Indian Banking system

HISTORY OF BANKING SYSTEM IN INDIA

Evolution of Banking in India

- **Phase I** (Before 1947)
- **Phase II** (1947 - 1990)
- **Phase III** (1991 - Present)

Phase I: Pre-Independence (Before 1947)

Imperial Bank of India

> Presidency Banks established by the East India Company:

- Bank of Calcutta (1806)
- Bank of Bombay (1840)
- Bank of Madras (1843)

> Presidency Banks amalgamated into a single banking entity called Imperial Bank

> Imperial Bank founded on 27 January 1921

> Imperial Bank nationalized on 1 July 1955 and transformed into the State Bank of India.

Phase II: Post-Independence (1947 – 1990)

Pre-Nationalization Phase (1947 – 1968)

> Commercial banks catered to the needs of only the rich and the industrial class.

> Refinance Corporation for Industry Ltd. (RCI) was set up in 1958 to refinance banks for industrial lending. RCI later merged with IDBI.

> Banks were encouraged to forward credit to small-scale industries and agriculture.

> Agricultural Refinance Corporation (ARC) set up as a subsidiary of RBI in 1963 to promote credit in agriculture by refinancing.

Nationalization of Banks (1969 – 1990)

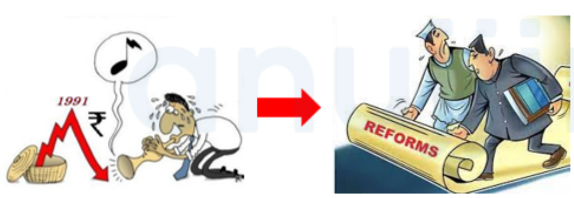
> In 1969, 14 major banks were purchased by the government and brought under its control.

> The reason behind this was to target inequality and poverty directly by state policy.

> 6 more commercial banks were nationalized in 1980.

Phase III: Liberalization (1991 – Present)

> The 1991 economic crisis in India, which resulted from a balance of payments deficit due to excess of imports, paved the way for the liberalization of the Indian economy.



💡 Two main committees formed in this regard, under the chairmanship of **M. Narasimham**, former RBI Governor:

1. Narasimhan Committee I (1991) (Committee on the Financial System – CFS).
2. Narasimhan Committee II (Committee on Banking Sector Reforms).

Narasimham Committee I (1991)

- **Committee on the Financial System – CFS:** Formed to recommend improvements in efficiency and productivity of financial systems

💡 **What were the major recommendations?**

> **Reduction in CRR and SLR:** CRR brought down to 3-5%, from 15%; and SLR brought down to 25% from 38.5%

> **Deregulation of Interest Rates** to make the structure of administered interest rates more simple and flexible

> **Phasing out Directed Credit Programmes** to improve profitability of banks

> **Establishment of Special Tribunals** to facilitate loan recovery and help banks get rid of bad debts – Debt Recovery Tribunal (DRT) established in 1993

> **Structural Reorganization of the Banking Sector** by reduction in the number of public sector banks through mergers and acquisitions to increase efficiency in banking operations

> **Elimination of Dual Control** of RBI and Ministry of Finance on banks by making RBI the primary agency for the regulation of the banking system.

Narasimham Committee II (1998)

- **Committee on Banking Sector Reforms:** For progress review of implementation of banking reforms since 1992

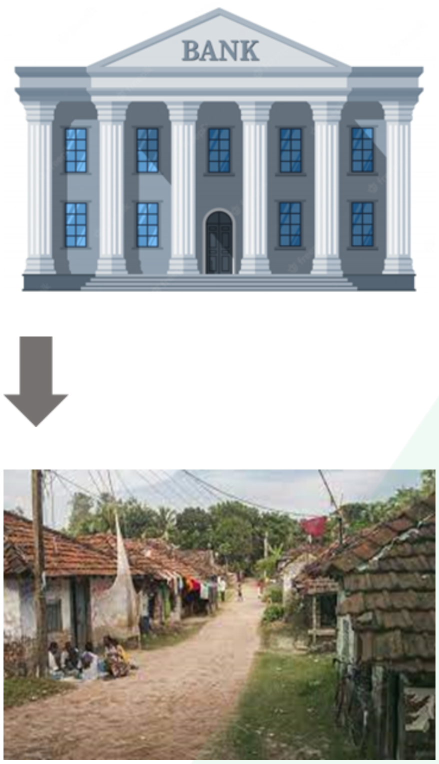
💡 **What were the major recommendations?**

> **Narrow Banking:** To facilitate rehabilitation of banks with high NPAs by allowing them to place their funds in short-term, risk-free assets.

Banks must bring down their **Non-performing Assets** to 3% by 2002.

Raise the **Capital Adequacy Ratio** to 9% by 2000 and 10% by 2002 and have penal provisions for banks that fail to meet these requirements.

Lead Bank Scheme



Launched by RBI in **December 1969** to mobilise deposits and step-up lending to weaker sections of the economy.

'Area Approach' recommended by **Gadgil Committee** to evolve plans and programmes for the development of an adequate banking and credit structure in the rural areas.

'Lead Bank' to act as a leader for coordinating the efforts of all credit institutions to increase the flow of credit to agriculture, small scale industries, and other areas.

💡 **Committees under LBS**

Block Level Bankers' Committee (BLBC)

> District Consultative Committee (DCC) & District Level Review Committee (DLRC)

> State Level Bankers' Committee (SLBC)

Important Committees

💡 Tandon Committee 1974

- Formed with the objective of framing guidelines for commercial banks for follow-up and supervision of bank credit for ensuring proper end-use of funds.

💡 Chore Committee 1979

- Formed under the chairmanship of Shri k. B Chore in order to review the cash credit system

💡 Khan Committee 1997

- Formed to examine the role and operations of Development Financial Institutions (DFIs)

💡 Bimal Jalan Committee 2013

- Formed to examine the criteria, business plans and corporate governance practices of applicants applying for new bank licenses.

STRUCTURE OF BANKING SYSTEM IN INDIA

Commercial Banks

> Commercial banks are institutions that accept deposits from the general public and advance loans with the purpose of earning profits.

> Commercial banks can be broadly categorised into public sector banks, private sector banks and foreign banks.

Cooperative Banks

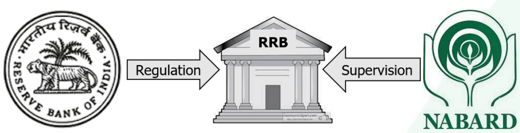
> A co-operative bank is a small-sized, financial entity, where its members are the owners and customers of the Bank.

> They play a vital role in mobilising deposits and purveying credit to people of small means.

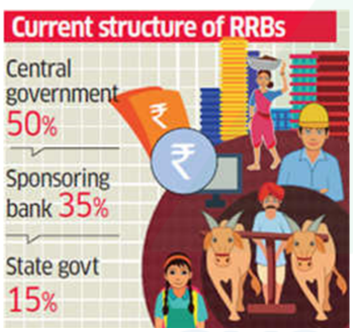
Regional Rural Banks

> **Hybrid banks** combining features of commercial banks and cooperative banks.n **1975** to enlarge institutional credit for the rural and agriculture sector.

> First RRB: **Prathama Bank** in UP; sponsored by Syndicate Bank.



Recapitalization of RRBs



> Recommended by Dr. K.C. Chakrabarty Committee in 2011 for strengthening CRAR of RRBs to 9% by March 2012

> 💡 **Shareholding pattern of RRBs – 50:35:15**

- GOI (50%)
- Sponsor Banks (35%)
- State Governments (15%)

Scheme for recapitalization of RRBs extended up to 2019-20.

Recapitalization plan of Rs.1340 crore approved in March 2020 to ensure liquidity in rural areas during the lockdown due to the COVID-19 crisis.

Non-banking Financial Institutions

All-India Financial Institutions

- AIFIs cater to the long-term financing needs of the industrial sector.
- AIFIs are regulated and supervised by RBI.

AIFIs

1.Export-Import Bank of India (EXIM Bank)

2.National Bank for Agriculture and Rural Development (NABARD)

3.National Housing Bank (NHB)

4.Small Industries Development Bank of India (SIDBI)

5.National Bank for Financing Infrastructure and Development (NaBFID)

National Bank for Financing Infrastructure and Development

- The NaBFID Act came into force w.e.f. April 19, 2021.
- NaBFID has been set up as a Development Financial Institution (DFI) to support the development of long-term infrastructure financing in India.

- NaBFID will commence its business operations in the first quarter of FY 2023-24.

💡 **Primary Dealers**

- RBI introduced the system of Primary Dealers (PDs) in 1995.
- PDs are registered entities with RBI, who have the license to purchase and sell government securities.

💡 **Non-banking Financial Companies**

- An NBFC is a company registered under the Companies Act, 1956 of India, engaged in the business of loans and advances, acquisition of shares, stock, bonds, hire-purchase insurance business or chit-fund business.

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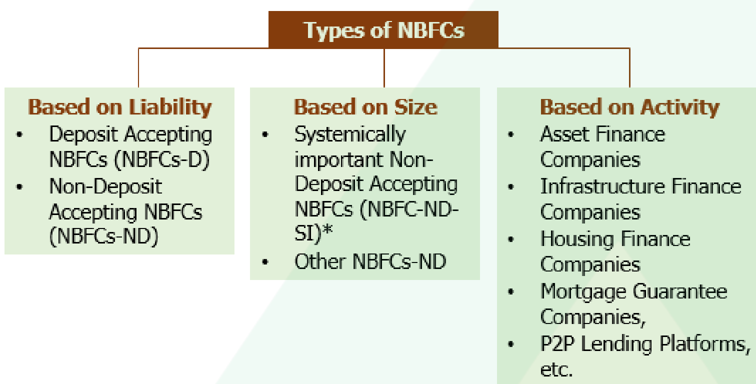
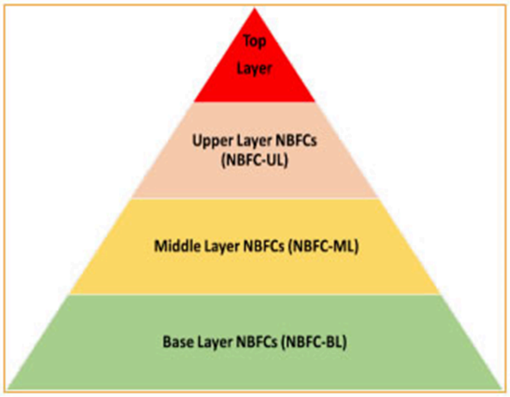
- They provide bank-like financial services but don't hold a banking license and are unregulated.

Companies engaged in the following activities are NBFCs	Companies engaged in the following activities are NOT NBFCs
Lending or financing for activities other than its own ✅	Agriculture activity ❌
Acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority ✅	Industrial activity ❌
Leasing or hire-purchase ✅	Purchase or sale of any goods (other than securities) ❌
Insurance business ✅	Sale/purchase/construction of immovable property ❌
Chit business ✅	
Collection of money ✅	
Acceptance of deposits ✅	



💡 An NBFCs-ND is categorized as **systemically important** (i.e., NBFC-ND-SI) if its asset size is **₹ 500 crore or more**.

scale based framework for NBFCs



Introduced by RBI in 2021

- Classification of NBFCs into 3 layers:
  - Base Layer (NBFC-BL)
  - Middle Layer (NBFC-ML)
  - Upper Layer (NBFC-UL)
  - Top Layer

💡 **Base Layer NBFCs**

NBFCs with assets of up to Rs. 1,000 crores.

NBFCs that require least regulatory intervention.

Consists of non-systemically important NBFCs (NBFC-ND), NBFC-P2P lending platforms, Type I NBFCs, etc.

💡 **Middle Layer NBFCs**

Consists of systemically important NBFCs (NBFC-ND-SI), deposit taking NBFCs (NBFC-D), housing finance companies, etc.

NBFCs that require stricter regulatory regime than base layer.

💡 **Upper Layer NBFCs**

> Consists of systemically significant NBFCs

> Common Equity Tier 1 (CET 1) capital could be introduced to enhance the quality of regulatory capital

💡 **Top Layer NBFCs**

> The top layer is currently empty

> NBFCs will be subject to higher capital charge, including capital conservation buffers

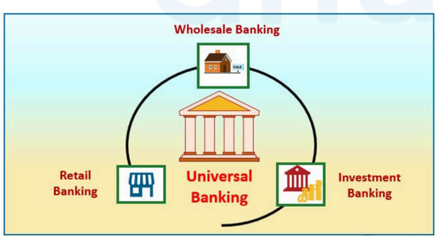
UNIVERSAL VS NICHE BANKING

💡 **Universal Banking**

> Universal banks are commercial banks which undertake multiple financial activities.

> The concept of 'Universal Banking' was implemented in India on the recommendations of the Khan Committee.

> ICICI Bank was the first financial institution in India, that adopted universal banking.



Niche or Differentiated Banking

| Licensed by RBI to provide specific banking services and products and to promote financial inclusion

| Offer a limited range of services / products or function

| Concept of ‘differentiated banking’ advocated by Nachiket Mor Committee in 2013

- Differentiated Banks
  - Payments Banks
  - Small Finance Banks

Small Finance Banks

| SFBs provide basic banking service of acceptance of deposits and lending.

| SFBs provide financial inclusion to weaker and marginalized sections of the economy.

| Individuals/professions with 10 years of experience in finance, NBFCs, micro finance companies, and local area banks are eligible to set up SFBs.

| Capital Small Finance Bank, founded in April 2016, is India's first small finance bank.

Payments Banks

| Payments banks cannot issue credit and can accept a restricted deposit, which is currently limited to ₹2,00,000 per customer.

| Payments banks can issue ATM cards or debit cards and provide online or mobile banking.

> Bharti Airtel set up India's first payments bank, Airtel Payments Bank, in 2017.

PRIORITY SECTOR LENDING

> Under PSL, RBI directs banks to dedicate funds for specific sectors of the economy.

> The goal of PSL is to provide credit to the weaker sections of the society.

> PSL guidelines are applicable to all Commercial Banks, Regional Rural Banks, Small Finance Banks, Local Area Banks, and Urban Co-operative Banks.

Priority Sectors

1. Agriculture
2. Micro, Small and Medium Enterprises
3. Export Credit (not applicable to RRBs and LABs)
4. Education
5. Housing
6. Social Infrastructure
7. Renewable Energy
8. Others

Agriculture

> Farm credit to individual farmers as well as corporate farmers, farmer producer organisations, companies of individual farmers, partnership firms and co-operatives of farmers engaged in agriculture and allied activities

> Agriculture infrastructure

> Ancillary services

Micro, Small and Medium Enterprises

- All bank loans to MSMEs conforming to RBI guidelines qualify for classification under PSL.

Export Credit

- Export Credit is not applicable to Regional Rural Banks and Local Area Banks.

- Export credit under agriculture and MSME sectors are allowed to be classified as PSL in the respective categories viz. agriculture and MSME.

Education

> Loans to individuals for educational purposes, including vocational courses, not exceeding ₹ 20 lakh will be considered as eligible for priority sector classification.

Housing

> Bank loans to individuals for purchase/ construction/ repairs of dwelling units as per limits prescribed below are eligible for priority sector classification.

Location	Purpose	Loan Amount	Overall Cost of Dwelling Unit
Metropolitan (population more than 10 lakh)	Purchase/ construction	Up to ₹ 35 lakh	Up to ₹ 45 lakh
	Repairs	Up to ₹ 10 lakh	
Other	Purchase/ construction	Up to ₹ 25 lakh	Up to ₹ 30 lakh
	Repairs	Up to ₹ 6 lakh	

Social Infrastructure

> Loans up to a limit of Rs 5 crore per borrower for setting up schools, drinking water facilities and sanitation facilities.

> Loans up to a limit of ₹10 crore per borrower for building health care facilities including under 'Ayushman Bharat' in Tier II to Tier VI centres.

Renewable Energy

> Bank loans up to a limit of ₹30 crore to borrowers for purposes like solar based power generators, biomass-based power generators, wind mills, micro-hydel plants and for non-conventional energy based public utilities.

> For individual households, the loan limit will be ₹10 lakh per borrower.

Weaker Sections

Priority sector loans to the following borrowers will be considered as lending under Weaker Sections category:

> Small and Marginal Farmers (SMFs)

> Artisans, village and cottage industries where individual credit limits do not exceed ₹1 lakh

> Beneficiaries under Government Sponsored Schemes such as National Rural Livelihood Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)

> Scheduled Castes and Scheduled Tribes

> Beneficiaries of Differential Rate of Interest (DRI) scheme

> Self Help Groups

> Distressed farmers indebted to non-institutional lenders

> Distressed persons other than farmers, with loan amount not exceeding ₹1 lakh per borrower to prepay their debt to non-institutional lenders

> Individual women beneficiaries up to ₹1 lakh per borrower (For UCBs, existing loans to women will continue to be classified under weaker sections till their maturity/repayment.)

> Persons with disabilities

> Minority communities as may be notified by Government of India from time to time.

PSL Targets for Banks

Note:

> ANBC = Adjusted Net Bank Credit; CEOBE = Credit Equivalent of Off-Balance Sheet Exposure

> PSL targets are a % of ANBC or CEOBE, whichever is higher

Domestic commercial banks & foreign banks with 20 branches and above	**40%**

Foreign banks with less than 20 branches	**40%**
Primary Urban Co-operative Banks	**40%**
Regional Rural Banks	**75%**
Small Finance Banks	**75%**

PSL Certificates

> PSLCs were introduced in 2016 to enable banks to achieve the PSL targets and sub-targets by purchase of these instruments in the event of shortfall.

> PSLCs have a standard lot size of ₹ 25 lakh and multiples thereof.

💡 **There are four kinds of PSLCs:**

- PSLC Agriculture
- PSLC SF/MF (Small and marginal farmers)
- PSLC Micro Enterprises
- PSLC General

On-lending to Priority Sectors

Banks → **NBFCs** → **Priority Sectors**

> On-lending means loans sanctioned by banks to eligible intermediaries for onward lending to priority sectors.

> Bank credit to NBFCs for on-lending is allowed up to an overall limit of 5% of an individual bank's total PSL in case of commercial banks.

Monitoring of PSL Targets

> PSL compliance of banks is monitored on 'quarterly' basis.

> Banks having any shortfall in PSL shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) and other funds with NABARD / NHB / SIDBI / MUDRA Ltd., as decided by RBI.

> All UCBs are required to contribute to RIDF and other funds with NABARD / NHB / SIDBI / MUDRA Ltd., against their PSL shortfall.

BASE RATE, MCLR, STERILIZATION

Base Rate & MCLR

💡 **Base Rate**

> Base rate is the minimum rate set by RBI below which banks are not allowed to lend to its customers.

> Base rate was implemented from 1 July 2010. It replaced the previous Benchmark Prime Lending Rate (BPLR).

💡 **Marginal Cost of Funds Based Landing Rate**

> MCLR is the minimum lending rate below which a bank is not permitted to lend.

> MCLR was implemented from 1 April 2016. It replaced the previous Base Rate.

💡 **The MCLR comprises –**

1.Marginal cost of funds

2.Negative carry on account of CRR

3.Operating costs

4.Tenor premium

Sterilization

> Sterilization is a form of monetary action in which RBI seeks to limit the effect of inflows and outflows of capital on the money supply.

> The main instrument of sterilization used by RBI is Open Market Operations (OMO).

> RBI conducts OMO for absorbing excess liquidity in the system through outright sale of securities.

FEOA, FIU, & CRILC

Fugitive Economic Offenders Act, 2018

> The FEOA empowers any special court (set up under the Prevention of Money Laundering Act, 2002) to confiscate all properties and assets of economic offenders.

💡 **An FEO is a person –**

> against whom an arrest warrant has been issued for committing any offence listed in the Schedule to the Fugitive Economic Offenders Bill, and the value of the offence is at least **Rs 100 crore**; and

> has left the country and refuses to return, in order to avoid facing prosecution.

Financial Intelligence Unit – India

> FIU-IND is an organisation set up under the Department of Revenue, Government of India.

> FIU-IND set up in November 2004 and reports directly to the Economic Intelligence Council (EIC).

> It collects financial intelligence about offences under the Prevention of Money Laundering Act, 2002.

Central Repository of Information on Large Credits

> CRILC was set up by RBI in 2014, to collect, store, and disseminate credit data to lenders.

> It helps banks and financial institutions to assess their NPAs and also share this information with other institutions.

> CRILC was created for early recognition of financial distress, enabling prompt action for resolution and fair recovery for lenders