requirements for banks. The original Principle 1 has been divided into three separate Principles, while new Principles related to corporate governance, and disclosure and transparency, have been added. This accounts for the increase from 25 to 29 Principles. Supervisory powers, responsibilities and functions.

- Principle 1 – Responsibilities, objectives and powers
- Principle 2 – Independence, accountability, resourcing and legal protection for supervisors
- Principle 3 – Cooperation and collaboration
- • Principle 4 – Permissible activities
- • Principle 5 – Licensing criteria

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[22] See CORE PRINCIPAL of Banking Principle.

- • Principle 6 – Transfer of significant ownership
- • Principle 7 – Major acquisitions
- • Principle 8 – Supervisory approach
- • Principle 9 – Supervisory techniques and tools
- • Principle 10 – Supervisory reporting
- • Principle 11 – Corrective and sanctioning powers of supervisors
- • Principle 12 – Consolidated supervision
- • Principle 13 – Home-host relationships
- • Principle 14 – Corporate governance
- • Principle 15 – Risk management process
- • Principle 16 – Capital adequacy
- • Principle 17 – Credit risk
- • Principle 18 – Problem assets, provisions and reserves
- • Principle 19 – Concentration risk and large exposure limits
- • Principle 20 – Transactions with related parties
- • Principle 21 – Country and transfer risks
- • Principle 22 – Market risks
- • Principle 23 – Interest rate risk in the banking book
- • Principle 24 – Liquidity risk
- • Principle 25 – Operational risk

- • Principle 26 – Internal control and audit
- • Principle 27: Financial reporting and external audit
- • Principle 28 – Disclosure and transparency
- • Principle 29 – Abuse of financial services

The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved. They are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of the assessments and in the dialogue between assessors and country authorities. National authorities should apply the Core Principles in the supervision of all banking organizations within their jurisdictions.[23] Individual countries, in particular those with advanced markets and banks, may expand upon the Core Principles in order to achieve best supervisory practice. A high degree of compliance with the Core Principles should foster overall financial system stability; however, this will not guarantee it, nor will it prevent the failure of banks. Banking supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are part of risk-taking. The

[23] In countries where non-bank financial institutions provide deposit and lending services similar to those of banks, many of the Principles set out in this document would also be appropriate to such non-bank financial institutions. However, it is also acknowledged that some of these categories of institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system.

Committee stands ready to encourage work at the national level to implement the Core Principles in conjunction with other supervisory bodies and interested parties. The Committee invites the international financial institutions and donor agencies to use the Core Principles in assisting individual countries to strengthen their supervisory arrangements.

1.4 Departments of Banking Supervision

The Banking Regulation Act, 1949 empowers the Reserve Bank of India to inspect and supervise commercial banks. These powers are exercised through on-site inspection and off-site surveillance.

Till 1993, regulatory as well as supervisory functions over commercial banks were performed by the department of Banking Operations and Development (DBOD). Subsequently, a new Department of Banking Supervision (DBS) was set up top take over the supervisory functions relating to the commercial Banks from DBOD. For dedicated and integrated supervision over all credit institutions i.e., banks, development financial institutions and non-banking financial companies, the Board for Financial Supervision (BFS) was set up in November 1994 under the aegis of the Reserve Bank of India.

For focused attention on the area of supervision over non-banking finance companies, Department of supervision was further bifurcated in August 1997 into Department of Banking Supervision (DBS) and Department of non- Banking Supervision (DNBS). These Departments now look after supervision over commercial banks and development financial institutions and non- banking financial companies, respectively. Both these departments now function under the direction of the Board for Financial Supervision (BFS)[24].

The Banking Regulation Act, 1949 empowers the Reserve Bank of India to inspect and supervise commercial banks. These powers are exercised through on-site inspection and off site surveillance. Till 1993, regulatory as well as supervisory functions over commercial banks were performed by the Department of Banking Operations and Development (DBOD). Subsequently, a new Department of Banking Supervision (DBS) was set up to take over the supervisory functions relating to the commercial banks from DBOD. For dedicated and integrated supervision over all credit institutions, i.e., banks, development financial institutions and non-banking financial companies, the Board for Financial Supervision (BFS) was set up in November 1994 under the aegis of the Reserve Bank of India. For focused attention in the area of supervision over non-banking finance companies, Department of Supervision

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[24] See supra Pp. 20-26

was further bifurcated in August 1997 into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS). These Departments now look after supervision over commercial banks & development financial institutions and non-banking financial companies, respectively. Both these departments now function under the direction of the Board for Financial Supervision (BFS). [25]The Board for Financial Supervision constituted an audit sub-committee in January 1995 with the Vice-Chairman of the Board as its Chairman and two non-official members of BFS as members. The sub-committees main focus is upgradation of the quality of the statutory audit and concurrent / internal audit functions in banks and development financial institutions.

On site Inspection

On site inspection of banks is carried out on an annual basis. Besides the head office and controlling offices, certain specified branches are covered under inspection so as to ensure a minimum coverage of advances[26].

The Annual Financial Inspection (AFI) focuses on statutorily mandated areas of solvency, liquidity and operational health of the bank. It is based on

[25]Reserve bank of India, "*Department of Banking Supervision*" available at http://rbi.org.in/scripts/AboutUsDisplay.aspx?pg=DeptOfBS.htm (last visited 1st May 2017)
[26] Reserve bank of India, "*Department of Banking Supervision*" available at http://rbi.org.in/scripts/AboutUsDisplay.aspx?pg=DeptOfBS.htm (last visited 1st May 2017)

internationally adopted CAMEL model modified as CAMELS, i.e., capital adequacy, asset quality, management, earning, liquidity and system and control. While the compliance to the inspection findings is followed up in the usual course, the top management of the Reserve Bank addresses supervisory letters to the top management of the banks highlighting the major areas of supervisory concern that need immediate rectification, holds supervisory discussions and draws up an action plan that can be monitored. All these are followed up vigorously. Indian commercial banks are rated as per supervisory rating model approved by the BFS which is based on CAMELS concept.[27]

Off-site Monitoring

As part of the new supervisory strategy, a focused off-site surveillance function was initiated in 1995 for domestic operations of banks. The primary objective of the offsite surveillance is to monitor the financial health of banks between two on-site inspections, identifying banks which show financial deterioration and would be a source for supervisory concerns. This acts as a trigger for timely remedial action.

[27] Reserve Bank of India, *"Function and Workings"* available at http://www.rbi.org.in/scripts/aboutusdisplay.aspx?pg=depts.htm (last visited 1st May 2017)

During December 1995 first tranche of off-site returns was introduced with five quarterly returns for all commercial banks operating in India and two half yearly returns one each on connected and related lending and profile of ownership, control and management for domestic banks. The second tranche of four quarterly returns for monitoring asset-liability management covering liquidity and interest rate risk for domestic currency and foreign currencies were introduced since June, 1999. The Reserve Bank intends to reduce this periodicity with effect from April 1, 2000[28].

Corporate Governance

With a view to strengthening the corporate governance and internal control function in the banks, several steps have been initiated. Introduction of concurrent audit system, constitution of independent audit committee of board, appointment of RBI nominees on boards of banks, creation of a post of compliance officer, such are some steps. Besides, the Reserve Bank monitors the implementation of recommendations of Jilani Committee relating to internal control systems in banks on an on-going basis during the annual financial inspection of banks.

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[28] Supra note 1 at 28

Initiatives and Directions

The Reserve Bank has taken several other supervisory policy initiatives. These include quarterly monitoring visits to banks displaying financial and systemic weaknesses, appointment of monitoring officers and direct monitoring of certain problem areas in house-keeping, etc. In addition the department provides secretarial support to the Board for Financial Supervision and acts as its executive arm. It is the BFS which evolves policies relating to supervision. It also attends to appointment of statutory central auditors / branch auditors for all banks and selected all India financial institutions and to complaints against banks. The department monitors cases of frauds perpetrated in banks and reported to it. The department as a onetime measure, issued several guidelines to banks and all India financial institutions to enable them to become Y2K compliant.

Core Principles

Against the backdrop of banking sector reforms in India and the global focus on internal control and supervisory mechanism, the need for building a strong and efficient banking system comparable to the international standards cannot be gainsaid. A detailed study was carried out so as to ascertain gaps, if any, in implementing the 25 core principles of effective banking supervision enunciated

by the Bank for International Settlements (BIS). Necessary steps have already been initiated to fill in the gaps, so as to make the regulatory as well supervisory system more sound and comparable to international standards.[29]

Supervision over FIs

On the basis of the recommendations made by an in-house group, the monitoring of the financial institutions first started after 1990. This was done through prescribed quarterly returns on liabilities / assets, source and deployment of funds, etc. The objective of this monitoring was to obtain a macro level perspective for evolving monetary and credit policy, to assess the quality of assets of the financial system and to improve co-ordination between banks and FIs. In 1994, these institutions were brought under the prudential regulation of the Reserve Bank.

The Reserve Bank has adopted more or less, the CAMELS approach for regulation of Fis. Since FIs are vested with developmental role as well and with responsibility of supervision of other institutions, evaluation of their

[29] Discussion Paper on Prompt Corrective Action "Department of Banking Supervision Central Office Policy Planning Division" available at https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&uact=8&ved=0CCoQFjAC&url=http%3A%2F%2Frbidocs.rbi.org.in%2Frdocs%2FPublications%2FDOCs%2F14690.doc&ei=5OcDVYKyCNG_uATciIL4Ag&usg=AFQjCNHBLdEkJt1X1tbYGSHyPzxC8jsGKg&sig2=X2dtDouKBP208u6ATiVHJA (last visited 1st May 2017)

developmental, co-coordinating and supervisory role is also undertaken. The newly created division in the department at present supervises and regulates ten select all-India financial institutions viz., IDBI, ICICI, IFCI, IIBI, Exim Bank, NABARD, NHB, SIDBI, IDFC and TFCI. With a view to having a continuous monitoring and supervision of these FIs, an off-site surveillance system has also been put in place. Further, the division collects from LIC, GIC and UTI information relating to assets and liabilities and flow of funds for the purpose of overall assessment of the impact of the operations of FIs on the total flow of resources in the economy and for compiling new liquidity and monetary aggregates.

1.5 Existing Framework for Supervisory Action

Under the powers conferred under RBI Act, 1934 and Banking Regulation Act, 1949, Reserve Bank has been taking bank-specific supervisory corrective actions where financial position warrants such measures. These included directing banks to submit quarterly Monitor able Action Plans and progress reports on various targets set by Reserve Bank, such as augmentation of capital, improvement in profitability, reduction of NPAs, reconciliation of entries in inter-branch, inter-bank and nostro accounts, review/renewal of borrowable accounts, etc. In extreme

cases, Reserve Bank had also put caps on credit-deposit ratio, restrictions on payment of dividend, call money borrowings and refinancing with high cost deposits including Certificate of Deposit, ban on recruitment and opening of branches, etc.

Chapter II - Role of Government in Banking Regulation Act 1949

2.1 Introduction

In developing countries, the banks constitute almost the entire financial sector. A strong banking system is therefore the sine qua non for a robust financial sector. A unique feature of the Indian financial system is the diversity of its composition. We have the dominance of government ownership coupled with significant private shareholdings in the public sector banks, and we also have cooperative banks, regional rural banks and foreign bank branches. By and large the regulatory standards for all these banks are uniform. Banks provide way to deal with the deficiencies in the infrastructure needed for equity and bond markets of flourish. Banks take advantage of scale economies and concentration of expertise to reduce the costs associated with financial transactions. Besides providing a return, they provide safe keeping, diversification and liquidity. Importantly they collect and analyses information on borrowers and their productive opportunities and use it to monitor relationships with their clients. As delegated monitors, they provide discipline on the functioning of the firms and a solution to the free rider problem that characterizes multiple stakeholders' relationships and the principle-agent problem that arises when ownership is

separated from control. Hence the regulatory framework for the banks and the way it evolves are of the fundamental importance to developing countries.[30]

2.2 Powers of Central Government under 1949 Act

India is the largest country in South Asia with a huge financial system characterized by many and varied financial institutions and instruments. Indian banking sector was well developed even prior to its political independence in 1947. There was significant presence of both foreign and domestic banks and well developed stock market. Central government acts through Reserve Bank of India which was established in1935. RBI acts as agent to the central government. Reserve Bank of India helps the government both the union and the states to float new loans and to manage public debt.

[30] See stigliz (2001). For a comprehensive look at the historical development of financial system, see Allen and Gale (2000).

Section 4 in BANKING REGULATION ACT, 1949

4. Power to suspend operation of Act.—

(1) The Central Government, if on a representation made by the Reserve Bank in this behalf is satisfied that it is expedient so to do, may by notification in the Official Gazette suspend for such period, not exceeding sixty days, as may be specified in the notification, the opera-tion of all or any of the provisions of this Act, either general-ly or in relation to any specified banking company.

(2) In a case of special emergency, the Governor of the Reserve Bank, or in his absence a Deputy Governor of the Reserve Bank nominated by him in this behalf may, by order in writing, exer-cise the powers of the Central Government under sub-section (1) so however that the period of suspension shall not exceed thirty days, and where the Governor or the Deputy Governor, as the case may be, does so, he shall report the matter to the Central Gov-ernment forthwith, and the order shall, as soon as may be, be pub-lished in the Gazette of India.

(3) The Central Government may, by notification in the Official Gazette, extend from time to time the period of any suspension ordered under sub-section (1) or sub-section (2) for such period, not exceeding sixty days at any one time, as it thinks fit so however that the total period does not exceed one year.

(4) A copy of any notification issued under sub-section (3) shall be laid on the table of 7 [Parliament] as soon as may be after it is issued[31].

Section 36AE in BANKING REGULATION ACT, 1949[32]

[36AE. Power of Central Government to acquire undertakings of banking companies in certain cases.—

(1) If, upon receipt of a report from the Reserve Bank, the Central Government is satisfied that a banking company—

(a) has, on more than one occasion, failed to comply with the directions given to it in writing under section 21 or section 35A, in so far as such directions relate to banking policy, or

(b) is being managed in a manner detrimental to the interests of its depositors, and that—

(i) in the interests of the depositors of such banking company, or

(ii) in the interest of banking policy, or

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[31] Central Government Act, "*Banking Regulation Act 1949*", available at http://indiankanoon.org/doc/252634/ (last visited 1st May 2017)
[32] Central Government Act, "*Banking Regulation Act 1949*", available at http://indiankanoon.org/doc/258343/ (last visited 1st May 2017)

(iii) for the better provision of credit generally or of credit to any particular section of the community or in any particular area,

it is necessary to acquire the undertaking of such banking compa-ny, the Central Government may, after such consultation with the Reserve Bank as it thinks fit, by notified order, acquire the undertaking of such company (hereinafter referred to as the acquired bank) with effect from such date as may be specified in this behalf by the Central Government (hereinafter referred to as the appointed day): Provided that no undertaking of any banking company shall be so acquired unless such banking company has been given a reasonable opportunity of showing cause against the proposed action. Explanation.—In this Part,—

(a) "Notified order" means an order published in the Official Gazette;

(b) "Undertaking", in relation to a banking company incorporated outside India, means the undertaking of the company in India.

(2) Subject to the other provisions contained in this Part, on the appointed day, the undertaking of the acquired bank and all the assets and liabilities of the acquired bank shall stand transferred to, and vest in, the Central Government.

(3) The undertaking of the acquired bank and its assets and li-abilities shall be deemed to include all rights, powers, authori-ties and privileges and all property, whether movable or immova-ble, including, in particular, cash balances, re-serve

funds, investments, deposits and all other interests and rights in, or arising out of, such property as may be in the possession of or held by, the acquired bank immediately before the appointed day and all books, accounts and documents relating thereto, and shall also be deemed to include all debts, liabili-ties and obligations, of whatever kind[33], then existing of the acquired bank.

(4) Notwithstanding anything contained in sub-section (2), the Central Government may, if it is satisfied that the undertaking of the acquired bank and its assets and liabilities should, instead of vesting in the Central Government, or continuing to so vest, vest in a company established under any scheme made under this Part or in any corporation (hereinafter in this Part and in the Fifth Schedule referred to as the transferee bank) that Government may, by order, direct that the said undertaking, in-cluding the assets and liabilities thereof, shall vest in the transferee bank either on the publication of the notified order or on such other date as may be specified in this behalf by the Central Government.

(5) Where the undertaking of the acquired bank and the assets and liabilities thereof vest in the transferee bank under sub-section (4), the transferee bank, shall, on and from the date of such vesting, be deemed to have become the transferee of the acquired bank and all the rights and liabilities in relation to the

[33] See supra Pp. 35-26

ac-quired bank shall, on and from the date of such vesting, be deemed to have been the rights and liabilities of the transferee bank.

(6) Unless otherwise expressly provided by or under this Part, all contracts, deeds, bonds, agreements, powers of attorney, grants of legal representation and other instruments of whatever nature subsisting or having effect immediately before the appointed day and to which the acquired bank is a party or which are in favor of the acquired bank shall be of as full force and effect against or in favor of the Central Government, or as the case may be, of the transferee bank, and may be enforced or acted upon as fully and effectually as if in the place of the acquired bank the Central Government or the transferee bank had been a party there-to or as if they had been issued in favor of the Central Govern-ment or the transferee bank, as the case may be.

(7) If, on the appointed day, any suit, appeal or other proceed-ing of whatever nature is pending by or against the acquired bank, the same shall not abate, be discontinued or be, in any way, prejudicially affected by reason of the transfer of the undertaking of the acquired bank or of anything contained in this Part, but the suit, appeal or other proceeding may be continued, prosecuted and enforced by or against the Central Government or the transferee bank as the case may be.][34]'

[34] See Supra Pp. 36-37

52. Power of Central Government to make rules

(1) The Central Government may, after consultation with the Reserve Bank, make rules to provide for all matters for which provision is necessary or expedient for the purpose of giving effect to the provisions of this Act and all such rules shall be published in the Official Gazette.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for the details to be included in the returns required by this Act and the manner in which such return shall be submitted 269[and the form in which the official liquidator may file lists of debtors to the Court having jurisdiction under Part III or Part IIIA and the particulars which such lists may contain and any other matter which has to be, or may be, prescribed].

(4) The Central Government may, by rules made under this section, annul, alter or add to, all or any of the provisions of the Fourth Schedule.]

(5) Every rule made by the Central Government under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rules or both Houses agree that

the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.][35]

2.3 Functions of Reserve Bank of India

In every country there is one organization which works as the central bank. The function of the central bank of a country is to control and monitor the banking and financial system of the country. In India, the Reserve Bank of India (RBI) is the Central Bank. Reserve Bank of India. The RBI was established in 1935. It was nationalized in 1949. The RBI plays role of regulator of the banking system in India. The Banking Regulation Act 1949 and the RBI Act 1953 has given the RBI the power to regulate the banking system. The RBI has different functions in different roles. Below, we share and discuss some of the functions of the RBI.

RBI is the Regulator of Financial System

The RBI regulates the Indian banking and financial system by issuing broad guidelines and instructions. The objectives of these regulations include:

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[35] Central Government Act, "*Banking Regulation Act 1949*", available at http://indiankanoon.org/doc/258343/ (last visited 1st May 2017)

- Controlling money supply in the system,
- Monitoring different key indicators like GDP and inflation,
- Maintaining people's confidence in the banking and financial system, and
- Providing different tools for customers' help, such as acting as the "Banking Ombudsman."[36]

RBI is the Issuer of Monetary Policy

The RBI formulates monetary policy twice a year. It reviews the policy every quarter as well. The main objectives of monitoring monetary policy are:

- Inflation control
- Control on bank credit
- Interest rate control

The tools used for implementation of the objectives of monetary policy are:

- Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR),
- Open market operations,
- Different Rates such as repo rate, reverse repo rate, and bank rate.

[36] Times of India, "*Role and Functions of Reserve Bank of India*" Monday 24th February 2014available at http://www.timespro.com/news/blog/role-and-function-of-the-reserve-bank-of-india-rbi/23-role-and-function-of-the-reserve-bank-of-india-rbi (last visited 2nd May 2017)

RBI is the Issuer of Currency

Section 22 of the RBI Act gives authority to the RBI to issue currency notes. The RBI also takes action to control circulation of fake currency.RBI is the Controller and Supervisor of Banking Systems. The RBI has been assigned the role of controlling and supervising the bank system in India. The RBI is responsible for controlling the overall operations of all banks in India. These banks may be:

- Public sector banks
- Private sector banks
- Foreign banks
- Co-operative banks, or
- Regional rural banks

The control and supervisory roles of the Reserve Bank of India is done through the following:

- **Issue Of License**
- **Prudential Norms**
- **Corporate Governance**
- **KYC Norms**
- **Transparency Norms**
- **Risk Management**

- ➢ **Audit and Inspection**
- ➢ **Foreign Exchange Control**
- ➢ **Development**

Apart from the above, the RBI publishes periodical review and data related to banking. The role and functions of the RBI cannot be described in a brief write up. The RBI plays a very important role in every aspect related to banking and finance. Finally the control of NBFCs and others in the financial world is also assigned with RBI.

2.3.1 Licensing of Foreign Banks

Foreign banks are allowed to operate in India through branches only. A foreign bank desirous of operating its maiden branch in India may apply to RBI giving relevant information about the bank, its major shareholders, financial position, etc. Request from banks will be examined, keeping in view

- The financial soundness of the bank
- International and home country ranking
- Rating
- International presence

- Economic and political relations between the two countries (in particular the home country of the bank should not discriminate against Indian Banks). The bank should be under consolidated supervision of the home country regulator.

A new foreign bank is required to bring in assigned minimum capital of US $ 25 million, of which US$10 million shall be brought in at the time of opening each of the first two branches and the balance of US$ 5 Million at the time of opening the third or more branches. One and half decades post liberalization[37], a robust regulatory framework governing foreign bank presence in the country became imperative. Twelve new private sector banks had been given licenses under the guidelines issued in 1993 and 2001. Beginning with the voluntary merger of Times Bank with HDFC, consolidation of the newly licensed banks had also started. ICICI and HDFC Bank had established themselves as iconic Indian brands with scale and distribution power. Many public sector banks had been listed and the adoption of technology powered by Indian technology giants had changed the face of Indian banking considerably, putting them on a profitable growth path for the near future. On 28 February 2005, the RBI released a roadmap for the presence of foreign banks in India along with guidelines on ownership and governance in private sector banks. This was indeed a watershed

[37]Pwc, "*Foreign Bank in India at An Inflection*" available at http://www.pwc.in/assets/pdfs/publications/2013/foreign-banks-in-india.pdf (last visited 3rd May 2017)

event as it provided the first ever documented policy on foreign banks in the country, and for the first time, spurred a debate about the present and future role of foreign banks in India. It was also no coincidence that the guidelines on private sector bank ownership and foreign bank roadmap were released together. The press release prefacing both documents makes an interesting point about the 'need for enabling shareholding higher than 10% to facilitate restructuring in the banking system and consolidation.' Ironically, that debate remains as relevant today as in 2005, despite an Act of Parliament in December 2012 having paved the way for enhanced voting rights up to 26%.The new private sector banks also spurred an opportunity for foreign banks and investors to participate in the Indian banking sector through equity investments. For example, ING hiked its stake in ING Vysya Bank to 44% in 2002, up from 20%, HSBC acquired 14.71% stake in UTI Bank (today known asAxis Bank) in 2003, Temasek Holdings acquired 5% stake in ICICI Bank in 2003 and later increased it to 9%, Rabobank acquired 20% stake in Yes Bank in 2004 and HSBC acquired 4.74% stake in Yes Bank in 2008.

2.3.2 Opening of branches in India by Foreign banks

The opening of branches by banks is governed by the provisions of Section 23 of BR ACT 1949. In terms of these provisions, banks without the prior approval of the RBI, cannot open a new place of business in India or abroad or change

otherwise than within the same city, town or village, the location of the existing place of business. Thus it is mandatory for banks to seek prior approval/license from RBI before opening of branches/offices-commercial banks from department of banking operations and development, urban co-operative banks from Urban Banks department, regional rural banks and local area banks from rural planning and credit department.

2.4 Conclusion

The monetary functions also known as the central banking functions of the RBI are related to control and regulation of money and credit, i.e., issue of currency, control of bank credit, control of foreign exchange operations, banker to the government and to the money market. Monetary functions of the RBI are significant as they control and regulate the volume of money and credit in the country. Equally important, however, are the non-monetary functions of RBI in the context of India's economic backwardness. The supervisory function of the RBI may be regarded as a non-moneatry function(through many consider this a monetary function.) The promotion of sound banking in India is an important goal of the RBI, the RBI has been given wide and drastic powers, under the Banking regulation Act of 1949- these powers relate to licensing of banks, branch

expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation.

Chapter III - Foreign Banking Operations in India: An Overview

3.1 Introduction

By promising a more liberal policy for opening branches in return for converting themselves into companies registered in India, the RBI has given foreign banks a chance to expand their presence in the country even while subjecting them to greater regulatory oversight. Currently, foreign banks operate in India solely through branches of their parents incorporated in jurisdictions where Indian regulations have limited applicability. While that has given these banks greater leeway in terms of disclosure requirements or usage of funds — even to the extent of privileging home country depositors in any settlement claims — it has severely constricted their growth opportunities in India. The 334 branches of 43 international banks now account for just 3.9 per cent of the total deposits and 5.8 of outstanding advances and investments of all scheduled commercial banks in India. This has partly to do with the restrictions on branch expansion; the World Trade Organization (WTO) rules oblige India to grant permits for only 12 new offices for foreign banks every year[38].

[38] The Hindu Business Line, "*Foreign Bank in India*" 7th November 2013, available at http://www.thehindubusinessline.com/opinion/editorial/foreign-banks-india-ltd/article5326431.ece (last visited 4th May 2017)

The RBI's new scheme for setting up wholly-owned subsidiaries (WOS) by foreign banks in India dangles a carrot by way of extending them "near national treatment" in opening new branches. As locally incorporated banks, the WOS will be allowed to establish offices anywhere in the country — barring certain "sensitive locations" — without having to seek the RBI's prior approval. While they would have to follow rules such as ensuring that at least a quarter of their new branches are in unbanked rural centers or meeting prescribed priority sector lending targets, these aren't very different from those imposed on other Indian banks. The stick is that the liberal branch licensing norms are conditional upon the banks bringing their entire operations in India under separate locally-incorporated WOS. If the banks choose to carry on business through the branch mode, their branch expansion would continue to be governed by India's commitments under the WTO framework.

The above carrot-and-stick approach policy makes sense, when major foreign banks are themselves keen on grabbing a bigger slice of the market for financial products in a $2 trillion (and growing) economy. Indian consumers stand to gain from their expanded operations and greater competition. But consumer interest will also be served by ring-fencing or making a clear delineation of their assets and liabilities from those of the foreign parents; especially important in the aftermath of the 2008 global financial crisis. Domestic incorporation of foreign

banks can help contain the contagion effects from crises that originate elsewhere, for which the depositors here aren't responsible.

3.2. Foreign Banks in India through Commercial Presence Mode

In commercial presence, foreign banks operating in India are doing their business quite efficiently. In India, foreign banks were allowed to operate only through branches till 2000-01. Four foreign banks had 10 or more branches while 18 operate through a single branch each. Twelve foreign banks have 367 ATMs located both at branches and off-sites. The branches of foreign banks are spread over 25 centers in 15 states/union territories. As on June 30, 2002, 23 banks from 12 countries had representative offices in India, of which 19 are in Mumbai, three in New Delhi and one in Chennai (Chowdary Prasad, 2004). The list of foreign banks operating in India is presented in the Annexure-I.

Though foreign banks account for only about 5.45 per cent of average total bank deposits and 7.63 per cent of average total bank loans in India (Annexure – II)[39], they nevertheless comprise an integral part of the banking sector in metropolitan areas. Foreign banks are the trendsetters in service and performance parameters

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[39] Business Line "*Foreign banks allowed 100 pc Subsidiaries*" , Saturday, March 6, 2004 last visited (10th May 2017)

in India and they were very active in retail banking long before it became the mantra for Indian banks.

3.3 Impact, Opportunities, Issues and Challenges

India's commitment to the FSA was very cautious and the impact is very nominal. There might be the reason that allowing more foreign banks may create severe competition and the industry was not adequately prepared to encounter. India's commitments under the financial services, as in the case of most services, have been very modest. Hence the commitments under GATS have little impact on the banking sector or for that matter on the services sector as a whole (P.P. Prabu, 2004)[40]. Many countries including developing countries had deregulated and opened their financial system as part of financial sector reforms or had programs to liberalize the sector. These were part of autonomous liberalization and implemented by countries voluntarily as being their interest. On the other hand GATS commitments are binding constraints for policy makers beyond which current policies cannot so easily be reversed and therefore more predictable for both domestic and foreign financial institutions. Furthermore, making commitments in GATS is also a way of signaling a country's seriousness to

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[40] See Supra Pp. 70-73

potential foreign investor and strategic partners...commitments are minimum guarantees of market access or national treatment and WTO members are free to apply more liberal regimes in practice. This helps sequencing reforms with freedom to commit to liberalization after allowing a period of time to strengthen domestic institutions, financial regulation and supervision (Shyamala Gopinath, 2004)[41].

India has initiated the process of reforms as early as in 1991 as part of reforms in other sector much before several developing countries, Asian financial crisis and the WTO agreement. Strengthening of the financial sector and improving he functions of financial markets can be described as the core principle of financial sector reforms in India. The banking industry's response to the reforms was very quick and highly positive in terms of competitiveness, financial position and performance. With the liberalization of the policy towards entry of foreign banks, Indian banks will be exposed to greater competition as a result of the global developments in the context of WTO regime.

Developing countries are engaged in a much broader process of financial reform beyond the limited opening-up of domestic markets to foreign financial firms committed in the WTO. The reforms being undertaken included not merely

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[41] "Changes in the world's Financing Markets in the last 30 years and its Implications for the Future". Journals of banking and finance..ideas.repec.org/s/eee/jbfinahtml

opening of domestic markets to competition from new banks domestic and foreign but also the process deregulation and strengthening domestic financial institutions (Shyamala Gopinath, 2004).

The entry of New Generation Banks (NGBs) has changed the entire landscape of the banking industry and re-defined the banking operations. Strengthening of the Indian banking system is absolutely essential in this situation. Though the establishment of the new generation banks had nothing to do with WTO as such, it has greatly helped the objective of meeting the challenges posed by the WTO agreement on financial services. The contribution made by these group of banks in strengthening of the Indian banking

system is highly significant and absolutely essential, especially in the areas like, leveraging information technology, retail banking, product and process innovation, risk management, capital adequacy, reduction of NPA level, global presence etc. In spite of their strong and larger network, public sector banks have proved to be surprisingly nimble and flexible to meet the emerging needs of customers. The paradigm shift in the industry has also signaled the banks to benchmark their competencies in order to successfully face the challenges in the global environment.

It is difficult to assess and judge whether the improvement in efficiency of our banks due to the opening-up of the financial sector or due to internal liberalization as they are synchronized. The impact of FSA is implicit as it has invited stunning changes in the industry and consequentially forced the players to become more competent. Especially the new generation private banks have re-written the banking rules in India, re-engineered the operations and came out with flying colors.

WTO regime opened-up business opportunities among member countries and moving towards globalization. In the WTO period, there will be not only increased presence of foreign banks in India, but also there will me more opportunities for increasing the foreign presence of Indian banks. Whether the Indian banking system make use of this opportunity and what role the new private sector banks can play in this regard also need to be looked into. The present overseas presence of Indian banks is very limited and that of the new private sector banks is even much less. As torch-bearers of technological change, the new generation banks have better scope for increasing their overseas presence[42].

Internet banking has just taken roots in India, with a few banks offering banking services on the internet. Internet banking has the potential for banks to lower the

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[42] Reserve Bank Of India, "*BANKING SECTOR REFORMS AND INDIAS' COMMITMENTS AT WTO*" available at http://wtocentre.iift.ac.in/CBP/Banking%20Sector%20Reforms%20&%20India's%20GATS%20commitment_RAJESH%20JAI%20KANTH.pdf last visited 10th May 2017

transaction cost, offer increasing number of products and services in timeless manner, thereby maximising customer satisfaction, enhancing geographical reach and enabling entry into new markets. Within the country, internet banking has hitherto not made much headway due to several psychological, technological and socio-economic reasons. However, so far as the non-residents are concerned, internet banking possesses a lot of potential, as many of these factors would not be relevant for non-residents (M.R.Das and Tapas.K.Chakrabory, 2003).

Establishment of Special Economic Zones (SEZs) is being projected as one of the steps to enhance the competitive strength of Indian exports in the WTO era. Banks should prepare themselves to play their role in the successful functioning of the SEZs, wherever they are established.

In May 2001, Foreign Direct Investment (FDI) in banks was allowed up to 49 per cent of the equity (earlier, FDI was restricted to 20 per cent of the equity). With the increase in the FDI limit in Indian banks, foreign banks are likely to increase their focus in India. (Earlier, foreign banks had expressed an interest in acquiring stakes in Indian banks, provided the restriction on FDI was reduced.) Hence, foreign banks would have the opportunity to acquire stakes in some of the efficient private sector banks in India, Chowdary Prasad, 2004).

3.4 Conclusion

The opening-up or financial sector and internal liberalization, undoubtedly, has brought radical transformation in every sphere of operations of Indian banking. The shift has also signaled the banks to benchmark their competencies in order to successfully face the challenges in the days ahead. The challenges are many and the opportunities are plenty to the banks in India in the changing economic order. Preparedness in all aspects, structural and operational, holds the key for the future of Indian banking. Over the last decade, many emerging Asian economies have been liberalizing their financial sectors, including opening up their banking systems to foreign competitions. It is becoming increasingly apparent that foreign competition tends to bring with it additional benefits that may not always result from domestic competition. The relaxation of restrictions on foreign bank entry may similarly reduce domestic banking profits, but with positive overall welfare implications for the domestic economy. An interesting finding is that the number of entrants matters rather than their market share. This indicates that foreign banks affect local bank competition upon entry rather than after they have gained substantial market share. Foreign banks tend to have higher interest margins, profitability, and tax payments than domestic banks in developing countries. Domestic systems have begun to change and make efforts towards international cooperation and international and supranational

organizations have developed to deal with issues of international banking and its regulation. But these regulations have been guarded slowly and cautions, seemingly flirting with prospect of real revolutionary change.

Chapter IV - Regulation of Foreign Banks in India

4.1 Introduction:

A type of foreign bank that is obligated to follow the regulations of both the home and host countries. Because the foreign branch banks loan limits are based on the parent banks capital, foreign banks can provide more loans than subsidiary banks. For example, suppose the SBI opens a foreign branch bank in America. The branch would be legally obligated to follow both Indian and American banking regulations.

- As at end November 2016, there were 41 foreign banks operating in India with 323 branches.
- Another 46 foreign banks and their representative offices in India.
- There are 1414 ATM'S (284 onsite + 1,130 offsite)
- Foreign Banks open its ATM in Rural area-29, Urban-268, Semi Urban-22, Metropolitan-1095
- Foreign Banks issued 4.92 million credit & 3.8 million debit card in 2012

4.2 Why foreign banks want to enter in India? Licensing of Foreign Banks: Open market vs. Protectionism:

In India, the presence of foreign banks dates back to the pre-independence period. Established in 1858, Standard Chartered bank is the oldest foreign bank that came to India i.e. 150years ago, now operates the maximum number of branches i.e. 95. Follows HSBC which entered in India in the year 1867, now operates the 51 branches. CITIBANK has the 3rdlargestbranch network in India i.e. 42.Citibank was badly affected by the financial crisis of 2008 .Follows ABN AMRO with 31 branches in India. The bank also offers specialized services to international diamond and jeweler merchants.

Royal Bank of Scotland in India goes back to 1921 There are total of 31 branches throughout the country with 1.4 million customers. In November 2006, Barclays started serving commercial customers. Barclays now operate 10 branches & 100 ATM network.

Reasons for Foreign Bank enter in India

➢ India's GDP is seen growing at a robust pace of around 7% over the next few years, throwing up opportunities for the banking sector to profit from.

- The credit of banks has risen by over 35% in 2011-12 and the growth momentum is expected to continue over the next four to five years.
- RBI is following a liberal branch licensing policy for those foreign banks who want to go to the unbanked pockets.
- RBI started sensing enormous business opportunities in financing trade and small and medium sectors in small towns in the worlds second fastest growing economy.

Open market vs. Protectionism

Indicates the need for imposing restrictions by host countries for protecting interest of their local investors as opposed to foreign investor's concept of open market relations in free trade. The evolution of banking in India has been slower; India's public sector banks hold more than 75% of commercial bank assets. As of 2007 , eight of the 10 largest commercial banks in India were public sector banks, with the state Bank of India alone directly accounting for 17% of commercial bank assets. While foreign banks currently have limited participation in India banking, in late 2007 the Reserve Bank of India announced pending phases of partial access with the first stage through March 2009, and a second

phase thereafter. Meanwhile, foreign banks are increasing their nonbank business, expanding activities through consumer finance Franchises[43].

4.3 RBI Guidelines for Foreign Banks in India

The framework released by the RBI for entry and expansion of foreign banks in India makes sense. If foreign banks do enter India, it would drive local banks to become more efficient and encourage mergers and acquisitions.

These banks will also bring in technology and expertise to foster financial inclusion. The RBI's final rules provide a foreign bank nearly the same freedom as a private sector bank in opening branches if it takes the form of a local subsidiary. New or existing entrants will have to set up wholly-owned arms if they are systemically important foreign banks, or banks that have a complex structure or those that do not have adequate disclosure requirement in their home jurisdictions or offer home residents preferential protection in case of a problem. However, those present in India before August 2010 —Citi, HSBC and Standard Chartered — have the option to continue as branches. Rightly, the regulator must encourage their conversion into local subsidiaries, following Indian laws. It wills

[43] Economist intelligence Unit. India Finance: foreign Banks in India(April 4, 2008) (last visited 11th May 2017)

ring-fence the capital and assets of the bank within India and enables effective risk control. Incentives by way of operational freedom could persuade some banks to convert into wholly-owned subsidiaries. India is a growing market and more branches would do no harm. However, technology has made physical branch networks much less relevant today. An example is the credit card business of foreign banks that has far surpassed their branch-network size[44].

Now, the opportunity created by the unique identity number, or Aadhaar, recognised as sufficient know your-customer to open bank accounts, will also create the technology and infrastructure needed for mass electronic banking. Whether these new accounts, most of them small, attract foreign or even Indian banks depends on what business models they follow and what kind of regulation the RBI offers. Foreign banks could also increase the potential for cross-border capital-flow volatility.

However, creation of more vibrant and deeper domestic financial markets would compensate for its worst effects.

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[44]The Economic Times, *"New RBI guidelines for foreign banks are welcome"* November 8th 2013, available at http://articles.economictimes.indiatimes.com/2013-11-08/news/43822196_1_foreign-banks-indian-banks-new-rbi (last visited 12th May 2017)

4.4 Are Foreign Banks Discriminated in India?

There is a popular perception that the entry of foreign banks in the Indian market is very restricted and the Indian market is very restricted and the regulatory framework discriminates against the foreign banks. A closure examination of current banking regulatory framework reveals that it is no longer discriminatory and in many important ways put foreign banks in the same footing as Indian banks. India issues a single class of banking license to foreign banks which means that there are no restrictions on the scope of their activities.[45] Owing to single class license policy, foreign banks are having a field day. They are handling bulk of their home-country trade and investment business. A substantial portion of foreign intuitional investments and foreign exchange business is also handled by the foreign banks thanks to this liberal policy. Foreign banks also enjoy comparative advantage in undertaking off-balance sheet activities, such as forward exchange contracts and guarantees owing to their foreign exchange positions and relevant expertise. According to the current guidelines. 26 % of the share capital of a subsidiary will have to be owned by the resident Indians. Foreign banks might not want to dilute their share capital. In addition, foreign banks are also exempted from differential rate of interest (DRI) scheme under which loans are offered to people below the poverty line. Moreover, foreign banks

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[45] Ibid

tend to follow "executive banking" by offering services to a small number of clients, instead of "inclusive banking"[46].

4.4 .1 RBI Guidelines on Bank Ownership

Banks are "special" as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. The banks are also important for smooth functioning of the payment system. In view of the above, legal prescriptions for ownership and governance of banks laid down in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time. The existing legal framework and significant current practices in particular cover the following aspects:

(i) The composition of Board of Directors comprising members with demonstrable professional and other experience in specific sectors like agriculture, rural economy, co-operation, SSI, law, etc., approval of Reserve Bank of India for appointment of CEO as well as terms and conditions thereof, and powers for removal of managerial personnel, CEO and directors, etc. in the interest of depositors are governed by various sections of the B.R. Act, 1949.

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[46] EPW research foundation, "*Financial Inclusion in a Deregulated Regime*," Economic and Political weekly, May 20, 2006, pp.1940-42 (last visited 15th May 2017)

(ii) Guidelines on corporate governance covering criteria for appointment of directors, role and responsibilities of directors and the Board, signing of declaration and undertaking by directors, etc., were issued by RBI on June 20, 2002 and June 25, 2004, based on the recommendations of Ganguly Committee and a review by the BFS.

(iii) Guidelines for acknowledgement of transfer/allotment of shares in private sector banks were issued in the interest of transparency by RBI on February 3, 2004.

(iv) Foreign investment in the banking sector is governed by Press Note dated March 5, 2004 issued by the Government of India, Ministry of Commerce and Industries.

(v) The earlier practice of RBI nominating directors on the Boards of all private sector banks has yielded place to such nomination in select private sector banks.

- Against this background, it is considered necessary to lay down a comprehensive framework of policy in a transparent manner relating to ownership and governance in the Indian private sector banks as described below.

➢ The broad principles underlying the framework of policy relating to ownership and governance of private sector banks would have to ensure that

(i) The ultimate ownership and control of private sector banks is well diversified. While diversified ownership minimizes the risk of misuse or imprudent use of leveraged funds, it is no substitute for effective regulation. Further, the fit and proper criterion, on a continuing basis, has to be the over-riding consideration in the path of ensuring adequate investments, appropriate restructuring and consolidation in the banking sector. The pursuit of the goal of diversified ownership will take account of these basic objectives, in a systematic manner and the process will be spread over time as appropriate.

(ii) Important Shareholders (i.e., shareholding of 5 per cent and above) are 'fit and proper', as laid down in the guidelines dated February 3, 2004 on acknowledgement for allotment and transfer of shares.

(iii) The directors and the CEO who manage the affairs of the bank are 'fit and proper' as indicated in circular dated June 25, 2004 and observe sound corporate governance principles[47].

(iv) Private sector banks have minimum capital/net worth for optimal operations and systemic stability.

(v) The policy and the processes are transparent and fair.

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[47] Reserve Bank of India, "*Guidelines on Ownership and Governance in Private Sector Banks*" October 2005, available at http://www.rbi.org.in/upload/content/pdfs/guidelines.pdf (last visited 16th May 2017)

Minimum capital -: The capital requirement of existing private sector banks should be on par with the entry capital requirement for new private sector banks prescribed in RBI guidelines of January 3, 2001, which is initially Rs.200 crore, with a commitment to increase to Rs.300 crore within three years. In order to meet with this requirement, all banks in private sector should have a net worth of Rs.300 crore at all times. The banks which are yet to achieve the required level of net worth will have to submit a time-bound programme for capital augmentation to RBI. Where the net worth declines to a level below Rs.300 crore, it should be restored to Rs. 300 crore within a reasonable time.

Shareholding-: (i) The RBI guidelines on acknowledgement for acquisition or transfer of shares issued on February 3, 2004 will be applicable for any acquisition of shares of 5 per cent and above of the paid up capital of the private sector bank.

(ii) In the interest of diversified ownership of banks, the objective will be to ensure that no single entity or group of related entities has shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector bank. Any higher level of acquisition will be with the prior

approval of RBI and in accordance with the guidelines of February 3, 2004 for grant of acknowledgement for acquisition of shares[48].

(iii) Where ownership is that of a corporate entity, the objective will be to ensure that no single individual/entity has ownership and control in excess of 10 per cent of that entity. Where the ownership is that of a financial entity the objective will be to ensure that it is a well established regulated 3 entity, widely held, publicly listed and enjoys good standing in the financial community.

(iv) Banks (including foreign banks having branch presence in India)/FIs should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's/FI's holding exceeds 5 per cent of the investee bank's equity capital as indicated in RBI circular dated July 6, 2004.

(vi) As per existing policy, large industrial houses will be allowed to acquire, by way of strategic investment, shares not exceeding 10 per cent of the paid up capital of the bank subject to RBI's prior approval. Furthermore, such a limitation will also be considered if appropriate, in regard to important shareholders with other commercial affiliations.

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[48] See Supra Pp. 85-86

(vii) In case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector, RBI may permit a higher level of shareholding, including by a bank.

Directors and Corporate Governance-:

(i) The recommendations of the Ganguly Committee on corporate governance in banks have highlighted the role envisaged for the Board of Directors. The Board of Directors should ensure that the responsibilities of directors are well defined and the banks should arrange need-based training for the directors in this regard. While the respective entities should perform the roles envisaged for them, private sector banks will be required to ensure that the directors on their Boards representing specific sectors as provided under the B.R. Act, are indeed representatives of those sectors in a demonstrable fashion, they fulfill the criteria under corporate governance norms provided by the Ganguly Committee and they also fulfill the criteria applicable for determining 'fit and proper' status of Important Shareholders (i.e., shareholding of 5 per cent and above) as laid down in RBI Circular dated June 25, 2004. (ii) As a matter of desirable practice, not more than one member of a family or a close relative (as defined under Section 6 of the Companies Act, 1956) or an associate (partner, employee, director, etc.) should be on the Board of a bank.

(iii) Guidelines have been provided in respect of 'Fit and Proper' criteria for directors of banks by RBI circular dated June 25, 2004 in accordance with the recommendations of the Ganguly Committee on Corporate Governance. For this purpose a declaration and undertaking is required to be obtained from the proposed / existing directors[49]

(iv) Being a Director, the CEO should satisfy the requirements of the 'fit and proper' criteria applicable for directors. In addition, RBI may apply any additional requirements for the Chairman and CEO. The banks will be 4 required to provide all information that may be required while making an application to RBI for approval of appointment of Chairman/CEO.

4.5 Foreign Direct Investment in banking sector: Indian Government policies:[50]

The aggregate foreign investment in a private bank from all sources will be allowed up to a maximum of 74 per cent of the paid up capital of the Bank. At all

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[49] See Supra Pp. 85-87

[50] Consolidated FDI Policy (Effective from June 07, 2016) http://dipp.nic.in/English/Policies/FDI_Circular_2016.pdf (last visited on 30 May 2017)

times, at least 26 per cent of the paid up capital will have to be held by residents, except in regard to a wholly-owned subsidiary of a foreign bank.

4.6. Setting up of Subsidiary by Foreign Banks:

The Narasimham Committee on banking sector reforms recommended setting up subsidiaries of foreign banks. A foreign bank is now permitted to establish subsidiary or through a fresh bank license. It is permitted to establish a subsidiary or through a fresh bank license. On 14th November 2013 Reserve Bank of India (RBI) has published the "Scheme for Setting up of Wholly Owned Subsidiaries by foreign banks in India" (WOS Scheme).

The main objective of the WOS Scheme is to ensure that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent and ring fencing capital and assets within India.

In FDI Policy 2016 –

Setting up of a subsidiary by foreign banks

1. (a) Foreign banks will be permitted to either have branches or subsidiaries but not both.

2. (b) Foreign banks regulated by banking supervisory authority in the home country and meeting Reserve Bank's licensing criteria will be allowed to hold 100 per cent paid up capital to enable them to set up a wholly-owned subsidiary in India.

(c) A foreign bank may operate in India through only one of the three channels viz., (i) branches (ii) a wholly-owned subsidiary and (iii) a subsidiary with aggregate foreign investment up to a maximum of 74 per cent in a private bank.

4. (d) A foreign bank will be permitted to establish a wholly-owned subsidiary either through conversion of existing branches into a subsidiary or through a fresh banking license. A foreign bank will be permitted to establish a subsidiary through acquisition of shares of an existing private sector bank provided at least 26 per cent of the paid capital of the private sector bank is held by residents at all times consistent with para (i) (b) above.
5. (e) A subsidiary of a foreign bank will be subject to the licensing requirements and conditions broadly consistent with those for new private sector banks.
6. (f) Guidelines for setting up a wholly-owned subsidiary of a foreign bank will be issued separately by RBI.

7. (g) All applications by a foreign bank for setting up a subsidiary or for conversion of their existing branches to subsidiary in India will have to be made to the RBI.

(iii) At present there is a limit of ten per cent on voting rights in respect of banking companies, and this should be noted by potential investor. Any change in the ceiling can be brought about only after final policy decisions and appropriate Parliamentary approvals.

4.7. Regulatory Mechanism of Foreign Banks

Indian economy and financial system was heavily regulated and dominated by the public sector. The entry of additional foreign banks would improve the competitive efficiency of the Indian banking system and induce an upgrading of banking technology. There were no restrictions on where foreign banks could choose to establish new branches; the expansion of foreign banks in India is done by de novo branches only, as foreign banks were not allowed to own controlling stakes in domestic banks.[51] The Banking Regulation Act,1949 is

[51] Foreign banks wishing to expand needed to seek RBI approval, as do all banks under Section 23 of BR ACT, 1949. Requests for new branches are evaluated on the "merits of each case and taking into consideration overall financial position of the bank, quality of its management, efficacy of the internal control system, profitability, and other relevant factors". See "Master

applicable to a foreign bank like any other Indian Bank and has to obtain license from RBI to carry on banking operation in India. RBI ensures that the carrying of banking business by the foreign banks in India is 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.[52] The branch of a foreign company is required to make certain fillings with the registrar of the companies.[53] Moreover where applicable, FDI in banking sector should confirm to the provisions regarding shareholding and share transfer etc as stipulated by SEBI, The Companies Act etc.

4.8. FEMA and Foreign Banks

The foreign investment are broadly classified as direct and portfolio investment[54].

In India, all transactions that include foreign exchange are regulated by the Foreign Exchange Management Act (FEMA), 1999. It repealed the Foreign

circular on Branch Licensing", DBOD.No. BL.BC.5/22.01.001/2004, Reserve Bank of India Mumbai, pp.4

[52] Section 22(3A) of Banking Regulation Act, 1949

[53] Section 592 of Companies Act 2013

[54] Gopalsamy .N "Inside capital Market" ,,Deccan publications, Madras , 1996, p.49

Exchange Regulations Act (FERA),1973. FEMA has been enacted to facilitate external trade and payments and to promote the orderly development and maintenance of foreign exchange market. It applies to all branches, offices and agencies outside India, owned or controlled by a person resident in India. According to the Act, the term 'foreign exchange' means "foreign currency and includes:- (I) deposits, credits and balances payable in any foreign currency; (ii) drafts, travelers cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency; (iii) drafts, travelers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency".

The Reserve Bank of India (RBI) has been assigned the function of administering the various provisions of FEMA. The rules, regulations and norms pertaining to several sections of the Act are laid down by the Reserve Bank of India, in consultation with the Central Government. Besides, the Central Government may appoint an Adjudicating Authority for holding inquiries pertaining to any contravention of the Act. There is also a provision for appointing one or more Special Directors (Appeals) to hear appeals against the order of the Adjudicating authorities. An Appellate Tribunal for Foreign Exchange to hear appeals against

the orders of the Adjudicating Authorities and the Special Director (Appeals) may also be established[55].

The main provisions of the Act are:-

➢ It permits only authorized person to deal in foreign exchange or foreign security. Such an authorized person, under the Act, means authorized dealer, money changer, off-shore banking unit or any other person for the time being authorized by Reserve Bank. The Act thus prohibits any person who:-

➢ Deal in or transfer any foreign exchange or foreign security to any person not being an authorized person;

➢ Make any payment to or for the credit of any person resident outside India in any manner;

➢ Receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner;

➢ Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person;

[55] Legal Aspect, "*Foreign Exchange Management Act*" available at http://business.gov.in/legal_aspects/fema.php (last visited 21st May 2017)

- is resident in India which acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.
- The Act regulates two types of foreign exchange transactions, namely 'Capital Account Transactions' and 'Current Account Transactions'.

- According to the Act, 'Capital account transaction' means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes the following transactions referred in the Act:-
- Transfer or issue of any foreign security by a person resident in India;
- Transfer or issue of any security by a person resident outside India;
- Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

- Any borrowing or lending in rupees in whatever form or by whatever name called;

- Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;

- Deposits between persons resident in India and persons resident outside India;
- Export, import or holding of currency or currency notes;
- Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;
- Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;
- Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred-

(I) By a person resident in India and owed to a person resident outside India; or

(ii) By a person resident outside India.

- It also defines the term 'current account transaction' as a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes:- (I) payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business; (ii) payments due as interest on loans and as net income from investments; (iii) remittances for living expenses of parents, spouse and children residing abroad; and (iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children.

- The Act has empowered the Reserve Bank of India (RBI) to specify, in consultation with the Central Government, the permissible capital account transactions and the limits up to which foreign exchange may be drawn for such transactions. But it shall not impose any restriction on the drawl of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.
- Any person may sell or draw foreign exchange if such sale or drawl is a current account transaction. Under the Act, Central Government may, in public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed[56].
- Every exporter of goods shall:- (I) furnish to the Reserve Bank or to such other authority a declaration in such form and in such manner as may be specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertainable at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in a market outside India; (ii) furnish to the Reserve Bank such other information as may be required by it for the purpose of ensuring the realization of the export proceeds by such exporter.

[56] Reserve Bank of India, " *Master Circular of Foreign Investment in India*" July 2014, available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/06FIC010714FL.pdf (last visited 22nd May 2017)

- The Reserve Bank may, at any time, cause an inspection to be made, by any officer specially authorized in writing by it in this behalf, of the business of any authorized person as may appear to it to be necessary or expedient for the purpose of:- (I) verifying the correctness of any statement, information or particulars furnished to the Reserve Bank; (ii) obtaining any information or particulars which such authorized person has failed to furnish on being called upon to do so; (iii) securing compliance with the provisions of this Act or of any rules, regulations, directions or orders made there under.
- If any person contravenes any provision of this Act, or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this Act, or contravenes any condition subject to which an authorization is issued by the Reserve Bank, he shall, upon adjudication, be liable to a penalty.

4.9 Money Laundering and regulation of Foreign Banks

An amount 13 times larger than the country's foreign debt –USD 1500 billion has been alleged to have been laundered by Indians in Swiss banks- an issue raised even during the recently concluded Parliamentary elections. Anti- Money Laundering (AML) has become a serious issue due to the possibility of such

funds being used for terrorist financing, apart from the revenue loss to the government.

A critical issue of increasing international concern is the question of money laundering. Reserve Bank of India Master circular on Know your Customer(kyc) norms/ Anti-money laundering(AML) standards/combining of Financing of Terrorism(CFT)/ onligation of banks under Prevention of Money Laundering Act,(PMLA),2002.

Simplified KYC norms for Foreign Portfolio Investors (FPIs) In terms of Rule 9 (14)(i) of the PML Rules, simplified norms have been prescribed for those FPIs who have been duly registered in accordance with SEBI guidelines and have undergone the required KYC due diligence/verification prescribed by SEBI[57] through a Custodian/Intermediary regulated by SEBI. Such eligible/registered FPIs may approach a bank for opening a bank account for the purpose of investment under Portfolio Investment Scheme (PIS) for which KYC documents prescribed by the Reserve Bank (as detailed in Annex II of the circular DBOD.AML.BC.No.103/14.01.001/2013-14 dated April 3, 2014) would be required. For this purpose, banks may rely on the KYC verification done by the

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[57] Reserve Bank of India, " *Master circular on Anti-Money Laundering*" July 2014, available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/70MK010714FL.pdf (last visited 23rd May 2017)

third party (i.e. the Custodian/SEBI Regulated Intermediary) subject to the conditions laid down in Rule 9 (2) [(a) to (e)] of the Rules

4.10. Conclusion

There are certain basic objectives on which the Indian Banking system is structures. The government had undertaken Nationalization of banks in 1969 with the aim of fulfilling these objectives like-giving effect the program for attaining a socialistic pattern of society and decentralization the credits to enable certain sectors- like agriculture to obtain liberal banking facilities. The government also wanted to change the urban centric profile of banking in India and keep a safeguard over public money deposited in the banks.

In the era of globalization significant changes have taken place in the operating environments of banks and financial institutions. The government has undertaken certain international commitments which are required to be honored. In some cases government has gone beyond its international commitments in order to expedite the process of foreign banks establishing their presence in India. Finally, foreign banks in India have increased. They have much more flexibility vis-à-vis the nature of their operations in India. While India's regulatory policies seem to provide a conductive environment for the entry and operation of foreign banks,

the significance of foreign banks in the domestic banking industry has actually been declining. The two new licensees in a month, shows RBI have once again opened its door to foreign players. It stopped granting any new license to foreign banks after the onset of the global financial crisis. During the last two years except Singapore-based DBS, only Swiss major give license

Chapter V - Banking Ombudsman & Role for Redressal of Disputes of Foreign Bank Customers.

5.1 Introduction

Banking Ombudsman is a quasi judicial authority functioning under India's Banking Ombudsman Scheme, and the authority was created pursuant to the a decision by the Government of India to enable resolution of complaints of customers of banks relating to certain services rendered by the banks.

5.1.1 What is the Banking Ombudsman Scheme?

The Banking Ombudsman Scheme enables an expeditious and inexpensive forum to bank customers for resolution of complaints relating to certain services rendered by banks. The Banking Ombudsman Scheme is introduced under Section 35 A of the Banking Regulation Act, 1949 by RBI with effect from 1995.

5.1.2 Who is a Banking Ombudsman?

The Banking Ombudsman is a senior official appointed by the Reserve Bank of India to redress customer complaints against deficiency in certain banking services

5.1.3 How many Banking Ombudsmen have been appointed and where are they located?

As on date, fifteen Banking Ombudsmen have been appointed with their offices located mostly in state capitals. The addresses and contact details of the Banking Ombudsman offices have been provided in the annex.

5.1.4 Which are the banks covered under the Banking Ombudsman Scheme, 2006?

All Scheduled Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks are covered under the Scheme.

5.2 What are the grounds of complaints?

The Banking Ombudsman can receive and consider any complaint relating to the following deficiency in banking services (including internet banking):

- non-payment or inordinate delay in the payment or collection of cheques, drafts, bills etc.;
- non-acceptance, without sufficient cause, of small denomination notes tendered for any purpose, and for charging of commission in respect thereof;

- non-acceptance, without sufficient cause, of coins tendered and for charging of commission in respect thereof;
- non-payment or delay in payment of inward remittances ;
- failure to issue or delay in issue of drafts, pay orders or bankers' cheques;
- non-adherence to prescribed working hours ;
- failure to provide or delay in providing a banking facility (other than loans and advances) promised in writing by a bank or its direct selling agents;
- delays, non-credit of proceeds to parties accounts, non-payment of deposit or non-observance of the Reserve Bank directives, if any, applicable to rate of interest on deposits in any savings, current or other account maintained with a bank ;
- complaints from Non-Resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank-related matters[58];
- refusal to open deposit accounts without any valid reason for refusal;
- levying of charges without adequate prior notice to the customer;
- non-adherence by the bank or its subsidiaries to the instructions of Reserve Bank on ATM/Debit card operations or credit card operations;

[58] Reserve Bank of India, " *Banking Ombudsman 2006*" available at http://rbi.org.in/scripts/FAQView.aspx?Id=24 (last visited 27th May 2017)

- non-disbursement or delay in disbursement of pension (to the extent the grievance can be attributed to the action on the part of the bank concerned, but not with regard to its employees);
- refusal to accept or delay in accepting payment towards taxes, as required by Reserve Bank/Government;
- refusal to issue or delay in issuing, or failure to service or delay in servicing or redemption of Government securities;
- forced closure of deposit accounts without due notice or without sufficient reason;
- refusal to close or delay in closing the accounts;
- non-adherence to the fair practices code as adopted by the bank or non-adherence to the provisions of the Code of Bank s Commitments to Customers issued by Banking Codes and Standards Board of India and as adopted by the bank ;
- non-observance of Reserve Bank guidelines on engagement of recovery agents by banks; and
- any other matter relating to the violation of the directives issued by the Reserve Bank in relation to banking or other services.

A customer can also lodge a complaint on the following grounds of deficiency in service with respect to loans and advances

- non-observance of Reserve Bank Directives on interest rates;
- delays in sanction, disbursement or non-observance of prescribed time schedule for disposal of loan applications;
- non-acceptance of application for loans without furnishing valid reasons to the applicant; and
- non-adherence to the provisions of the fair practices code for lenders as adopted by the bank or Code of Bank's Commitment to Customers, as the case may be;
- non-observance of any other direction or instruction of the Reserve Bank as may be specified by the Reserve Bank for this purpose from time to time.
- The Banking Ombudsman may also deal with such other matter as may be specified by the Reserve Bank from time to time.

5.3 When and where can one file a complaint?

One can file a complaint before the Banking Ombudsman if the reply is not received from the bank within a period of one month after the bank concerned has received one s representation, or the bank rejects the complaint, or if the complainant is not satisfied with the reply given by the bank.

One may lodge his/ her complaint at the office of the Banking Ombudsman under whose jurisdiction; the bank branch complained against is situated. For complaints relating to credit cards and other types of services with centralized operations, complaints may be filed before the Banking Ombudsman within whose territorial jurisdiction the billing address of the customer is located.

Address and area of operation of the banking ombudsmen are provided in the annex.

5.4 What details are required in the application?

The complaint should have the name and address of the complainant, the name and address of the branch or office of the bank against which the complaint is made, facts giving rise to the complaint supported by documents, if any, the nature and extent of the loss caused to the complainant, the relief sought from the Banking Ombudsman and a declaration about the compliance of conditions which are required to be complied with by the complainant[59].

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[59] Reserve Bank of India, " *Banking Ombudsman 2006*" available at http://rbi.org.in/scripts/FAQView.aspx?Id=24 last visited 27th May 2017

5.5 Working of Banking Ombudsman on receiving complaint

The Banking Ombudsman endeavors to promote, through conciliation or mediation, a settlement of the complaint by agreement between the complaint and the bank named in the complaint.

If the terms of settlement (offered by the bank) are acceptable to one in full and final settlement

of one s complaint, the Banking Ombudsman will pass an order as per the terms of settlement which becomes binding on the bank and the complainant.

5. 6 Rejection of Complaint:-

The Banking Ombudsman may reject a complaint at any stage if it appears to him that a complaint made to him is:

· not on the grounds of complaint referred to above

· Compensation sought from the Banking Ombudsman is beyond Rs 10 lakh .

· requires consideration of elaborate documentary and oral evidence and the proceedings before the Banking Ombudsman are not appropriate for adjudication of such complaint

· without any sufficient cause

· that it is not pursued by the complainant with reasonable diligence

· In the opinion of the Banking Ombudsman there is no loss or damage or inconvenience caused to the complainant.

5.5 What happens after a complaint is received by the Banking Ombudsman?

The Banking Ombudsman endeavours to promote, through conciliation or mediation, a settlement of the complaint by agreement between the complaint and the bank named in the complaint.
If the terms of settlement (offered by the bank) are acceptable to one in full and final settlement of one s complaint, the Banking Ombudsman will pass an order as per the terms of settlement which becomes binding on the bank and the complainant.

5. 6 Can the Banking Ombudsman reject a complaint at any stage?

Yes. The Banking Ombudsman may reject a complaint at any stage if it appears to him that a complaint made to him is:

- not on the grounds of complaint referred to above
- Compensation sought from the Banking Ombudsman is beyond Rs 10 lakh .
- requires consideration of elaborate documentary and oral evidence and the proceedings before the Banking Ombudsman are not appropriate for adjudication of such complaint
- without any sufficient cause
- that it is not pursued by the complainant with reasonable diligence
- In the opinion of the Banking Ombudsman there is no loss or damage or inconvenience caused to the complainant.

5.7 Is there any time limit for filing an appeal?

If one is aggrieved by the decision, one may, within 30 days of the date of receipt of the award, appeal against the award before the appellate authority. The appellate authority may, if he/ she is satisfied that the applicant had sufficient cause for not making an application for appeal within time, also allow a further period not exceeding 30 days.

5. 8 How does the appellate authority deal with the appeal?

The appellate authority may

i. dismiss the appeal; or

ii. Allow the appeal and set aside the award; or

iii. Send the matter to the Banking Ombudsman for fresh disposal in accordance with such directions as the appellate authority may consider necessary or proper; or

iv. modify the award and pass such directions as may be necessary to give effect to the modified award; or v. pass any other order as it may deem fit.

5.9 Conclusion

The success of banking ombudsman scheme can be enumerated by looking at the facts and figures. As many complaints were settled by mutual agreement during the year as compared to mutual settlement of 29,295 complaints during the 2008-09.Customers can now appeal against the Banking Ombudsman's Decision Bank customers can now appeal against the decision of the Banking Ombudsman where he has rejected the customer's complaint relating to matters falling within the grounds of complaints specified under the scheme. The Reserve Bank of India has amended the Banking Ombudsman Scheme, 2006 to enable the customers to appeal against the Banking Ombudsman's decision. The amendments are available on the RBI website. Before the scheme was amended, the bank customers could appeal only against the awards given by the Banking Ombudsman. The appellate authority for the Banking Ombudsman Scheme is the Deputy Governor of Reserve Bank of India. It may be recalled that in the Annual Policy for 2007-2008, the Reserve Bank had announced that based on customer feedback, it would amend the Banking Ombudsman Scheme, 2006 to extend the appeal option also to the decisions of the Banking Ombudsman. Originally introduced in 1995, the Banking Ombudsman Scheme enables speedy and cost effective resolution of complaints of bank customers relating to deficiency in bank services. The Scheme now covers all Scheduled Commercial

Banks, Regional Rural Banks and Scheduled Primary Cooperative Banks. The customers can also now complain to the Banking Ombudsman against deficiency in almost any banking services, including credit cards, after exhausting the channel available with the bank concerned for resolving their complaints. The Reserve Bank has appointed 15 Banking Ombudsmen who are located mostly in State Capitals under the Scheme. The Banking Ombudsman tries to resolve the complaint through conciliation or mediation and even passes an award if it is not resolved through such settlement.

With the liberalization of banking services and entry of foreign banks in India, the need of the hour is that foreign bank must introduce banking ombudsman scheme with their dispute resolution policies. Moreover, the access of foreign customers should be simplified and must be at par with international banking standards.

Chapter VI Conclusion & Suggestion

6.1 Conclusion:

To summarize, there is substantial evidence that factors such as market opportunities, regulatory barriers in the host countries along with economic, cultural and institutional similarties between home and host economies influence the decision of banks to operate overseas. Contrary to the wealth of evidence on these factors, the role that crisis can play in bringing about foreign bank participation has only been discussed anecdotally. The question needs to be answered is : Do we need foreign bank in India?

There is enormous scope because only 60% of the adult population in India has working bank accounts. In rural areas, the coverage among the adult population is ever lower. Foreign banks started reaching out to small towns such as Akola, Nanded, Jolgaon, Kanchipuram, Nelamangal, Kurnool, Siliguri, Nanglore, Moradabad, Nashik, Panipat, Tirupur, Salem, Udaipur, Kolhapur and a few others. Indeed, foreign entry can provoke changes in the host country's credit market that potentially affect all firm positively. By poaching more credit worthy and transparent borrowers, foreign banks may induce domestic banks to

increase lending to opaque firms. Additionally, competition and the threat of foreign takeovers may force domestic banks to reduce cost and lower interest rates in order to maintain market share. More in general, the removal of restrictions to foreign banks sharpens the threat of takeovers for domestic banks. All in all the evidence on competition and efficiency suggests that foreign bank entry can bring potential gains in this area except in environments which limit competitive forces such as when bank concentration is high, bank activities are restricted, and bank entry and exit is difficult. The rise in importance of foreign banks in developing countries has led to an intense debate on the pros and cons of foreign bank participation in terms of its impact on stability. Overall, the evidence available so far suggests that foreign banks can have a stabilizing influence on credit markets in developing countries, at least where financial sector depth is concerned. The extent to which foreign banks contribute to greater access to credit, in particular for small firms, in developing countries is perhaps the most controversial aspect of the process of foreign bank participation. There is also evidence that their presence can have overall positive effects on access to credit, even if foreign banks themselves are not lending to small firms. Foreign bank presence affects the lending policies of domestic banks and improves access to credit for all firms as the positive effects of country aggregate changes in foreign bank presence on firm performance. In the eight

years following the acceptance of GATS, however, 17 new foreign bank and 89 new foreign bank branches were opened in India bringing the total number foreign banks to 41 with 212 branches were opened in India bringing the total number foreign banks to 41 with 212 branches as of march 2007. In 2005 RBI policy on the roadmap for presence of foreign banks laid out the 2 forms[60] of presence with an aim to push for Wholly-owned subsidiary (WOS) model. But from the view of foreign banks there is no incentive for moving to the WOS model. The contention regarding the form of presence has remained over the years. Looking at the impact of foreign banks over the years, the following characteristics have been observed:

1) Rural presence: Foreign banks have a very small presence in rural and semi-rural areas. Only 1 or 2 percent of the total branches of foreign banks are in rural / semi-rural areas. This is in contrast with the scheduled commercial banks which have grown enormously in the rural sector (currently rural branches account for 58 percent of their total number of branches).

2) Technological development: Foreign banks have helped in bettering the technology used in the banking sector. The first ATM in India was brought up by

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[60] Indian Institute of Management Bangalore, " *Impact of Foreign Banks on the Indian Economy*" available at http://www.iimb.ernet.in/research/sites/default/files/WP%20No.%20451.pdf (last visited on 4th May 2017)

HSBC and from then on foreign banks have contributed to the latest banking practices helping them become more efficient

3) Priority sector lending: The priority sector requirement itself is different for foreign banks and also the percentage rates are lower for them. For banks with less than 20 branches the requirement is at 32 percent as against 40 percent for the other nationalized banks. Also the requirement is mostly satisfied by banks by lending in the export-import sector and not lending in sectors like agriculture which are the actual constituents of the priority sector.

4) Return on Assets: This has clearly shown a positive trend bringing into forefront the improvements brought across by the operational improvements through better practices of foreign banks.

Although FDI/FII remains favorite modes of direct investment in India through a bank has 2 options to open branches, by opening wholly owned subsidiary and by operating Liaisons offices in India. Under WTO GATS modes of providing services, 2nd mode and 4th mode are most favorable.

Foreign banks on India have aided in technological improvements but not really entered the growth sectors like the agriculture sector in India. The common perception of foreign banks in India is that they are focused on profitability and not on the development issues of the country. There are many benefits of foreign

banks but it is never to be forgotten that everything comes with pros and cons, they are like two sides of same coin.

6.2 Suggestions

New rules announced by the Reserve Bank of India for foreign banks in India in this Union Budget 2014-2015 presented on July 10, 2014, the Hon'ble Finance Minister announced that: "After making suitable changes to current framework, a structure will be put in place for continuous authorization of universal banks in the private sector in the current financial year[61]. RBI will create a framework for licensing small banks and other differentiated banks. Differentiated banks serving niche interests, local area banks, payment banks etc. are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force". Now foreign banks in India are permitted to set up local subsidiaries. The policy conveys that foreign banks in India may not acquire Indian ones (except for weak banks identified by the RBI, on its terms) and their Indian subsidiaries will not ne able to open branches. Such restriction seems unnecessary. Once license is granted foreign banks must be

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[61] Reserve Bank of India, "*RBI releases Guidelines for Licensing of Small Finance Banks in the Private Sector*" November 2014, available at http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/IEPR1090GLS1114.pdf(last visited on 6th April 2017)

treated at par with domestic banks. There are many benefits of foreign banks but it is never to be forgotten that everything comes with pros and cons, they are like 2 side of same coin or beds of same river. RBI should be careful about the unforeseen future foreign banks in India.

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