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# GOVERNMENT SUPERVISION AND CONTROL OVER BANKING MANAGEMENT

--An analytical study of Government control and Supervision through the  
Regulator over Banks in India--

*A Dissertation Submitted in Partial  
Fulfillment of Requirement of the Degree*

*Of*

*LL.M. [Business Laws]*

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## DECLARATION

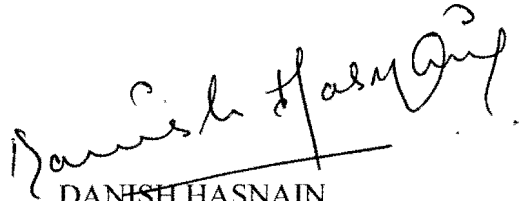
I hereby declare that this dissertation entitled “**Government Supervision & Control over Banking Management**” is the outcome of research conducted by me under the guidance of **Dr. N.L.Mitra, Former Director, National Law School of India University, Bangalore.**

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

I further declare that this work has not been submitted for any degree in any university.

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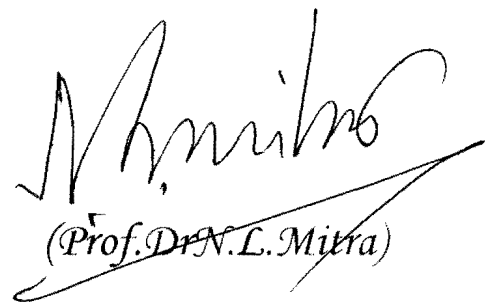
  
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## CERTIFICATE

*This is to certify that this Dissertation "Government control and supervision over Banking Management" submitted by Danish Hasnain (ID. No. 303) for the Degree of Master of Laws of the National Law School of India University is the product of bona fide research carried out under my guidance and supervision. This Dissertation or any part thereof has not been submitted elsewhere for any other degree.*

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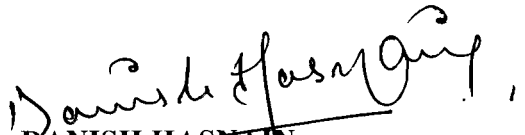
  
*(Prof. Dr. N. L. Mitra)*

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## **INTRODUCTION**

Today globally all the economies of the world are facing the heat of the global financial meltdown which is now been compared to the great economic depression .The economies all over the world are worst hit by the collapse of the banking sector. The major players like Lehman & Brothers have been declared bankrupt and on the same day sale of Merrill lynch to Bank of America was announced. In the backdrop of all these, economist have started arguing that the government should have more control over the banking sector.

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

The focus on control and regulation is particularly acute in financial services and most of all in the banking sector. High profile financial failures in the past like Enron and WorldCom and Satyam scandal recently, have undermined trust in the corporate sector and sent shockwaves through stock markets-all over the world trust in the financial system was quite low and confidence was eroded in the veracity of statements and audited accounts.

Internationally, following the failure of some large banks and bank related entities, there has been a debate on the segregation of supervision from traditional central banking, citing the conflict between monetary policy objectives and bank supervision objectives. At the same time, there is also a considered view that bank supervision function can provide the central bank with far more information from and control over the institutions and markets and thus assist in maintaining financial stability. The financial markets have become more sophisticated and global in nature, adding to the challenges faced by central banks while at the same time rapid strides in telecommunication and electronic data processing coupled with new funding instruments, growth of securitization, emergence of new institutions have increased the role and responsibilities of government supervisors.

The Government of India regulates through Reserve Bank of India which performs all the following important functions which are expected of a central bank. 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 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<sup>1</sup>.

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<sup>1</sup> Tandon, Prakash, *Development of Banking in India*, Journal of Indian School of Political Economy, Jan-April (1)51.



## **RESEARCH METHODOLOGY**

### **Abstract**

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protection for confidentiality of such information should be in place.

### **Research Questions**

- How Government does ensure the regulation & supervision of Banks?
- What is the role of Central Bank in regulation and supervision?
- What method the government needs to adopt to regulate a bank?
- What are the international experiences in the banking sector reforms?
- Status of present banking system?

### **Hypothesis**

- Objectives of banking regulation in India.
- Dual Control: An area of tension between RBI and the State Government.
- BASLE Committee core principles and supervision & surveillance across central Banks.

**Method of Writing:** The researcher has primarily adopted the descriptive method of writing. The tool of comparison and analysis has been adopted where necessary.

**Method of Citation:** A uniform method of citation has been adopted and followed consistently throughout this paper.

## CHAPTER 1

### MEANING OF CONTROL AND SUPERVISION

Banks in our country have been playing their role as growth facilitators and the evolution of banking is closely connected with the growth and evolution of other sectors. The more developed a country is, the greater is the instrumentality of the banker utilized to carry through commercial transactions. The importance of banking also lies in the fact that it is a social institution and this social phase of banking has to be integrated with the economic phase of banking. The strategy of the banks should be to serve the society needs which in turn will lead to better economic results and thus, the society will grow faster.

#### **1.1 The Rationale behind Regulation.**

Poorly functioning banking systems impede economic progress, exacerbate poverty, and destabilize economies. Specifically, a substantial literature documents that well-functioning banks accelerate economic growth, which in turn alleviates poverty. Furthermore, there have been an unprecedented number of disruptive banking crises in recent decades.<sup>2</sup>

The staggering scope of recent crises, coupled with evidence on the beneficial effects of banking systems on economic growth, have generated calls for reforms in bank regulation and supervision.<sup>3</sup> The Basle Committee on Bank Supervision has developed an extensive list of “best practices” for the regulation and supervision of banks, which is

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<sup>2</sup> Deal, John C, *Bank regulatory enforcement-1985 developments*, 42  
The Business Lawyer 145

<sup>3</sup> *Ibid* p-3

promoted by the International Monetary Fund and the World Bank. There is a strong sense that if only policymakers in countries around the world would implement particular regulatory and supervisory practices, then bank “safety and soundness” would improve, thereby promoting growth and stability. There is no evidence, however, that the best practices currently being advocated by international agencies are the best ones for promoting well-functioning banks. There is no evidence that successful practices in the United States, for example, will succeed in countries with different institutional and political environments<sup>4</sup>. There is no evidence, moreover, that each regulatory and supervisory practice can be considered as part of an extensive checklist of desirable best practices in which more checks are better than fewer as opposed to considering regulation and supervision as reflecting broad views about the role of government in society. There is no broad cross-country evidence about which regulatory and supervisory policies work best to promote bank development, efficiency, and stability<sup>5</sup>.

## **1.2 Government ownership of Banks**

Economists hold sharply different views about the impact of government ownership of banks on financial and economic development. The statist or socialist view argues that government ownership of banks facilitates the mobilization of savings and the allocation of those savings toward strategic projects with long-term beneficial effects on an economy. According to this view, governments have adequate information and sufficient incentives to ensure socially desirable investments. Consequently,

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<sup>4</sup> Kulkarni,P.B., *Banking Sector Reforms*, 10(14) Journal of Indian School of Political Economy, 663.

<sup>5</sup> **Bank Regulation and Supervision:What Works Best?**James R. Barth, Gerard Caprio. Jr. and Ross Levine.2002

government ownership of banks helps economies overcome private capital-market failures, exploit externalities, and invest in strategic sectors. Some specifically advocate government ownership of banks to promote economic and financial development, especially in under developed countries. Whole others in contrast, argue that governments do not have sufficient incentives to ensure socially desirable investments. Government ownership tends to politicize resource allocation, soften budget constraints, and otherwise hinders economic efficiency. Thus, government ownership of banks facilitates the financing of politically attractive projects, but not necessarily economically efficient projects<sup>6</sup>.

In an influential study, some economists piece together data on government ownership of banks from an assortment of sources. They find that countries with higher initial levels of government ownership of banks tend to have both slower subsequent rates of financial-system development and slower economic growth. In a related paper, use data on government ownership from Bank scope. We find that greater government ownership is generally associated with less efficient and less well-developed financial systems.

### **1.3 The Role of the Regulator.**

The powers, the range of functions and the organizational set up of central banks vary from country to country. On the one hand, we see the State-owned and State-controlled Bank of England, which follows the centralized system of central banking. At the other extreme, we see the American system of Federal Reserve Banks owned by the Member Banks and coordinated by the Federal Reserve Board, following the decentralized

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<sup>6</sup> **Bank Regulation and Supervision:What Works Best?**James R. Barth, Gerard Caprio, Jr. and Ross Levine.2008

system of central banking. However, a careful study into the operative techniques of the various central banks would enable us to draw-certain broad conclusions as to the general functions of a central bank<sup>7</sup>.

One of the earliest of the functions to be discharged by a central bank is that of acting as a bank of issue. In addition, it is a controller of currency, a banker's bank and lender of the last resort; an agent, advisor and banker to the Government; a custodian of the nation's metallic reserves etc. In this connection, the observations made by the Governor of the Bank of England before the Royal Commission on Indian Currency (1926) are highly illuminating. According to him, a central bank should have the sole right of note issue; it should be the channel and sole channel for the output and intake of legal tender currency. It should be the holder of all Government balances; the holder of the reserves of the other banks in the country; it should be the agent, so to speak, through which the financial operations, at home and abroad, of the Government would be performed. It should further be the duty of a central bank to effect, so far as it could, suitable contraction and expansion, in addition to aiming generally at stability, and to maintain that stability within as well as without. When necessary it should be the ultimate source from which emergency credit might be obtained in the form of discounting of approved bills or advances on approved bills or advances on short-term securities, of Government paper.

The nature of these functions points out one basic fact, namely, that central banking is

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<sup>7</sup> Tannan's, **Banking Law and practice in India**, 19 edn. Vol.1, India Law House: New Delhi, 1997

entirely different from commercial or other branches of banking and that its main aim is to serve in the public interest and not to secure profits. The functions of a central bank and the obligations resting upon it are of a very special character calling for skill, experience and judgment of a kind different from those which must be possessed by commercial and other branches of banks. It is true that no banker can neglect the rules of prudence and safety; but the object of a commercial banker is to make a profit. The situation of a central bank is such that it must often undertake operations which are not only profitable, but result in losses its aim must be the economic welfare of the country<sup>8</sup>

#### 1.4 Why Government Control Is Essential.

The banking business, because of its nature and its relation to the fiscal affairs of the people and the revenues of the state, is properly subject to regulation under the power of the state. There are basically, five reasons of bank regulation:

- To protect the integrity or smooth functioning of the currency and payments system
- To protect the interests of depositors, which are unable to protect themselves;
- The accounts books are opaque and lack transparency;
- To insure equal access to credit;
- To protect shareholders and competitors of banks
- To prevent the undue concentration of economic power; and
- The interdependence of one bank on another and the correlation of the banks with the financial system and the whole economy make it imperative for the

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<sup>8</sup> Tannan's, **Banking Law and practice in India**, 19 edn. Vol.1, India Law House: New Delhi, 1997

supervision and regulation of the banking activities. The efficiency with which the banks attract savings and transform them into investments will influence the performance of the economy. The two critical issues that need to be considered in this process are the ability of the banks to control and manage the risks that arise while extending their functions and secondly, allocation of resources. Both, the mismanagement of the risks and the misallocation of resources will lead to the failure of the bank. And unlike the other sectors, the problems in the banking sector are rapidly transferred to the entire financial system and the economy<sup>9</sup>.

The Reserve Bank of India performs all the following important functions which are expected of a central bank. The bank issue and regulates the issue of currency in India in fact the Reserve Bank of India is sole authority of for the issue of currency in the country.

The Reserve Bank of India acts as a banker not only to the government of India but also as a banker to the state governments. The Reserve Bank of India looks after the current financial transaction of the government and manages the public debt of the government. As a banker to the government the reserve bank of India has the obligation to transact the banking business of the central government. The reserve bank undertakes to accept money on account of the government of make payment on behalf of the government. It also carries out exchange remittance and other banking appertains including the management of public debt. The bank acts as a banker to the commercial bank. Just as the private Individual keep and maintain their accounts either commercial banks.

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<sup>9</sup> Narendra Jadhav, **Challenges to Indian Banking, Competition, Globalization and Financial markets**, MacMillan: Delhi, 1996

Commercial banks keep and maintain their accounts with the reserve bank of India and they borrow money for the bank when necessary. In case of difficulties the bank acts as a lender of the last resort to commercial banks. The bank exercises its control over the volume of credit created by the commercial banks in order to ensure price stability.

The bank has the responsibility to maintain not only the internal value of the currency i.e., the Indian rupee but it has also to maintain the external value of the currency. In short the Reserve Bank of India is largely concerned with organization of a sound and healthy commercial banking system, ensuring effective co-ordination and control over credit through appropriate monetary and credit policies followed from time to time. However, in India the reserve bank of India is also concerned with development of rural banking, promotion of financial institutions and development of money and capital market in India<sup>10</sup>.

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<sup>10</sup> Manubhai Shah, The new role of Reserve Bank in India's economic development, 1<sup>st</sup> Edn., Vora & Co.



## CHAPTER 2

### ROLE OF CENTRAL BANK IN REGULATION AND SUPERVISION

#### 2.1 Role of the Central Bank

The Reserve Bank of India as the central bank, controls the activities of the commercial banks by virtue of the powers vested in it under the Banking Regulations Act of 1949 (10 of 1949) and the Reserve Bank of India Act, 1934 (2 of 1934). The Banking Companies Act was passed in the year 1949 in order to remove the defects in the banking system and to strengthen the banking structure. The Banking Regulation Act 1949 also gives powers to the Reserve Bank of India to control and supervise the activities of the commercial banks in the country. Under the Banking Regulation Act, 1949, the Reserve Bank of India is given a power to issue licence to commercial banks to open branches. No commercial banks can commence the business of banking without obtaining licence from the Reserve Bank of India. The Reserve Bank of India has also power to withdraw the licence once granted in case it is found the, affairs of the bank are not managed properly. The Reserve Bank of India has been given a power to inspect the commercial banks under Section 35 of the Banking Regulation Act. Under this power, the Reserve Bank can itself at any time cause an inspection to be carried out by one or more of its officers of any bank and its books of accounts and if there are defects, the banks concerned are required to rectify them.<sup>11</sup>

Under the Banking Regulation Act, the Reserve Bank of India has wide powers of over-

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<sup>11</sup> C.A.E. Goodhart, The Central Bank and the Financial System, McMillan: London, 1995.

all control over the management of banks. Under this Act Section 35(6), the approval of the Reserve Bank of India is necessary for the appointment or re-appointment or termination of an, appointment of a Chairman, Managing or whole time Director. The Reserve Bank of India has a power, to prevent a commercial bank from undertaking certain types of transactions.

**2.1.1 Selective credit control,** Under Section 21, the Reserve Bank of India has been given a power to control advance granted by the commercial banks. This power is known as the power of Selective Credit Control- Under this Section, the Reserve Bank of India is empowered to determine the policy in relation to advances to be followed by banks generally or by any bank in particular and under this section, the Reserve Bank of India has been authorised to issue directions to banks as regards the purpose of the advances, the, margins to be maintained in respect of the secured advances and it can also prescribe the rate of interest and other terms and conditions on which advances may be made<sup>12</sup>.

**2.1.2 Quantitative control of credit.** - Apart from the Selective Control of Credit exercised by the Reserve Bank of India controls the volume of credit in a quantitative way so as to influence the total volume of bank credit. The reserve bank of India does this through the use of following instruction:

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<sup>12</sup> Management of payment system may vary from country to country depending upon their financial system.

**(1) The Bank Rate**

**(2) Open Market Operations**

**(3) Variable Cash Reserve Requirements**

**1) Bank Rate** - The Bank Rate is the rate of interest at which the Reserve Bank of India rediscounts the first class bills of exchange from commercial banks or other eligible paper. Whenever the Reserve Bank of India wants to reduce credit, the bank rate is raised and whenever the volume of bank credits is to be expanded the bank rate is reduced. This is because by change in the bank rate the Reserve Bank of India seeks to influence the cost of bank credit. In India the bank rate has been changed frequently from 1951 onwards and today the bank rate stands at 10%<sup>13</sup>.

However, the efficacy of the bank rate depends on the extent of integration in the money market and also it depends upon how far the commercial banks resort to borrowings from the Reserve Bank of India.

**2) Open Market Operations.** - The Reserve Bank of India can influence the reserves of commercial banks, i.e., the cash base of commercial banks by buying or selling government Securities in open market. If the Reserve Bank of India buys Government Securities in the market from commercial banks, there is transfer of cash from the Reserve Banks of India to the commercial banks and this increases the cash base of the commercial banks enabling them to expand credit and conversely if the Reserve Bank of India sells Government Securities to the Commercial Banks, the commercial banks transfer cash to that Reserve Bank of India and therefore their cash base is reduced thus adversely affecting the capacity of commercial banks, to expand credit.

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<sup>13</sup> Tannan's, **Banking Law and practice in India**, 19 edn. Vol.1, India Law House: New Delhi, 1997

**3) Variable Reserve Requirements.** - The commercial banks are required to keep a certain percentage of deposits as reserves with the Reserve Bank of India. The Reserve Bank of India is legally authorised to raise or lower the minimum reserves that the bank must maintain against, the total deposits. If the percentage of reserves to be maintained is increased, the commercial banks will be left with less cash and therefore, they have to contract credit and if this limit is reduced, the commercial banks will have more cash with them and they would be able to expand credit. The Reserve Bank of India has got the power to use the variable reserve requirements as an instrument of monetary control only in 1956 when the bank was authorised to vary the minimum cash reserve requirement to be maintained by commercial banks between 5% and 20% of demand deposits and 1% and 8% of time deposits<sup>14</sup>.

In addition to this, the Reserve Bank of India was empowered to impound banks' reserves in excess' of a certain level reached in a phased period. The commercial-banks are, also required to maintain a Statutory Liquidity Ratio and to arrive at the statutory liquidity ratio, the following assets are taken into account:

1. Cash in hand in India.
2. Balance in the current accounts with the State Bank of India (SBI) and its subsidiaries in India.
3. Balances with the Reserve Bank in excess of the minimum reserve requirement at 7 per cent of total demand and time liabilities<sup>15</sup>.

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<sup>14</sup> Ibid at pg-292

<sup>15</sup> Glidden, William B, *Regulation of National Bank subsidiaries*, 40 The Business Lawyer 1299

## CHAPTER 3

### CONTROL AND SUPERVISION OF BANKS IN INDIA

#### 3.1 Banking System in India

The transition from money-lending to banking must have occurred before Manu, who has devoted a special section to the subject of deposits and pledges, where he says, "A sensible man should deposit his money with a person of good family, of good conduct, well-attested and minted with the law, veracious, having many relatives wealthy and honorable".

As central banking is entirely different from commercial or other branches of banking and that its main aim is to serve in the public interest and not to secure profits. The functions of a central bank and the obligations resting upon it are of a very special character calling for skill, experience and judgment of a kind different from those which must be possessed by commercial and other branches of banks. It is true that no banker can neglect the rules of prudence and safety; but the object of a commercial banker is to make profit. The situation of a central bank is such that it must often undertake operations which are not only profitable, but result in losses its aim must be the economic welfare of the country. It contributes to financial stability by promoting the development of the financial system and maintaining orderly conditions in financial markets<sup>16</sup>. The Commercial Banks maintain accounts with the Reserve Bank of India and borrow money when necessary from the Reserve Bank of India. The Reserve Bank of India thus provides credit to commercial banks and commercial banks in turn provide credit

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<sup>16</sup> Narendra Jadhav, **Challenges to Indian Banking, Competition, Globalization and Financial markets**, MacMillan: Delhi, 2006.

to their clients to promote economic growth and development. However, credit cannot be extended to an unlimited extent because it would disturb price stability in the country and therefore, it becomes necessary for the Reserve Bank of India to control the activities of the commercial banks in the interest of price stability. The Reserve Bank of India controls, the activities of the commercial banks by virtue of the powers vested in it under the Banking Regulations Act of 1949 (10 of 1949) and the Reserve Bank of India Act, 1934 (2 of 1934). The Banking Companies Act was passed in the year 1949 in order to remove the defects in the banking system and to strengthen the banking structure so that the banking system can be used as an instrument of economic change in the country. The Banking Regulation Act 1949 also gives powers to the Reserve Bank of India to control and supervise the activities of the commercial banks in the country<sup>17</sup>.

Under the Banking Regulation Act, 1949, the Reserve Bank of India is given a power to issue license to commercial banks to open branches. No commercial banks can commence the business of banking without obtaining license from the Reserve Bank of India. The Reserve Bank of India has also power to withdraw the license once granted in case it is found the, affairs of the bank are not managed properly. The Reserve Bank of India has been given a power to inspect the commercial banks under Section 35 of the Banking Regulation Act. [Refer to ANNEXURE I]. Under this power, the Reserve Bank can itself at any time cause an inspection to be carried out by one or more of its officers of any bank.

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<sup>17</sup> Tandon, Prakash, *Development of Banking in India*, Journal of Indian School of Political Economy, 51.

Under the Banking Regulation Act, the Reserve Bank of India has wide powers of over-all control over the management of banks. Under this Act, Section 35(6) [ANNEXURE I], the approval of the Reserve Bank of India is necessary for the appointment or re-appointment or termination of an, appointment of a Chairman, Managing or whole time Director. The Reserve Bank of India has a power, to prevent a commercial bank from undertaking certain types of transactions.<sup>18</sup>

### **3.2 Role of Government through Regulator.**

The supervision of the banking sector in most countries is usually through a semi-autonomous central bank, and where it exists, a financial services authority. In some economies the role of the Finance Ministry also assumes some degree of supervision, even if considered not very desirable.

The Reserve Bank of India, as the Central Bank, has to perform not merely the negative role of controlling credit and currency in the economy to maintain the internal and external value of the rupee to ensure price stability in the economy, but also to act as a promoter of financial institution in the country so that its policies could be effective in promotion economic growth as per the guidelines and policies formulated by the government. When the Reserve Bank of India was established in 1935 our country was a backward country which lacked a well-developed commercial banking system apart from the absence of a well-developed money market in the country. After 1945, the Reserve bank of India became very active to take steps to promote and develop financial institution so that the Reserve Bank of India can pursue appropriate credit and

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<sup>18</sup> Ibid at pg-322

monetary policies for economic growth and development in an era of planned economic development of the country,

The Bank has, therefore, taken the following steps as promotional measures:

1. The Bank established the bill market scheme in 1952.
2. The Bank has tried to help the establishments of financial corporations to provide credit to the agriculture sector of economy and also the industrial sector of the economy.
3. The Bank has promoted Regional Rural Banks with the help of Commercial Banks to extend banking facilities to rural areas.
4. The Bank has taken steps to enable the Commercial Banks to open branches in foreign centers and has helped the establishment of an export-import bank in India to provide finance to exporters.
5. The Bank encourages and promotes research in the areas of banking.<sup>19</sup>

The role of the central bank in financing economic development is a matter of acute controversy. The advocates of orthodox central banking ideas hold that it is not the function of a central bank to finance economic development. They fear that such financing would ultimately lead to monetary disequilibrium. According to them the primary responsibility of the central bank is the maintenance of monetary and exchange stability.

In contrast to the view held by orthodox central bankers is of the view that due consideration should be given to the role of central banks in financing economic development. In 1937 the Board of Governors of the Federal Reserve System in the USA

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<sup>19</sup> Tannan's, **Banking Law and practice in India**, 19 edn. Vol.1, India Law House: New Delhi, 1997.



stressed the inadequacy of mere price stability or exchange stability as an objective of central banking policy. The Board observed that the maximum sustainable utilization of the nation's resources rather than mere price stability or exchange stability should be the goal of public policy<sup>20</sup>.

In conformity with this view, many central banks had been called upon to provide direct finance to carry out the developmental activities of the State. There had also been a widening of the eligibility rules. In addition, many central banks had been authorized to extend direct or indirect industrial and agricultural credit. For instance, in the USA under the Federal Reserve Act of 1934, the Federal Reserve Banks were allowed to discount or buy from any bank, trust company, mortgage company, credit corporation for industry or other financing institutions obligations maturing within five years entered into for the purpose of advances to commercial and industrial enterprises. In exceptional circumstances, they were also authorized to make direct working capital advances to established private enterprises. The intention behind this wave of discarding orthodox central banking ideas had been the desire on the respective central banks to help the money market to tide over temporary difficulties, the need to finance the growing expenditure of Government departments by means other than an appeal to the capital market and to provide funds to branches of the economic system for which were not in a position to obtain them through the usual channels<sup>21</sup>. At this juncture, it would not be out of place to examine the dangers and difficulties involved in extending the activities of a central bank far beyond the traditional boundaries.

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<sup>20</sup> Ibid at Pg,248

<sup>21</sup> Id.

In the first place, it is maintained that an increase in the total currency issued by the central bank does of itself initiate processes of economic expansions. Money is only one of the factors on which economic growth depends. Besides, there are other and more important factors such as the will and ability of the entrepreneurs, availability of other factors of production, capital formation, effective demand, total volume of production, etc. Therefore, a policy of the central bank to inject more money into circulation need not foster economic growth. On the other hand, an 'indiscriminate creation of money will create inflationary tendencies in the economy and impair economic development. This point is countered by arguing that financing of economic growth could be tempered by an appropriate monetary policy intended to stimulate private initiative and to keep the volume of money within appropriate limits. Further, it is pointed out that there is nothing inherent in central bank financing economic development to lead inevitably to inflation<sup>22</sup>.

The proponents of this line of argument say that everything will depend on the terms of overall financing of the economic development and on the extent to which it depends on planned savings and taxation. They further maintain that abuse is no argument against use, and the point that some central banks have in the past overstepped the limits under the pressure of the Government does not invalidate the proposition that central bank financing of economic development may be usefully undertaken without the dangers of inflation.

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<sup>22</sup> Richard Dale, **The Regulation of International Banking**, Cambridge: Woodhead, Faulkner, 1984

There is a further argument that the central bank, being the controller of the money market, should not take part in the financing of ordinary industrial and commercial activities. This may blur its vision as an impartial observer and affect adversely its monetary policy functions.

In a nutshell, it may be stated that the central banks, especially those in emerging economies, would do well to promote the process of accelerated economic growth by infusing efficiency and effectiveness in financial intermediation and stability in the financial system. Admittedly, ensuring availability of credit for all productive purposes is necessary for accelerating economic growth and this could be ensured through the pre-condition of efficiency and stability in the financial system. After the onset of East Asian crisis in mid-1997, there has been an increasing realization that proper development of the financial system cannot be regarded as ancillary or an adjunct to the development of the real sector; but it is a pre-condition of growth. There has also been an increasing realization during the recent past that an efficient and well functioning financial system contributes to economic growth by raising the level of savings and investment and the productivity of capital<sup>23</sup>.

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<sup>23</sup> It is true that credit availability to the small and medium industries sector in many countries is lagging behind. But recent thinking in central banking circles indicates that recourse to the same instruments of same methods through which direct financing was undertaken during the past is not appropriate since they had proved to be more harmful than beneficial in the context of economic development. In continuation of this line of thinking, contemporary central bankers hold the view that central banks should give adequate support for, the development of technological infrastructure or-financial structure or funding of research and training in this sector and should be catalyst for the development of new type of financial institutions; but they should not become the conduit for resources for financial intermediaries.

### 3.3 Indian scenario

The factors responsible for the growth of governance like- globalization, competition, technology and consolidation are very important from the Indian point of view in order to adopt better governance practices by the Indian industrial sector and to compete in the international market.

The RBI as the regulator of the financial (money) market in India is responsible for the governing the financial sector. This is done along with the compliance of the rules and regulations of the SEBI, being the regulator of the capital market<sup>24</sup>. Since the objectives which the central banks have to strive for in developing economies being varied and numerous and more complex in nature, special attention has to be given to both policies and techniques applied. The conventional and established tools should be applied only on a selective basis. It should not be taken for granted that the same technology tried and found successful in a different financial climate will yield the same results. Much more attention will have to be paid to the general economic policy.

Central banks should find ways to influence such policies and obtain the necessary help for their being able to do so. It is not surprising, therefore, that central banks in developing countries have fashioned tools of policy and control to suit their particular purpose and have branched out into new areas of activity which though not sanctified by the practices of their arch-types in the developed economies, are nevertheless relevant in their immediate situation.

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<sup>24</sup> **The Reserve Bank of India, Functions and Working**, RBLBombay 1956 & 1970.

### 3.4 Regulatory Structure in India.

The RBI in the beginning had no adequate powers of control or regulation. Commercial banks were governed by Company Law applicable to other companies, and the permission of the RBI was not required even for floatation of the new bank<sup>25</sup>. The Central Banking Enquiry Committee, in 1931, recommended the special comprehensive legislation to cover the organization, management, audit and liquidation of banks. In 1936, a separate chapter was added in the Companies Act, which relates to the banking companies. These provisions proved ineffective, and in 1939 the central board of RBI submitted a draft bill of the special legislation. In March 1949, the Banking Companies Act was legislated which was later amended to be the Banking Regulation Act, 1949. Apart from the various guidelines it issued for the banks, the Act also empowered the RBI to control and supervise the activities of the commercial banks in India<sup>26</sup>.

The chairman of the central board of directors of the bank is the chief executive authority of the bank and the Bank and he is known as the Governor. The Governor has the power of general superintendence and direction of the affairs and business of the bank and he is authorized to exercise all powers, which may be exercised or done by the

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<sup>25</sup> The policy goals of regulating banks in India are-

Monetary stability- One of the oldest concerns of bank regulators centered on the ability of a bank to 'create' money. By extending credit, the bank expands the money supply in the economy. In a developing economy, the keynote of monetary policy is what may be called controlled expansion. Money supply has to be expanded sufficiently to match the growth of real national income.

Social and economic development- After 1969, a need was felt for social control of banking to reduce/eliminate such imbalances and achieve developmental goals.

Prudential functioning of banks- The hallmark of a prudent banking system is its financial viability. Safety and soundness of an individual bank, and public confidence in the banking system, are the aims of prudential norms for banks. Prudential regulation helps prevent, limit or stop the damage caused by inefficient management.

<sup>26</sup> Ibid pg-17

bank. In the absence of the Governor, the Deputy-Governor nominated by him in this behalf exercises his powers<sup>27</sup>.

Thus the Reserve Bank of India has been empowered to control the volume of credit quantity through the use of bank rate, open market operations and variable reserve treatments apart from impounding of deposit beyond a certain level and the Reserve bank can influence the volume of credit in certain selected areas through the use of selective credit control by prescribing the margins to be maintained in respect of secured advances against communities. Rate of interest on advance and by regulation the purpose or purpose for which advance may or not be granted by the banking system as a whole or by group of banks or by a single bank as the case may be.

Central banks increasingly realize that their traditional command and control approach is not effective under the present day circumstances. During the 1950s and 1960s, it was still possible for central banks, especially in more industrially advanced countries, to use moral suasion, to enforce interest rate ceilings and use credit rationing to successfully implement controls over the rate of growth of credit and monetary aggregates. In Japan, this was the case up to the late 1980s. But those days are gone. In a market driven world, 'control' has been superseded by 'influence'. The modern central bank has to make use of the few instruments which it can still directly control to convince the market, with its immense deep pockets, of both the intention and capacity to achieve stated objectives. It is the realization of this fact that has driven the central banks to become much more transparent over the course of recent years.

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<sup>27</sup> Shockey, John E, *Discovery in bank regulatory agency enforcement actions*, 42 *The Business Lawyer* 91

## CHAPTER 4

### CONTROL AND SUPERVISION OF BANKS IN OTHER COUNTRIES.

#### 4.1 Position in United States.

The basic premise of bank regulation in United States is safety and soundness, similar to the United Kingdom. United States is a fragmented market regulated by a number of regulators. The Federal Reserve in USA, has role to play. It is both a monetary authority and a supervisory Authority Reserve System in US is an example of the central bank being Independent of the Government and take monetary policy decisions of their own<sup>28</sup>. In the USA, which is considered by most writers as a country with an independent central banking system, it would not be correct to say that the central banking system is an entirely independent one. All central banking operations are under the control of the Board of Governors of the Federal Reserve System. The Board consists of seven members appointed by the President of the USA, with the approval of the Senate.

The other primary features of US Banking System are:

**Federal Licensing-** Section 4(a) of the Act (IBA) provides that a foreign bank which "engages directly in a banking business outside the United States" may establish, with the approval of the Comptroller, one or more Federal branches or agencies in any state in which it is not operating a state branch or agency, provided that the laws of such state do not prohibit the establishment of an agency or branch by a foreign bank. In addition,

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<sup>28</sup> Gerald C. Fischev, **American Banking Structure**, Columbia University Press: New York, 1968.

in an effort to further the "federal-state option", Section 4(f) of the Act establishes procedures by which a foreign bank may convert an existing state agency or branch into a federal agency or branch. Except as otherwise specifically provided in the Act or in rules, regulations or orders issued by the Comptroller, the operations of a foreign bank at a federal agency or branch are to be conducted with the same rights and privileges applicable to a national bank at the same location and are subject to the same duties, restrictions, penalties, liabilities, conditions and limitations that would apply under the National Bank Act to a national bank doing business at the same location. Federal agencies are not required to obtain FDIC insurance, however, since the Act prohibits them from accepting deposits. Another exception provides that federal agencies and branches are not required to become members of the Federal Reserve System. The Act recognizes that federal agencies and branches, unlike national banks, will not be separately incorporated entities. Sarbanes-Oxley, among other regulations, has put compliance on the leadership agenda. This mandate can be used to facilitate change and integrate a compliance/risk management focus into every aspect of the business.

**Interstate Branching-** the McFadden Act of 1927 and the Bank Holding Act of 1956, restrict domestic banking organizations from establishing full service banking facilities in more than one state. In effect, the Act leaves each state free to decide whether and to what extent it wishes to permit foreign banks whose "home" is in another state to establish branches and to acquire banking subsidiaries within the state<sup>29</sup>.

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<sup>29</sup> Gerald C. Fischev, **American Banking Structure**, Columbia University Press: New York, 1968



## 4.2 Banking Regulation in UK.

The story of bank regulation in United Kingdom and United States is based on the common premise of safety and soundness.

Even in England, the home of orthodox central banking ideas, there had been considerable departure from the traditional principles. Instances could be found in the setting up of the Bankers Industrial Development Company in 1950 under the auspices of the Bank of England and in the extension of direct financial assistance to certain industrial enterprises. The association of the Bank of England with the Credit for Industry Limited, a specialized institution for financing small and medium sized industries, was another instance. The Bank of England takes the centre stage with few elite firms. Till Nineteenth Century, The Bank of England was established as a commercial bank and was the only bank allowed to raise capital from a large body of investors. The 1826 Act was the most significant bank legislation in the Nineteenth Century. It laid the foundation of the modern form of banking<sup>30</sup>. The 1844 Joint Stock Bank Act tightened the regulation of the joint stock banks. The Act was repealed in 1857 bringing with it the demise of the statutory regulation of the banks. This century witnessed the transformation of the Bank of England from a commercial bank to the central bank. The Bank of England inherited statute-based supervision as a natural extension of its traditional role. The new legislation the Banking Act of 1979 included a two tier system of banking supervision. The law also drew a distinction between "recognized banks" and "licensed deposit takers" (LDT). There were many anomalies regarding the treatment of recognized banks and the licensed deposit takers. Significantly, the 1979

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<sup>30</sup> Lomnicka, Eva, *Financial Services, Reforming UK Financial Services Regulation: The creation of single regulator*, [1999] J.B.L.480

Act provided the Bank with the power to require the production of information only from LDTs, but not from recognized banks. In these respects, the 1979 Act perpetuated the Bank's established practice rather than requiring significant break with the past. The 1979 Act established a Deposit Protection Scheme, which was significantly different from the Deposit Insurance Scheme of the U.S. With regard to the Bank's supervisory role, the 1979 Act imposed on the Bank a statutory duty to "protect the interests of depositors." The 1987 Act (the Banking Act) replaced the recognized banks/LDT distinction with a single category of "authorized institution" subject to statutory criteria set forth in Schedule 3 of the Act.<sup>31</sup> Directors, controllers, and managers must be "fit and proper;" the Board of Directors must consist of appropriate number of non-executives; the institution's business must be governed integrity and skill" and "in a prudent manner." Section 39 of the 1987 Act granted the power to obtain information and require the production of documents from authorized institutions. In particular, Section 39 empowered the Bank to instruct an authorized institution to provide it with a report from "an accountant or other person with relevant professional skill." The 1987 Act created the Board of Banking Supervision, which had the responsibility for overseeing the Bank's execution of its supervisory duties and to provide consultation in difficult cases. A major change took place in Britain in 1997, when the Government announced a unified regulatory authority for the banking, securities, and insurance industries, and thus the "Financial Services Authority" was created.

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<sup>31</sup> David Rodgers, **The Big Four British Banks Organisation, Strategy and The Future**, MacMillan: London, 1999.

The responsibility for the supervision of banks was transferred from the Bank of England to the Financial Services Authority in 1998. However, the Banking Act 1987 was not repealed, and it continued to provide the framework for supervision. Later in 2001, the Act was repealed by the coming into force of the FSMA [Financial Services and Markets Act] 2000<sup>32</sup>.

The Banking Act 1987- It was principally concerned with regulating the acceptance of deposits in the course of a deposit-taking business. Its other provisions concerned the Deposit Protection Scheme, banking names and descriptions, overseas institutions with representative offices, restriction on disclosure of information, and other matters<sup>33</sup>.

Bank regulation in the United Kingdom developed largely outside of the law. The Bank of England's form of supervision did not rely on legal institutions for its authority. Its authority derived from private ordering, i.e., its close, trusting relationships with individual firms in the banking industry. In contrast, the U.S. system of bank regulation is almost a legal system.

Bank regulation in the United States grew, in large part, out of antipathy toward large banking institutions rather than trust in them. The United States provided earlier and more extensive deposit insurance<sup>34</sup>.

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<sup>32</sup> Lomnicka, Eva, *Financial Services, Reforming UK Financial Services Regulation: The creation of single regulator*, [1999] J.B.L.480

<sup>33</sup> William H. Baughn and Donald R. Mandich, *The International Banking handbook*, Dow Jones-IRWIN: Illinois, 1983

<sup>34</sup> Richard Dale, *The Regulation of International Banking*, Cambridge: Woodhead, Faulkner, 1984

## CHAPTER 5

### COMMITTEES REVIEWING REGULATION AND SUPERVISION OF BANKS

The Basel Committee on Banking supervision, has been in the forefront of the international attempt in the development of standards and the establishment of a framework for bank supervision towards strengthening international financial stability. Being one of the central bank which was involved in the exercise of drawing up the Core Principles, the Reserve Bank of India had assessed its own position with respect to these principles. The assessment had shown that most of the Core Principles were already enshrined in our existing legislation or current regulations. Gaps had been identified between existing practice and principle mainly in the areas of risk management in banks, inter-agency cooperation with other domestic/international regulators and consolidated supervision. Internal working groups were set up to suggest measures to bridge these gaps and their recommendations have been accepted by the Board for Financial Supervision and are now in the process of being implemented. Given the spread and reach of the Indian banking system, implementation is a challenge for the supervisors. However, the Reserve Bank of India is committed to the full implementation of the Core Principles. The Bank also serves on the Core Principles Liaison Group of the BCBS, which has been formed "to promote the timely and complete implementation of these principles world-wide". It provides the framework within which one can view the developments in the Indian Banking System in a proper perspective.<sup>35</sup>

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<sup>35</sup> Kurup,N,P., Banking sector reforms and transparency, 1996 Vol.12 EPW 745

## 5.1 Basle Committee Core Principles On Effective Banking Supervision

### 5.1.1 Framework and Coordination

An effective system of banking supervision will have clear cut responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protection for confidentiality of such information should be in place.

The Reserve Bank of India ("RBI"), an autonomous body created under an act of the Indian parliament i.e. The Reserve Bank of India Act, 1934, is entrusted, inter alia, with the sole responsibility of regulation and supervision of banks under the Banking Regulation Act, 1949. Section 35 of the Banking Regulation Act vests powers in RBI for inspection of books of any banking company at any time<sup>36</sup>.

Both the regulatory and supervisory functions of RBI were earlier carried out through its Department of Banking Operations and Development ("DBOD") till December 1993, when a separate department entitled 'Department of Supervision (DOS)' was formed to take over the supervisory function, leaving regulatory functions to DBOD. In November 1994, RBI constituted the Board for Financial Supervision (BFS) under RBI (BFS) Regulations 1994 to give undivided attention to the prudential supervision and regulation of banks, financial institutions and non-bank financial institutions in an integrated

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<sup>36</sup> **The Reserve Bank of India, Functions and Working**, RBLBombay 1956 & 1970

manner. DBOD continues to perform the regulatory function pertaining to banks. However, DOS has since been bifurcated into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS). DBS is responsible for the supervision of commercial banks and their merchant banking subsidiaries. Both regulation and supervision of the development financial institutions (DFI's) are handled by the Financial Institutions Division (FID) of the DBS.

Section 7 of the RBI Act provides for operational independence to RBI while at the same time reserving the Central Government's right to issue directions to RBI from time to time in public interest. The management of RBI rests with the Central Board of Directors. The RBI is headed by the Governor who is appointed by the Central Government for a term not exceeding five years and is eligible for reappointment.

The RBI equips its officers with latest techniques of supervision through ongoing training programmes organized at its own staff colleges viz. Reserve Bank Staff College, Chennai; College of Agricultural Banking, Pune Bankers Training College, Mumbai; and Institute for Development and Research of Banking Technology, Hyderabad. Besides, the RBI regularly deutes its officers to training programmes, seminars and conferences conducted by international bodies, Central Banks of other countries and international organisations like Bank for International Settlements and the International Financial Institutions<sup>37</sup>.

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<sup>37</sup> Tandon, Prakash, *Development of Banking in India*, Journal of Indian School of Political Economy, Jan-April 1990 (1)51.

### 5.1.2 Licensing and Structure

The permissible activities of a banking company are listed in Section 6(1) of the Banking Regulation Act, 1949. Section 6(2) specifically prohibits a banking company from carrying on any form of business other than those referred to in Section 6(1). The term "banking" as defined in Section 5 means "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, or otherwise". A banking company means any company that transacts the business of banking in India. Any company other than banking company accepting deposit of money from the public merely for the purpose of financing its business is not deemed to transact the business of banking. A banking company could be either a public sector bank, privately held bank, foreign bank or co-operative bank.

The first three types of banks are called "commercial" banks by practice. Commercial banks are divided into certain distinct categories depending on their method of establishment and pattern of ownership, namely public sector banks, i.e. (State Bank of India, its associate banks and other nationalized banks), old private sector banks i.e. those which were in existence before the guidelines<sup>38</sup>.

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<sup>38</sup> Narendra Jadhav, **Challenges to Indian Banking, Competition, Globalization and Financial markets**, MacMillan: Delhi, 1996.

The permissible activities of banks in India are defined in the Banking Regulation Act that allow banks to undertake both commercial banking and investment banking. However, banks are not allowed to undertake mutual fund business departmentally. Similarly, banks cannot yet undertake insurance business. Banks are permitted to set up subsidiaries only for undertaking activities that are permissible under Section 19 of the Banking Regulation Act. Banks are not allowed to trade in commodities or become members of the stock exchange<sup>39</sup>.

### **5.1.3 Licensing of Banks**

Section 22 of the Banking Regulation Act provides that a company intending to carry on banking business must obtain a licence from RBI except such of the banks (public sector banks and RRBs), which are established under specific enactments. The RBI issues licence only after "tests of entry" are fulfilled. These tests include minimum capital, ownership structure, bank's operating plans and controls, ability of the bank to pay its present and future depositors in full, quality of management and whether the licensing of the bank would be in the public interest. Section 22(3) of the Banking Regulation Act provides that the RBI may require to be satisfied by an "inspection of books of the company and methods of operation of the company or otherwise" regarding the capital structure, proposed management etc. prior to grant of licence. By virtue of Section 10A(2) of the Banking Regulation Act, not less than 51% of the total number of members

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<sup>39</sup> Ibid at Pg.272



of the Board of Directors of a banking company should have special knowledge or practical experience in accountancy, agriculture, banking, cooperation, economics, finance, law, small scale industry, etc.

#### **5.1.4 Acquisition & Investments**

Banks are allowed to set up subsidiaries and make significant investment only in companies that are undertaking business authorized under section 19(1) of the Banking Regulation Act. This ensures that banks form subsidiaries only in financial services sector, and this requires prior approval of RBI. The RBI applies 'fit and proper' test and examines viability report of the proposed subsidiary before granting permission. Under Section 19(2) of the Banking Regulation Act, other investments by banks whether as pledgee, mortgagee or absolute owner in other companies cannot exceed 30% of the paid-up share capital or 30% of its own paid-up share capital, whichever is less. Investment by banks in a financial services company requires prior approval of RBI and is subject to a ceiling of 10% of the bank's paid-up capital and reserves. Aggregate investment in all the subsidiaries shall not exceed 20% of the bank's paid-up capital. In the case of investments in equity shares of companies not engaged in financial services, investment in a year should not exceed 5% of incremental deposits of the previous year<sup>40</sup>.

The RBI insists on arms length relationship between the bank and its subsidiary. As regards supervision, RBI has the authority to supervise companies undertaking non-banking financial services.

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<sup>40</sup> Kurup, N.P, *Restructuring Bank's capital: Need for an integrated approach*, 1995 Vol..30 (9) EPW 421

### 5.1.5 Internal Controls.

Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility, separation of the functions that involve committing the bank, paying away its funds, and proper accounts for its assets and liabilities reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations<sup>41</sup>.

RBI has issued a number of instructions/guidelines to banks to streamline their inspection and audit machinery, introduce concurrent audit, monitor treasury operations, introduce internal control system for prevention of frauds, monitor cash flows in accounts, promptly reconcile inter-branch accounts, and balance books periodically. The RBI has also issued guidelines from time to time on segregation of duties and responsibilities in front office, mid office and back office for treasury operations. Each bank is required to have a written policy on delegation of powers for managing credit, investments, money market operations, foreign exchange operations, etc.

All exceptionally large branches (whose total of deposits and advances are Rs1 billion and above) are subjected to concurrent audit so as to cover at least 50% of bank's business operations (total of deposits and advances). The treasury related transactions and specialized activities like portfolio management services and credit card business are also subjected to concurrent audit. Each bank has an internal audit department that undertakes audit of bank's operations periodically. With a view to strengthening the governance

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<sup>41</sup> Manubhai Shah, The new role of Reserve Bank in India's economic development, 1<sup>st</sup> Edn., Vora & Co.: Bombay, 1970

function, the banks have set up an Audit Committee of the Board (ACB) for supervising the internal audit function. The non-official Chartered Accountant Director is necessarily to be member of the ACB. The Chairman / Managing Director/ Chief Executive Officer does not participate in Audit Committee meetings<sup>42</sup>.

Examination and evaluation of the adequacy and effectiveness of the Internal Control System in the banks form one of the important aspects during on - site inspection by the RBI.

All domestic banks have been advised to name the General Manager in-charge of Audit and Inspection function as Compliance Officer, who should ensure ongoing compliance with instructions issued by the RBI and Government of India.

The RBI is vested with powers to remove managerial and other persons from the office of a banking company and appoint additional directors on the Board of a bank to secure proper management of the banking company in public interest as per Section 36-AA and 36-AB of the Banking Regulation Act.

## **5.2 Methods of Ongoing Banking Supervision**

### **5.2.1 Instruments of Supervision**

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

The main instrument of supervision in India is the periodical on-site inspection of banks

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<sup>42</sup> **The Reserve Bank of India, Functions and Working**, RBLBombay 1956 & 1970

that is supplemented by off-site monitoring and surveillance. Since 1995, on-site inspections are based on CAMELS (Capital adequacy, asset quality, management, earning, liquidity and systems and controls)<sup>43</sup> model and aim at achieving the following objectives:

1. Evaluation of bank's safety and soundness,
2. Appraisal of the quality of Board and top management
3. Ensuring compliance with prudential regulations,
4. Identifying the areas where corrective action is required to strengthen the bank,
5. Appraisal of soundness of bank's assets,
6. Analysis of key financial factors such as capital, earnings, and liquidity and determine bank's solvency,
7. Assessment of the quality of its management team and evaluation of the bank's policies, systems of management, internal operations and control.

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<sup>43</sup> Robert C.Effros (editor), **Current Legal Issues Affecting the Central Banks**, Vol.4, International Monetary Fund : Washington, 1994

### 5.2.2 Supervisory Contact.

Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

The contact between supervisors and banks is almost continuous. Senior executives at Regional office of RBI meet the bank management if serious supervisory issues crop up. Senior Executives at Central Office of RBI meet annually top management of banks to discuss matters of supervisory concerns identified during on-site inspection. The overall CAMELS rating is communicated to the bank management. Supervisory concerns emanating out of off-site supervision are also communicated to banks on an ongoing basis.

Meetings are also held with banks for various purposes like discussions on Resource Management. Banks are often consulted before introduction of major reporting changes and senior bank officers are often associated with the working groups and committees set up by the RBI to examine / deliberate on regulatory / supervisory issues. RBI Nominee Directors on the Boards of banks are also required to report bimonthly on the important policy decisions taken by the bank in particular highlighting supervisory issues, if any<sup>44</sup>.

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<sup>44</sup> Raj Kapila & Uma Kapila, **Ongoing Developments in Banking and Financial Sector**, Vol.4, Academic Function: Delhi, 2000.

### 5.2.3 Adequate Records & Financial Statements

RBI is committed to enhance and improve increasing the levels of transparency and disclosure in the annual accounts of banks. The formats for preparation of financial statements are prescribed under Section 29 of the Banking Regulation Act. The financial statements are prepared based on accounting standards prescribed by Institute of Chartered Accountants of India (ICAI) except those that have been specifically modified by RBI in consultation with ICAI keeping in view the nature of banking industry<sup>45</sup>..

The banks are mandated to disclose additional information as part of,

- Capital Adequacy Ratio
- Tier I ratio;
- Tier II ratio;
- Percentage of shareholding of the Government of India in nationalised banks;
- Net NPL ratio;
- Amount of provision made towards NPLs and provisions for income-tax for the year;
- Amount of subordinated debt raised as Tier II capital (by way of explanatory notes / remarks in the balance sheet as well as in Schedule 5 relating to other liabilities and provision);

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<sup>45</sup> Tandon, Prakash, *Development of Banking in India*, Journal of Indian School of Political Economy.

- Gross value of investments, provision for depreciation on investments and net value of investments separately for within India and outside India;
- Interest income as percentage to working funds;
- Non-interest income as a percentage to working funds;
- Operating profit as a percentage to working funds;
- Return on assets; business (deposits and advances) per employee;
- Profit per employee;
- Maturity pattern of certain assets and liabilities;
- Movement in NPLs<sup>46</sup>.

It is mandatory for all the banks to get their annual accounts audited every year by statutory auditors appointed by the RBI or appointed with approval of RBI. The auditors are required to report whether the financial statements exhibit a true and fair view of affairs of the bank.

Adequacy and accuracy of records maintained are verified during on-site inspection. Guidelines on minimum record maintenance in computerized environment have been issued by RBI.

As per Section 31 of the Banking Regulation Act, banks incorporated in India are required to publish their balance sheet and profit and loss account together with the auditor's report in a newspaper in circulation at the place where the bank has its principal office. Further, banks have been advised to publish its annual accounts in abridged form in additional newspapers, journals, etc. to give wider coverage to bank's operations. They should also

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<sup>46</sup> Kulkarni, P.B., *Banking Sector Reforms*, 10(14) Journal of Indian School of Political Economy, 663,

furnish copies to the concerned Regional Office and Central Office of RBI, where these are examined and taken up with the bank, if considered necessary<sup>47</sup>.

### **5.3 Supervisory Intervention**

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

The RBI is vested with powers to issue directions under the Banking Regulation Act where necessary in the interest of banking policy, in public interest or where the affairs of the banking company are being conducted in a manner detrimental to the interest of the depositors. The Banking Regulation Act also gives RBI wide powers to obtain any information from the supervised institutions (Section 27), issue directions on any aspect of their business (Section 35A), appoint nominees on their boards, cause change of management (Section 36AA and 36AB), cancel their licence (Section 22(4)), take monetary and non-monetary penal measures (Section 46 to 48).

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<sup>47</sup> Narendra Jadhav, **Challenges to Indian Banking, Competition, Globalisation and Financial markets**, MacMillan: Delhi, 1996.



#### 5.4 Narasimham Committee to Review Progress in Banking Sector.

The Narasimham Committee II was appointed to review the progress made in the banking sector since the Committee made their set of recommendation in 1991<sup>48</sup>. The Narasimham Committee II made their recommendation to further strengthen the banking system in India. Amongst others, the major recommendations, which have a direct bearing in the regulation and supervision of banks, have been listed as follows.

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

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<sup>48</sup> Also known as the First Narasimham Committee set up by the Government of India in 1991 to strengthen the banking system and make it internationally competitive.

prudential norms, capital adequacy and like, while the function of supervision should be regarded as the instrumentality for ensuring that the regulatory norms are complied with.

- Board of Financial supervision be established as an autonomous body.
- There are host of banking sector laws like the RBI Act, BR Act, SBI Act, Nationalisation Act and soon which are in urgent need of review and amendments to bring some of the provisions in line with the current needs of the banking industry in the country<sup>49</sup>.
- Reserve Bank should be made the Primary agency for regulation. The supervisory function over banks and financial institutions should, however, be given off to a separate authority to operate as quasi-autonomous body, under the Reserve Bank, but should be separate from the other Central Banking functions of the Reserve Bank.
- There is a need for constant review of prudential norms, governing bank's operations.

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<sup>49</sup> The emphasis for banking and financial sector reform should be to enhance the inherent strength of banks, review the structure of the system, the internal organisation of banks and streamlining the procedures taking into account institutional and technological dimensions. An analysis of the banking policy in the new milieu would also be required.

## CHAPTER 6

### CONCLUSION

The theory underlying the concept of giving independence to central banks for control and supervision was largely based on the point that absolute government control would pave the way for mismanagement of currency and credit.

According to Kisch and Elkin : "*The network of financial and commercial life is so intricate, and the decisions of the bank on important points have such widespread results that all interests are not affected in the same way. If the Government has a controlling influence over the bank, there are obvious ways by which the more powerful interests in the country can try to enforce their wishes. The road is open for political intrigue, and there can be no safeguard that the policy of the bank will be carried on without bias as national interests require*"<sup>50</sup>. It is further maintained in some quarters that if the central bank is brought under the control of the State, it becomes 'fatally easy' for the latter to abuse its powers by reducing the central bank to a mere mechanism for issuing notes, which will ultimately lead to currency depreciation and monetary chaos. Further, it is essential that the working of the central bank should be unbiased and continuous. But if the bank is under State control, continuity of policy cannot be guaranteed with changing Governments, nor the freedom from political bias in the administration be assured.

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<sup>50</sup> Kulkarni, P.B., *Banking Sector Reforms*, 10(14) Journal of Indian School of Political Economy, 663,

However, the trend since the late 1940s has been towards State control of central banks. There has been an almost universal recognition that the State should necessarily exercise a considerable measure of control over the central bank, whether or not the State owns the central bank. The observations made by the Governor of the Bank of England regarding the relationship between the State and the central bank deserve special mention in this connection. According to him, “it is of the utmost importance that the bank and the policy of the Government should at all times be in harmony—in as complete harmony as possible”. He further contended that “although the central bank has a right to offer advice, it is always subject to the supreme authority of the Government”<sup>51</sup>.

Thus, most of the central banks are either owned by the State or are controlled by the State through the appointment of a Governor or Board. The statutes of these central banks lay down express provisions governing the relation between the central bank and the State. In some cases, they expressly subordinate the central bank to the Government; and in some other cases they empower the State to give legally binding directions or require the central bank to issue directions only after consultation with the State. One basic fact may be noted here. The State exercises considerable measure of control over the central bank, whether or not the former owns the latter.

As observed by A.I. Krai<sup>52</sup>, “the central banks must not feel themselves bound by the established practices and must try to introduce such new instruments and methods of banking that would be basically sound and assist their countries in economic growth.

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<sup>51</sup> The future of banking supervision, Jerry L. Jordan, [www.cler.frb.org/ccca/jorlando.htm](http://www.cler.frb.org/ccca/jorlando.htm)

<sup>52</sup> Former Advisor to the Central Bank of Trinidad and Tobago.

Central banks in developing countries shall not be shy of innovations. Besides transplanting the known techniques from other countries, they should cooperate in devising new tools in banking and new methods of their application". He even advocated the establishment of a permanent organization of central banks in developing economies. Such an organization may assist in fostering the most advanced knowledge of the principles of policy. According to him, "there is no need for each country to obtain the experience desired at the price of one's own mistakes which may have been costly to somebody else before, and whose repetition can easily be avoided".

The Narasimham Committee had emphasized the need for separation of the functions of regulation and supervision. Though the RBI has created a separate Board for Supervision but the function carried out by them are similar. Separation of supervisory function for instance like NABARD for rural banks have given it a competitive edge in terms of achieving a professional approach in supervising these rural banks. Though, setting up a separate institution will increase the cost of exchequer but over the period of time it may prove fruitful<sup>53</sup>. The Committee on the Financial System 1991 (Narasimham Committee I) had strongly recommended that the "duality of control over the banking system between the Reserve Bank and the banking division of the Ministry of Finance (in. case of Commercial Banks) should end and that the Reserve Bank should be the primary agency for the regulation of the banking system"<sup>54</sup>.

Under the Banking Regulation Act, the RBI is also vested with the powers to issue

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<sup>53</sup> Kurup,N,P., *Banking sector reforms and transparency*, 1996 Vol.12 EPW 745

<sup>54</sup> Committee on Financial Sector Reforms, M.Narasimham, 1991 at p. 130

directions to banks whenever it considers it necessary. The power to grant licenses to banking companies is also vested solely in the RBI. Therefore, the RBI controls the entry into the banking sector, operations and health within it and also the exit point. There is a large element of control by the Central Government built into the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 by virtue of its overriding powers and the factum of its ownership of the largest chunk of the Banking sector, thereby making the Central Government and the RBI joint regulators of the banking sector.

An important point to be noted in this context is that although State control over central banks has been accelerated during the second half of the 20th century, recent trend is giving some sort of 'independence' to the central banks. It is true that the term 'independence' used in this connection could be somewhat misleading. In a democratic set up, no Government agency, including the central bank, can be wholly independent from Government. As far as 'independence' in the exercise of powers is concerned (this is what the majority have in mind as to the meaning of 'independence'), the trend today is for the central banks to exercise these powers without too much interference or guidance from the State. The objective is to insulate the central bank from short-term political influence and to ensure a consistent pursuit of medium term objective<sup>55</sup>.

It is clear that the fundamental approach, scope and methodologies of supervision must evolve in line with the way financial institutions manage their activities keeping in view the overall legal framework. Good banking supervision is a balancing act. It is

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<sup>55</sup> Gangopadhyay D.R, *Review of Banking Supervision: U.K. South Africa and India*, Vol.68.

important for the banking supervisor to identify prevailing risks and take proper remedial action. The banking supervisor needs to understand the functioning of the markets, existing and future financial products and current bank practices. As control is not an end in itself, there is obviously a need to ensure that the business is sustainable and that the banking company continues to be a going concern. And here the issues of control and governance come to fore. The governance issues are also raised in a wholly-owned corporation of a government to safeguard the interest of investors. Governance is indeed an art of balancing the autonomy and flexibility of the management with checks on strategic decisions, while ensuring that the interests of shareholders are not sacrificed. The term also implies professionalism in the conduct of the board, business ethics, conformity with law and regulations and sensitivity to social concerns. Appropriate constitution of the board, together with a meaningful measure of operational autonomy and flexibility to managements and the boards of banks and is a sine qua non of governance, regulation and control.

The conclusions arrived at the International Seminar on Central Banking and Development some time back are pertinent even today<sup>56</sup>, in the discussions, there was a consensus that with all the refinements of theory and statistical and other data available, there could be no precise rules and techniques in central banking. Central banking thus remains an art to be perfected by practice. An important task of a central bank in a developing economy is to give advice to the Government, sharing the latter's concern with economic development. Also the government through the central bank should also be continuously in dialogue with the other factors of the economy to contribute to the

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<sup>56</sup> Tannan's, **Banking Law and practice in India**, 19 edn. Vol.1, India Law House: New Delhi, 1997

realization of the objective of development with stability. Thus it should endeavour to build up lines of communication with Government on the one hand and other sectors of the economy on the other. In summary, it may be observed that the point involved in defining the relation between the State and the central bank is neither 'absolute subordination' nor 'absolute independence'.

Nevertheless, it has been the opinion on the part of many Governments that the central banks possessing large and important powers should be controlled by the governments so that a proper coordination and integration of the currency, credit and monetary policy of the central bank with the Government's financial and economic policy might be secured.<sup>57</sup> Operational independence helps to take prudent decisions and in a democratic set up like India, autonomy is more necessary for prudent decision making and ensuring greater transparency in the policies.

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<sup>57</sup> Tandon, Prakash, *Development of Banking in India*, Journal of Indian School of Political Economy,



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## **ANNEXURE-I**

### **BANKING REGULATION ACT, 1949 [Relevant Provisions]**

#### **PART 1:- PRELIMINARY**

##### **1. Short title, extent and commencement**

(1) This Act may be called the Banking 2[Regulation] Act, 1949.

3[(2) It extends to the whole of India 4[\* \* \*]

(3) It shall come into force on such date<sup>5</sup> as the Central Government may, by notification in the Official Gazette, appoint in this behalf.

##### **2. Application of other laws not barred**

The provisions of this Act shall be in addition to, and not, save as hereinafter expressly provided, in derogation of the 6[Companies Act, 1956 (1 of 1956)], and any other law for the time being in force.

7[3. Act to apply to co-operative societies in certain cases

Nothing in this Act shall apply to-

- (a) a primary agricultural credit society;
- (b) a co-operative land mortgage bank; and
- (c) any other co-operative society, except in the manner and to the extent specified in Part V.]

##### **4. Power to suspend operation of Act**

(1) The Central Government, if on a representation made by the Reserve Bank in this behalf it 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 operation of all or any of the provisions of this Act, either generally 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, exercise 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 Government forthwith, and the order shall, as soon as may be, be published 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 8[Parliament] as soon as may be after it is issued.

## **5. Interpretation**

9[In this Act], unless there is anything repugnant in the subject or context,-

10[(a) "approved securities" means-

(i) securities in which a trustee may invest money under clause (a), clause (b), clause (bb), clause (c) or clause (d) of section 20 of the Indian Trust Act, 1882 (2 of 1882);

(ii) such of the securities authorised by the Central Government under clause (f) of section 20 of the Indian Trust Act, 1882 (2 of 1882), as may be prescribed];

(b) "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.

(c) "banking company" means any company which transacts the business of banking 11[in

India];

Explanation: Any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause;

12[(ca) "banking policy" means any policy which is specified from time to time by the Reserve Bank in the interest of the banking system or in the interest of monetary stability or sound economic growth, having due regard to the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources;]

13[(CC) "branch" or "branch office", in relation to a banking company, means any branch or branch office, whether called a pay office or sub-pay office or by any other name, at which deposits are received, cheques cashed or moneys lent, and for the purposes of section 35 includes any place of business where any other form of business referred to in sub-section (1) of section 6 is transacted;]

14[(d) "company" means any company as defined in section 3 of the Companies Act, 1956 (1 of 1956); and includes a foreign company within the meaning of section 591 of that Act;]

15[(da) "corresponding new bank" means a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980);]

(e) 16[\* \* \*]

(f) "demand liabilities" means liabilities which must be met on demand, and "time liabilities" means liabilities which are not demand liabilities;

17[(ff) "Deposit Insurance Corporation" means the Deposit Insurance Corporation established under section 3 of the Deposit Insurance Corporation Act, 1961 (47 of 1961);]

15[(ffa) "Development Bank" means the Industrial Development Bank of India established under section 3 of the Industrial Development Bank of India Act, 1964 (18 of 1964);

(ffb) "Exim Bank" means Export-Import Bank of India established under section 3 of the Export-Import Bank of India Act, 1981 (28 of 1981);]

18[(ffc) "Reconstruction Bank" means the Industrial Reconstruction Bank of India established under section 3 of the Industrial Reconstruction Bank of India Act, 1984 (62 of 1984);]

19[(ffd) "National Housing Bank" means the National Housing Bank established under section 3 of the National Housing Bank Act, 1987;]

(g) "gold" includes gold in the form of coin, whether legal tender or not, or in the form of bullion or ingot, whether refined or not;

12[(gg) "managing agent" includes-

(i) secretaries and treasurers,

(ii) where the managing agent is a company, any director of such company, and any member thereof who holds substantial interest in such company,

(iii) where the managing agent is a firm, any partner of such firm;]

14[(h) "managing director", in relation to a banking company, means a Director who, by virtue of agreement with the banking company or of a resolution passed by the banking company in general meeting or by its Board of Directors or, by virtue of its memorandum or articles of association, is entrusted with the management of the whole, or substantially the whole of the affairs of the company, and includes a Director occupying the position of a Managing Director, by whatever name called;]

20[PROVIDED that the Managing Director shall exercise his powers subject to the superintendence, control and direction of the Board of Directors;]

21[(ha) "National Bank" means the National Bank for Agriculture and Rural Development established under section 3 of the National Bank for Agriculture and Rural Development Act, 1981 (61 of 1981);]

(i) 22[\* \* \*1

(j) "prescribed" means prescribed by rules made under this Act;

21[(ja) "regional rural bank" means a regional rural bank established under section 3 of the Regional Rural Banks Act, 1976 (21 of 1976);]

(k) 23[\* \* \*]

10[(l) "Reserve Bank" means the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934);]

(m) 24[\* \* \*]

(n) "secured loan or advances" means a loan or advance made on the security of assets the market value of which is not at any time less than the amount of such loan or advance; and "unsecured loan or advance" means a loan or advance not so secured;

27[(ni) "Small Industries Bank" means the Small Industries Development Bank of India established under s. 3 of the Small Industries Development Bank of India Act, 1989;]

12[(na) "small-scale industrial concern" means an industrial concern in which the investment in plant and machinery is not in excess of seven and a half lakh of rupees or such higher amount, not exceeding twenty lakhs of rupees, as the Central Government may, by notification in the Official Gazette, specify in this behalf, having regard to the trends in industrial development and other relevant factors;]

15[(nb) "Sponsor Bank" has the meaning assigned to it in the Regional Rural Banks Act, 1976 (21 of 1976);]



(nc) "State Bank of India" means the State Bank of India constituted under section 3 of the State Bank of India Act, 1955 (23 of 1955);]

26[(nd)] "subsidiary bank" has the meaning assigned to it in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);

27[(ne)] "substantial interest:-

(i) in relation to a company, means the holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares thereof, the amount paid-up on which exceeds five lakhs of rupees or ten per cent of the paid-up capital of the company, whichever is less;

(ii) in relation to a firm, means the beneficial interest held therein by an individual or his spouse or minor child, whether singly or taken together, which represents more than ten per cent of the total capital subscribed by all the partners of the said firm;

28[(o) all other words and expressions used herein but not defined and defined in the Companies Act, 1956 (1 of 1956), shall have the meanings respectively assigned to them in that Act.]

(2) 29[\* \* \*]

28[5A. Act to override memorandum, articles, etc.

Save as otherwise expressly provided in this Act,

(a) the provisions of this Act shall have effect notwithstanding anything to the contrary contained in the memorandum or articles of a banking company, or in any agreement executed by it, or in any resolution passed by the banking company in general meeting or by its Board of Directors, whether the same be registered, executed or passed, as the case may be, before or after the commencement of the Banking Companies (Amendment) Act, 1959 (33 of 1959); and

(b) any provision contained in the memorandum, articles, agreement or resolution aforesaid

shall, to the extent to which it is repugnant to the provisions of. this Act, become or be void, as the case may be.

## **BANKING REGULATION ACT, 1949**

### **PART II: - BUSINESS OF BANKING COMPANIES**

#### **6. Form and business in which banking companies may engage**

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

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

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

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

(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock,

debentures or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

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

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

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

(h) undertaking and executing trusts;

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

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

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

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

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

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

engage.

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

**<sup>9</sup>[7. Use of words "bank", "banker", "banking" or "banking company"]**

(1) No company other than a banking company shall use as part of its name 15[or, in connection with its business] any of the words "bank", "banker" or "banking" and no company shall carry on the business of banking in India unless it uses as part of its name at least one of such words.

(2) No firm, individual or group of individuals shall, for the purpose of carrying on any business, use as part of its or his name any of the words "bank", "banking" or "banking company".

(3) Nothing in this section shall apply to-

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

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

**8. Prohibition of trading**

Notwithstanding anything contained in section 6 or in any contract, no banking company shall directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realization of security given to or held by it, or engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business as is referred to in clause (i) of sub-section (1) of section 6:

10[PROVIDED that this section shall not apply to any such business as is specified in pursuance of clause (o) of sub-section (1) of section 6.]

Explanation: For the purposes of this section, "goods" means every kind of movable property, other than actionable claims, stock, shares, money, bullion and specie and all instruments referred to in clause (a) of sub-section (1) of section 6.

### **9. Disposal of non-banking assets**

Notwithstanding anything contained in section 6, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof or from the commencement of this Act, whichever is later or any extension of such period as in this section provided, and such property shall be disposed of within such period or extended period, as the case may be:

PROVIDED that the banking company may, within the period of seven years as aforesaid, deal or trade in any such property for the purpose of facilitating the disposal thereof:

PROVIDED FURTHER that the Reserve Bank may in any particular case extend the aforesaid period of seven years by such period not exceeding five years where it is satisfied that such extension would be in the interests of the depositors of the banking company.

### **31[10. Prohibition of employment of Managing Agents and restrictions on certain forms of employment**

(1) No banking company-

(a) shall employ or be managed by a Managing Agent; or

(b) shall employ or continue the employment of any person-

(i) who is, or at any time has been, adjudicated insolvent, or has suspended payment or has compounded, with his creditors, or who, is or has been, convicted by a criminal court of an offence involving moral turpitude; or

(ii) whose remuneration or part of whose remuneration takes the form of commission or of a share in the profits of the company:

14[PROVIDED that nothing contained in this sub-clause shall apply to the payment by a

banking company of-

(a) any bonus in pursuance of a settlement or award arrived at or made under any law relating to industrial disputes or in accordance with any scheme framed by such banking company or in accordance with the usual practice prevailing in banking business;

(b) any commission to any broker (including guarantee broker), cashier-contractor, clearing and forwarding agent, auctioneer or any other person, employed by the banking company under a contract otherwise than as a regular member of the staff of the company; or]

(iii) whose remuneration is, in the opinion of the Reserve Bank, excessive; or

(c) shall be managed by any person-

14[(i) who is a Director of any other company not being-

(a) a subsidiary of the banking company, or

(b) a company registered under section 25 of the Companies Act, 1956 (1 of 1956):

PROVIDED that the prohibition in this sub-clause shall not apply in respect of any such Director for a temporary period not exceeding three months or such further period not exceeding nine months as the Reserve Bank may allow; or]

(ii) who is engaged in any other business or vocation; or

(iii) 9[whose term of office as a person managing the company is] for a period exceeding five years at any one time:

32[PROVIDED that the term of office of any such person may be renewed or extended by further periods not exceeding five years on each occasion subject to the condition that such renewal or extension shall not be sanctioned earlier than two years from the date on which it is to come into force:

PROVIDED ALSO that where the term of office of such person is for an indefinite period, such term, unless it otherwise comes to an end earlier, shall come to an end immediately on the expiry of five years from the date of his appointment or on the expiry of three months from the date of commencement of section 8 of the Banking Laws (Miscellaneous Provisions) Act, 1963 (55 of 1963), whichever is later:]

PROVIDED FURTHER that nothing in this clause shall apply to a Director, other than the Managing Director, of a banking company by reason only of his being such Director.

Explanation : For the purpose of sub-clause (iii) of clause (b), the expression "remuneration ", in relation to a persons employed or continued in employment, shall include salary, fees and perquisites but shall not include any allowances or other amounts paid to him for the purpose of reimbursing him in respect of the expenses actually incurred by him in the performance of his duties.

(2) In forming its opinion under sub-clause (iii) of clause (b) of sub-section (1), the Reserve Bank may have regard among other matters to the following:-

(i) the financial condition and history of the banking company, its size and area of operation, its resources, the volume of its business, and the trend of its earning capacity;

(ii) the number of its branches or offices;

(iii) the qualifications, age and experience of the person concerned;

(iv) the remuneration paid to other persons employed by the banking company or to any person occupying a similar position in any other banking company similarly situated; and

(v) the interests of its depositors.

(3) 33[\*\*\*]

(4) 33[\*\*\*]

(5) 33[\*\*\*]

(6) Any decision or order of the Reserve Bank made under this section shall be final for all purposes.]

**34[10A. Board of Directors to include persons with professional or other experience**

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

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

(b) which comes into existence thereafter,

shall comply with the requirements of this section:

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

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

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

(i) accountancy,

(ii) agriculture and rural economy,

(iii) banking,

(iv) co-operation,

(v) economics,



(vi) finance,

(vii) law,

(viii) small-scale industry,

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

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

(b) shall not-

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

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

(ii) any firm,

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

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

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

(i) no Director of a banking company, other than its Chairman or whole-time Director, by

whatever name called, shall hold office continuously for a period exceeding eight years;

(ii) a Chairman or other whole-time Director of a banking company who has been removed from office as such Chairman, or whole-time Director, as the case may be, under the provisions of this Act shall also cease to be a Director of the banking company and shall also not be eligible to be appointed as a Director of such banking company, whether by election or co-option or otherwise, for a period of four years from the date of his ceasing to be the Chairman or whole-time Director, as the case may be.]

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

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

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

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

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

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

**10B. Banking company to be managed by whole-time Chairman**

35[(1) Notwithstanding anything contained in any law for the time being in force or in any contract to the contrary, every banking company in existence on the commencement of the Banking Regulation (Amendment) Act, 1994, or which comes into existence thereafter shall have one of its Directors, who may be appointed on a whole-time or a part-time basis as Chairman of its Board of Directors, and where he is appointed on a whole-time basis as Chairman of its Board of Directors, he shall be entrusted with the management of the whole of the affairs of the banking company:

PROVIDED that the Chairman shall exercise his powers subject to the superintendence, control and direction of the Board of Directors.

(1A) Where a Chairman is appointed on a part-time basis-

(i) such appointment shall be with the previous approval of the Reserve Bank and be subject to such conditions as the Reserve Bank may specify while giving such approval:

(ii) the management of the whole of the affairs of such banking company shall be entrusted to a Managing Director who shall exercise his powers subject to the superintendence, control and direction of the Board of Directors.]

(2) 35[Every Chairman of the Board of Directors who is appointed on a whole-time basis and every Managing Director] of a banking company shall be in the whole-time employment to such company and shall hold office for such period, not exceeding five years, as the Board of Directors may fix, but shall subject to the provision of this section, be eligible for re-election or re-appointment:

PROVIDED that nothing in this sub-section shall be construed as prohibiting a chairman from being a Director of a subsidiary of the banking company or a Director of a company registered under section 25 of the Companies Act, 1956 (1 of 1956).

(3) Every person holding office on the commencement of section 3 of the Banking Laws (Amendment) Act, 1968 (58 of 1968), as Managing Director of a banking company shall-

(a) if there is a Chairman of its Board of Directors, vacate office on such commencement, or

(b) if there is no Chairman of its Board of Directors, vacate office on the date on which the Chairman of its Board of Directors is elected or appointed in accordance with the provisions of this section.

(4) 35[Every Chairman who is appointed on a whole-time basis and every Managing Director of a banking company appointed under sub-section (1A)] shall be a person who has special knowledge and practical experience of-

(a) the working of a banking company or of the State Bank of India or any subsidiary bank or a financial institution, or

(b) financial, economic or business administration:

PROVIDED that a person shall be disqualified for being a 35[Chairman who is appointed on a whole-time basis or a Managing Director], if he-

(a) is a Director of any company other than a company referred to in the proviso to sub-section (2), or

(b) is a Partner of any firm which carries on any trade, business or industry, or

(c) has substantial interest in any other company or firm, or

(d) is a Director, Manager, Managing Agent, Partner or Proprietor of any trading, commercial or

industrial concern, or

(e) is engaged in any other business or vocation.

(5) 35[A Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director] of a banking company may, by writing under his hand addressed to the company, resign his office 36[\* \* \*].

37[(5A) 35[A Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director] whose term of office has come to an end, either by reason of his resignation or by reason of expiry of the period of this office, shall, subject to the approval of the Reserve Bank, continue in office until his successor assumes office.]

(6) Without prejudice to the provisions of section 36AA, where the Reserve Bank is of opinion that any person who is, or has been elected to be, the 35[Chairman of the Board of Directors who is appointed on a whole-time basis or the Managing-Director] of a banking company is not a fit and proper person to hold such office, it may, after giving to such person and to the banking company a reasonable opportunity of being heard, by order in writing, require the banking company to elect or appoint any other person as the 35[Chairman of the Board of Directors who is appointed on a whole-time basis or the Managing-Director] and if, within a period of two months from the date of receipt of such order, the banking company fails to elect or appoint a suitable person as 35[Chairman of the Board of Directors who is appointed on a whole-time basis or the Managing Director], the Reserve Bank may, by order, remove the first-mentioned person from the office, of the 35[Chairman of the Board of Directors who is appointed on a whole-time basis or a Managing Director] of the banking company and appoint a suitable person in his place whereupon the person so appointed shall be deemed to have been duly elected or appointed, as the case may be, as the 35[Chairman of the Board of Directors who is appointed on a whole-time basis or the Managing Director] of such banking company and any person elected or appointed as Chairman under this sub-section shall hold office for the residue of the period of the person in whose place he has been so elected or appointed.

(7) The banking company and any person against whom an order of removal is made under subsection (6) may, within thirty days from the date of communication to it or to him of the order, prefer an appeal to the Central Government and the decision of the Central Government

thereon, and subject thereto, the order made by the Reserve Bank under sub-section (6), shall be final and shall not be called into question in any court.

(8) Notwithstanding anything contained in this section, the Reserve Bank may, if in its opinion it is necessary in the public interest so to do, permit the 35[Chairman of the Board of Directors who is appointed on a whole-time basis or a Managing Director] to undertake such part-time honorary work as is not likely to interfere with his duties as 35[such Chairman or Managing Director.]

(9) Notwithstanding anything contained in this section, where a person 35[appointed on a whole-time basis, as Chairman of the Board of Directors or Managing Director] dies or resigns or is by infirmity or otherwise rendered incapable of carrying out his duties or is absent on leave or other wise in circumstances not involving the vacation of his office, the banking company may, with the approval of the Reserve Bank, make suitable arrangements for carrying out the 35[duties of Chairman or Managing Director] for a total period not exceeding four months

## **PART II: - BUSINESS OF BANKING COMPANIES**

### **15[10BB. Power of Reserve Bank to appoint Chairman of a banking company**

(1) Where the office of the 35[Chairman of the Board of Directors appointed on a whole-times basis or the Managing Director] of a banking company is vacant, the Reserve Bank may, if it is of opinion that the continuation of such vacancy is likely to adversely affect the interests of the banking company, appoint a person eligible under sub-section (4) of section 10B to be so appointed, to be the 35[Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director of the banking company and where the person so appointed is not a director of such banking company, he shall, so long as he holds the office of the 35[Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director], be deemed to be a Director of the banking company.

(2) The 35[Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director] so appointed by the Reserve Bank shall be in the whole-time employment of the banking company and shall hold office for such period not exceeding three years, as the Reserve Bank may specify, but shall, subject to other provisions of this Act, be eligible for re-

appointment.

(3) The 35[Chairman of the Board of Directors who is appointed on a whole-time basis or a Managing Director] so appointed by the Reserve Bank shall draw from the banking company such pay and allowances as the Reserve Bank may determine and may be removed from office only by the Reserve Bank.

(4) Save as otherwise provided in this section, the provisions of section 10B shall, as far as may be, apply to the 35[Chairman of the Board of Directors appointed on a whole-time basis or a Managing Director] appointed by the Reserve Bank under sub-section (1) as they apply to a 35[Chairman of the Board of Directors appointed on a whole-time basis or the Managing Director] appointed by the banking company.]

**10[10C. Chairman and certain Directors not to be required to hold qualification shares**

35[A Chairman of the Board of Directors who is appointed on a whole-time basis or a Managing Director] of a banking company (by whomsoever appointed) and a director of a banking company (appointed by the Reserve Bank under section 10A) shall not be required to hold qualification shares in the banking company.]

10D. Provisions of sections 10A and 10B to override all other laws, contracts, etc.

Any appointment or removal of a 35[Director, Chairman of the Board of Directors who is appointed on a whole-time basis or Managing Director] in pursuance of section 10A or section 10B 10[or section 10BB] shall have effect and any such person shall not be entitled to claim any compensation for the loss or termination of office, notwithstanding anything contained in any law or in any contract, memorandum or articles or associations

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

(1) Notwithstanding anything contained in 38[section 149 of the Companies Act, 1956], no banking company in existence on the commencement of this Act, shall, after the expiry of three years from such commencement or of such further period not exceeding one year as the Reserve Bank, having regard to the interests of the depositors of the company, may think fit in any particular case to allow, carry on business 11[in India], and no other banking company shall, after the commencement of this Act, commence or carry on business 11[in India], 14[unless it complies with such of the requirements of this section as are applicable to it.]

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

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

(b) 39[the banking company shall deposit and keep deposited with the Reserve Bank either in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities-

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

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

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

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

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

41[(2A) Notwithstanding anything contained in sub-section (2), the Central Government may, on the recommendation of the Reserve Bank, and having regard to the adequacy of the amounts already deposited and kept deposited by a banking company under sub-section (2), in relation to its deposit liabilities in India declare by order in writing that the provisions of sub-clause (ii) of clause (b) of sub-section (2) shall not apply to such banking company for such period as may be specified in the order.]

(3) In the case of any banking company to which the provisions of sub-section(2) do not apply,



the aggregate value of its paid-up capital and reserves shall not be less than -

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

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

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

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

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

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

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

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

to be situated within the same State as such principal place of business.

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

14[(5) For the purposes of this section-

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

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

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

### **31[12. Regulation of paid-up capital, subscribed capital and authorised capital and voting rights of shareholders**

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

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

(ii) that the capital of the company consists of ordinary shares only or of ordinary shares or equity shares and such preferential shares as may have been issued prior to the 1st day of July, 1944:

PROVIDED that nothing contained in this sub-section shall apply to any banking company

incorporated before the 15th day of January, 1937.

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

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

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

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

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

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

#### **47[12A. Election of new Directors**

(1) The Reserve Bank may, by order, require any banking company to call a general meeting of the shareholders of the company within such time, not less than two months from the date of the order, as may be specified in the order or within such further time as the Reserve Bank may allow in this behalf, to elect in accordance with the voting rights permissible under this Act fresh Directors, and the banking company shall be bound to comply with the order.

(2) Every Director elected under sub-section (1) shall hold office until the date up to which his predecessor would have held office, if the election had not been held.

(3) Any election duly held under this section shall not be called in question in any court.].

### **13. Restriction on commission, brokerage, discount, etc., on sale of shares**

Notwithstanding anything to the contrary contained in 48[sections 76 and 79 of the Companies Act, 1956 (1 of 1956)]1, no banking company shall pay out directly or indirectly by way of commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, any amount exceeding in the aggregate two and one-half per cent of the paid-up value of the said shares.

### **14. Prohibition of charge on unpaid capital**

No banking company shall create any charge upon any unpaid capital of the company, and any such charge shall be invalid.

### **28[14A. Prohibition of floating charge on assets**

(1) Notwithstanding anything contained in section 6, no banking company shall create a floating charge on the undertaking or any property of the company or any part thereof, unless the creation of such floating charge is certified in writing by the Reserve Bank as not being detrimental to the interests of the depositors of such company.

(2) Any such charge created without obtaining the certificate of the Reserve Bank shall be invalid.

(3) Any banking company aggrieved by the refusal of certificate under sub-section (1) may, within ninety days from the date on which such refusal is communicated to it, appeal to the Central Government.

(4) The decision of the Central Government where an appeal has been preferred to it under sub-section (3) or of the Reserve Bank where no such appeal has been preferred shall be final.

### **15. Restrictions as to payment of dividend**

49[(1)] No banking company shall pay any dividend on its shares until all its capitalised

expenses (including preliminary expenses, organisation expenses, share selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off.

28[(2) Notwithstanding anything to the contrary contained in sub-section (1) or in the Companies Act, 1956 (1 of 1956), a banking company may pay dividends on its shares without writing off-

(i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

(ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

(iii) the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.]

### **31[16. Prohibition of common Directors**

35[(1) No banking company incorporated in India shall have as a Director in its Board of Directors any person who is a Director of any other banking company.

(1A) No banking company referred to in sub-section (1) shall have in its Board of Directors more than three Directors who are Directors of companies which among themselves are entitled to exercise voting rights in excess of twenty per cent of the total voting rights of all the shareholders of that banking company.

(2) If immediately before commencement of the Banking Companies (Amendment) Act, 1956 (95 of 1956), any person holding office as a Director of a banking company is also a Director of companies which among themselves are entitled to exercise voting rights in excess of twenty per cent of the total voting rights of all the shareholders of the banking company, he shall, within such period from such commencement as the Reserve Bank may specify in this behalf-

(a) either resign his office as a Director of the banking company; or

(b) choose such number of companies as among themselves are not entitled to exercise voting rights in excess of twenty per cent of the total voting rights of all the shareholders of the banking company as companies in which he wishes to continue to hold the office of a Director and resign his office as a Director in the other companies.]

12[(3) Nothing in sub-section (1) shall apply to, or in relation to, any Director appointed by the Reserve Bank.]

#### **14[17. Reserve Fund**

(1) Every banking company incorporated in India shall create a reserve fund and 50[\* \*\*] shall, out of the balance of profit of each year, as disclosed in the profit and loss account prepared under section 29 and before any dividend is declared, transfer to the reserve fund a sum equivalent to not less than twenty per cent of such profit.

41[(1A) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Reserve Bank and having regard to the adequacy of the paid-up, capital and reserves of a banking company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not apply to the banking company for such period as may be specified in the order:

PROVIDED that no such order shall be made unless, at the time it is made, the amount in the reserve fund under sub-section (1), together with the amount in the share premium account is not less than the paid-up capital of the banking company.]

(2) Where a banking company appropriates any sum from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the Reserve Bank, explaining the circumstances relating to such appropriation:

PROVIDED that the Reserve Bank may, in any particular case, extend the said period of twenty-one days by such period as it thinks fit or condone any delay in the making of such report.

**51[18. Cash reserve**

(1) Every banking company, not being a scheduled bank, shall maintain in India by way of cash reserve with itself or by way of balance in a current account with the Reserve Bank or by way of net balance in current accounts or in one or more of the aforesaid ways, a sum equivalent to at least three per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight and shall submit to the Reserve Bank before the twentieth day of every month a return showing the amount so held on alternate Fridays during a month with particulars of its demand and time liabilities in India on such Friday or if any such Friday is a public holiday under the Negotiable Instruments Act, 1881 (26 of 1881), at the close of business on the preceding working day.

Explanation : In this section, and in section 24-

(a) "**liabilities in India**" shall not include-

(i) the paid-up capital or the reserves or any credit balance in the profit and loss account of the banking company,

(ii) any advance taken from the Reserve Bank or from the Development Bank or from the Exim Bank 52[or from the Reconstruction Bank] 19[or from the National Housing Bank] or from the National Bank 82[or from the Small Industries Bank] by the banking company;

(iii) in the case of a Regional Rural Bank, also any loan taken by such bank from its sponsor bank;

(b) "**fortnight**" shall mean the period from Saturday to the second following Friday, both days inclusive;

(c) "**net balance in current accounts**" shall, in relation to a banking company, mean the excess, if any, of the aggregate of the credit balance in current account maintained by that banking company with the State Bank of India or a subsidiary bank or a corresponding new bank over the aggregate of the credit balances in current account held by the said banks with such banking company;

(d) for the purpose of computation of liabilities, the aggregate of the liabilities of banking company to the State Bank of India, a subsidiary bank, a corresponding new bank, a Regional Rural Bank, another banking company, a co-operative bank or any other financial institution notified by the Central Government in this behalf, shall be reduced by the aggregate of the liabilities of all such banks and institutions to the banking company;

(e) the expression "Co-operative Bank" shall have the meaning assigned to it in clause (cci) of section 56.

(2) The Reserve Bank may, for the purpose of this section and section 24, specify from time to time, with reference to any transaction or class of transactions, that such transaction or transactions shall be regarded as liability in India of a banking company and, if any question arises as to whether any transaction or class of transaction shall be regarded for the purposes of this section and section 24 as liability in India of a banking Company, the decision of the Reserve Bank thereon shall be final.]

#### **19. Restriction on nature of subsidiary companies**

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

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

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

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

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



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

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

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