BANKING & FINANCIAL INSTITUTIONS
BANKING SYSTEM
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SECOND SEMESTER

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Banking System

The term 'bank' is derived from the French word 'Banco' which means a Bench or Money exchange table. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging.

Banking System – Definitions

Banking systems refer to a structural network of institutions that provide financial services in a country. It deals with the ownership of banks, the structure of banking system, functions performed and the nature of business. The elements of the banking system include:

a) Commercial banks

b) Investment banks

c) Central bank.

The commercial banks accept deposits and lend loans and advances; the investment banks deal with capital market issues and trading; and the central bank regulates the banking system by setting monetary policies besides many other functions like currency issue. A banking system also refers a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolio throughout the day.

What is a Bank?

Oxford Dictionary defines a bank as "an establishment for custody of money, which it pays out on customer's order."According to Prof. Sayers, "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.

According to the Indian Banking Company Act 1949, "A banking company means any company which transacts the business of banking. Banking means accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other wise and withdrawable by cheque, draft or otherwise."This definition throws light on the three major functions of a bank. They are:

(i) Accepting of deposits and lending loans

(ii) Issue and pay cheques,

(iii) Collect cheques on behalf of the customers.

A bank is a financial institution that provides banking and other financial services to their customers. A bank is an institution which provides fundamental banking services such as accepting deposits and lending loans. As financial intermediaries, banks stand between depositors who supply capital and borrowers who demand capital. When banks accept deposits its liabilities increase and it becomes a debtor, but when it makes advances its assets increases and it becomes a creditor.

Banks are a subset of the financial services industry. The banks are the main participants of the financial system in India. All the banks safeguard the money and valuables and provide loans, credit, and payment services, such as money orders, and cheques. The banks also offer investment and insurance products. Due to the emergence of integration among finance industries, some of the traditional distinctions between banks, insurance companies and securities firms have diminished and they have converted themselves into Universal Banks to offer a variety of services under one umbrella.Example: IDBI Bank and ICICI. In spite of these changes, banks continue to maintain and perform their primary role—accepting deposits and lending funds from these deposits.

History of Modern Banking in India

Modern Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1770; both are now defunct. The oldest bank still in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955.

In April 1935, the Reserve Bank of India was established. At the time of first phase the progress of banking sector was very sluggish. Between 1913 and1948 there were around 1100 small banks in India. To reform the working and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.

After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in1960.

According to the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969, the objective and reasons for bank nationalization are: "The banking system touches the lives of millions and has to be inspired by large social purposes and has to sub-serve national.priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising of employment levels, encouragement of new entrepreneurs and the development of the backward areas. "For this purpose, it is necessary for the Government to take direct responsibility for the extension and diversification of banking services and for the working of the substantial part of the banking system."On 19th July, 1969, 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to20. Seven more banks were nationalized with deposits over 200 Crores. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. Till the year1980 approximately 80% of the banking segment in India was under government's ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and hence, the gateways for the new private sector banks were opened.

The following are the major steps taken by the Government of India to Regulate Banking institutions in the country:-

➢➢ 1949: Enactment of Banking Regulation Act.

➢➢ 1955:Nationalization of State Bank of India.

➢➢ 1959: Nationalization of SBI subsidiaries.

➢➢ 1961: Insurance cover extended to deposits.

➢➢ 1969:Nationalisation of 14 major Banks.

➢➢ 1971: Creation of Credit Guarantee Corporation.

➢➢ 1975: Creation of Regional Rural Banks.

➢➢ 1980:Nationalisation of seven banks with deposits over 200 Crores.

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalisation, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank (earlier as UTI Bank), ICIC bank and HDFC bank.

Functions of Banks

The functions of commercial banks can be broadly categorized into

a) Primary functions

b) Secondary functions.

Primary Functions

Following are the primary functions rendered by banks.

Accepting of Deposits

The primary function of commercial banks is to accept money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. For these deposits, the banks pay a rate of interest, which is called as interest expenditure. Thus, banks act as a custodian of depositors' funds. **The deposits may be of various types such as savings deposits, current deposits, fixed deposits and recurring deposits.**

Savings deposits encourage customers to save money and promote banking habit among the public. Savings Bank accounts provide a low rate of interest and they have restrictions on the number of withdrawals by the customers.

Current Deposit accounts are opened by business people. These accounts have no restrictions on the number of withdrawals and are subject to service changes. There is no interest payment but current account holders can also avail the benefits such as overdraft and cash credit facilities.

Fixed deposits accounts can be opened by any person who wants to deposit a lump sum funds at one time for a specific time period. These accounts provide higher rate of interest depending on the time period for which it is deposited. These accounts do not allow withdrawal before the expiry of the period.

Recurring deposit accounts are normally opened and operated by persons who get regular income such as salary class and petty shop owners. A specific amount of money is deposited periodically, say, monthly for a specific period, say, one year. These accounts provide higher rate of interest and do not allow withdrawal before the expiry of the period.

Lending Loans and Advances

The second primary function of commerce bank is to lend loans and advances to the corporate sector and households. Normally, the rate of interest levied on these loans and advances is higher than what it pays on deposits. The interest income is the major source of income for commercial banks. The difference in the interest rates (Interest Received and Interest Paid) is called Interest Spread, which contributes to its profitability. Apart from leading, the banks usually keep some portion of funds to meet the demands of depositors and running expenses. The various types of loans and advances include overdraft, cash credit, loans, discounting of bills of exchange.

Over Draft (OD) is a facility extended by banks to the current account holders who maintain their accounts for business purposes. In this facility, the current account holders can withdraw more money fromtheir accounts than what they maintain as balance. Under this facility, banks honour the cheques drawn by the customers of the current account even if sufficient money is not available in their account. This overdrawing limit will be fixed by the banks for a certain period, based on the credit quality of the current account holders and their history of dealing with the bank. The amount overdrawn will be considered as loan and interest will be charged on the actual amount withdrawn.

Cash Credit (CC) is a facility extended by banks to current account holders and other who do not have account. In this facility, banks sanction a credit limit to a borrower for a certain period (usually for a longer period than overdraft) after verifying the credit worthiness, history of bank dealings and the track record of business. Normally banks expect security of tangible assets (such as stock of inventory) and/or guarantees for sanction cash credit facility. Interest will be charged on the portion of amount withdrawn from the cash credit account but not on the entire amount sanctioned to the borrower.

Loans are normally sanctioned for a short term period (say one year) or medium term (say three to five years). At present, banks lend long term loans also. Repayment of loan will be made in various installments (say monthly, quarterly, semiannually, annually) over a specific period of time or in a lump sum. Banks charge interest on the actual amount of loan sanctioned and rate of interest is somewhat lower than what is charged on OD or CC facility. Regarding the collateral (security), banks expect some tangible assets (like stock of raw materials, finished goods) from the borrower. There are various types of loans such as secured loans, mortgage loans, educational loans, personal loans, etc. Examples for secured loans include two wheeler loans to the individuals, working capital loans to the business firms, etc. Mortgage loans are given to the borrowers to purchase immovable tangible assets such as land, buildings, homes, etc. with a lien/charge on the asset which will serve as collateral. At present, majority of the banks are granting home loans to the customers. Educational loans for higher studies and professional courses are given by banks to the students at a reasonable rate of interest. Personal Loans (Consumer finance) for individuals are provided on easy terms and conditions to buy consumer durables like T.V, refrigerators etc.

Discounting of Bill of Exchange is another method of granting advances to the traders. The banks can advance funds by purchasing or discounting the bills from traders which arise from trade. Trade bills are those bills which emerge due to credit sale to customers. If the traders require money before the expiry of the bills, they can discount the bills with the banks. The banker will pay an amount to the drawer or beneficiary of the bill (usually trader who sold goods on credit basis to customers) after deducting the discount amount. On maturity of the bill, the banker will receive the amount from the drawee or acceptor of the bill (the customer who bought goods on credit terms).

Secondary Functions

Following are the secondary functions performed by the banksBesides the primary functions of accepting deposits and lending loans and advances, banks perform various other functions, which are called secondary functions. They include agency functions and utility functions.

Agency Functions

The banks act as agent of their customers and perform a number of agency functions which include transfer of funds, collection of cheques, periodic payment, periodic collections, portfolio management and other agency functions.Transfer of Funds is made by banks from one branch to another or from one place to another for customers. At present, banks use technology and telecommunication systems to facilitate these transfers. Example: Electronic fund transfers (EFT). For this service, banks collect service charges. Collection of Cheques is facilitated by banks through clearing section. Thus, the cheques deposited or presented for collection are credited to the customers' account once they collect the same through clearing process. This includes the cheques of the same bank or other banks and within the station and outstation. For providing this service, they charge collection charges which are very nominal.Periodic Payments such as payment of public utility bills, rent, interest, etc. are made by banks on behalf of the customers based on their standing instructions. A specific example: Payment of housing loan interest from salary account.Periodic Collections such as receipt of salary, pension, dividend, interest, rent, etc. are made by banks on behalf of the customers based on their standing instructions. A specific example: Receipt of dividend from investments.

Portfolio Management services are offered by banks to guide the customers or clients on their investment decisions to buy or sell the securities (shares and debentures) to achieve optimal portfolio for getting maximum returns. Other Agency Functions like acting as trustee, administrator, adviser, executor, etc. on behalf of the customer or client are provided by banks.

General Utility Functions/Financial Services

The banks performs general utility functions such as issue of drafts,letter of credits, locker facility, underwriting of shares, dealing in foreign exchange, project counseling, social responsibility programmes and other utility functions. Issue of Drafts, Traveller Cheques and Letter of Credits are done by banks for facilitating the transfer of money from one place to another and for giving guarantee for import trade. Travellers'cheques is also issued by banks.

Safety Locker Facility is provided to customers for safe keeping their valuables such as documents, gold, silver articles and other values. Underwriting of Shares and debentures are done by banks in

the capacity of merchant banker through their subsidiaries. In the case of client's capital issue fails in the market, the banks assume the risk of under subscription by underwriting the issue. For this, banks receive underwriting commissions.

Dealing in Foreign Exchange can be undertaken by banks as they are allowed by RBI. They will act as deal makers or traders depending on their position. Project Reports are being prepared on behalf of the clients or customers. Many corporate which take up projects and look for financial assistance have to prepare project reports for submitting the same to the Financial Institutions or Banks. This project report preparation requires expertise personnel which the banks possess. Banks collect consultancy charges from their clients or customers.Social Responsibility Programmes such as public welfare campaigns, adult literacy programmes, maintenance of schools, parts, blood donation camps, etc. are undertaken by banks to showcase their social responsibility.

Other Utility Functions may include any other function the bank may render for customers. Examples include collecting and supplying business information, acting as a referee to a financial standing of customers, etc.

Types of Banks

Banks can be classified into various types based on some criteria like organizational setup, ownership, functions performed by them. The factors which affected the classification include

a) The regulatory set up prevailing in a country

b) The impact of LPG (Liberalization, Globalization Privatization) process

c) The need for various financial services among the customers. With the changing perspectives of trade and commerce, banking and financial system in India has undergone tremendous changes in the recent past. In this section, we will learn as how to classify the banks based on various criteria such as organizational set up, ownership and functions performed by bank.

Types of Banks

The following figure explains the various types of banks based on structure, ownership and function.

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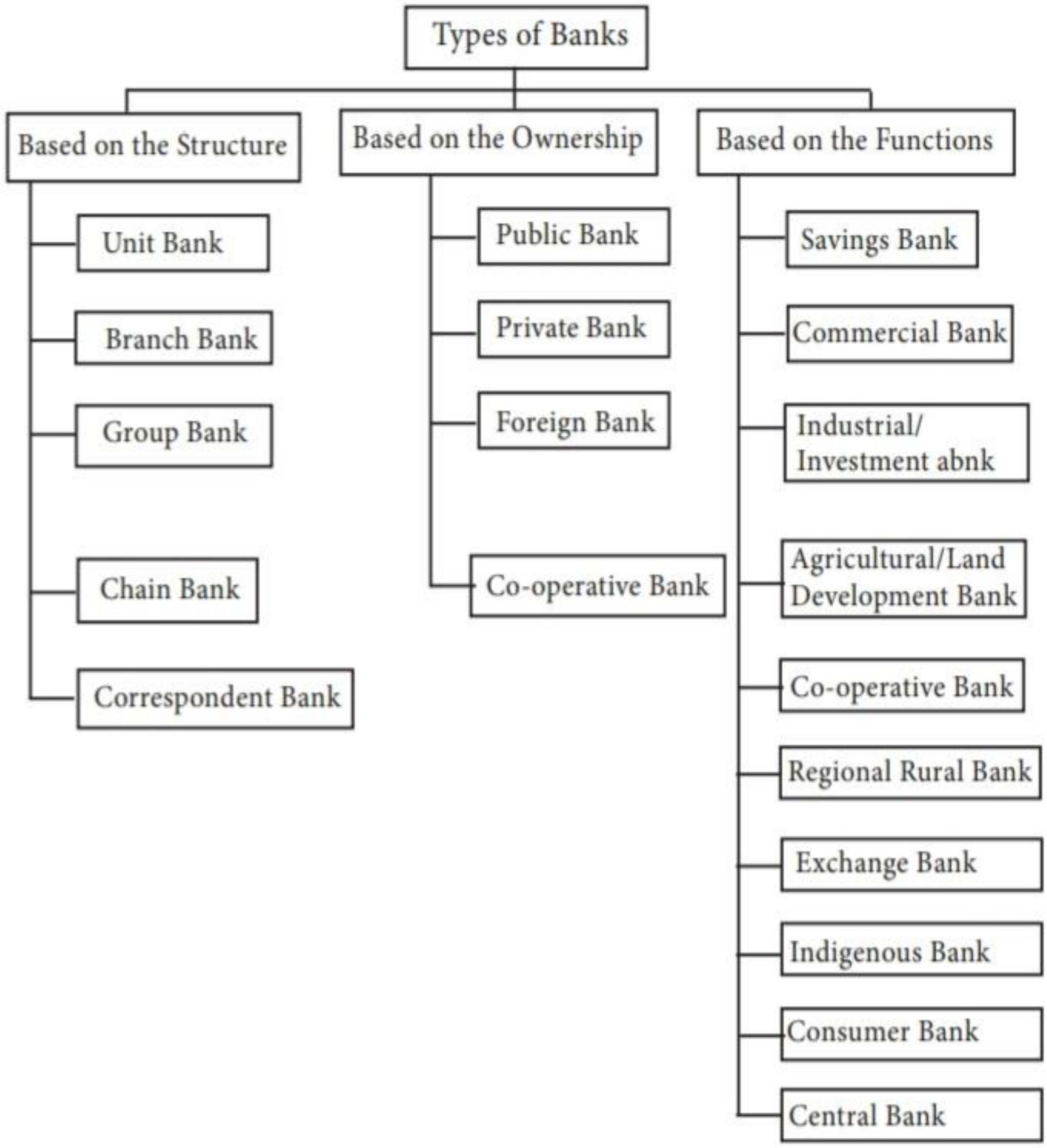

Figure showing the Types of Banks

Let us now discuss the meaning of each one of them.

Based on the Structure or Organizational Setup Banks can be of five types based on the structure or organizational setup, viz., unit bank, branch bank, group bank, chain bank and correspondent bank.

1) Unit Bank is a type of bank under which the banking operations are carried by a single branch with a single office and they limit their operations to a limited area. Normally, unit banks may not have any branch or it may have one or two branches. This unit banking system has its origin in United State of America (USA) and each unit bank has its own shareholders and board of management. In USA, each State may have many unit banks but each unit bank limits its operation within the State or country.

There may be many central banks and they control the unit banks operating in their States. Collectively the central banks are called Federal Reserve Banks.

2) Branch Bank is a type of banking system under which the banking operations are carried with the help of branch network and the branches are controlled by the Head Office of the bank through their zonal or regional offices. Each branch of a bank will be managed by a responsible person called branch manager who will be assisted by the officers, clerks and sub-staff. In England and India, this type of branch banking system is in practice. In India, State Bank of India (SBI) is the biggest public sector bank with a very wide network of 16000 branches.

3) Group Bank is a system of banking under which there will be holding company controlling the subsidiary companies which carry out banking business. In some cases, both the holding and subsidiary companies may carry out banking business. An apt example in India is SBI which has many subsidiary banks such as State Bank of Mysore, State Bank of Indore, State Bank of Hyderabad, State Bank of Bikaner and Jaipur, State Bank of Patiala and State Bank of Travancore. These subsidiaries carry out banking and other operations such as leasing, merchant banking and so on.

4) Chain Bank is a system under which different banks come under a common control through common shareholders or by the inter-locking of directors. An apt example in India is KarurVysya Bank and Lakshmi Vilas Bank having their head offices located in the same place, viz., Karur and sharing common directors by which they may have common management policy.

5) Correspondent Bank is a bank which link two banks of different stature or size. Many Indian banks act as correspondent bank for many foreign banks.

Based on the Ownership

Banks can be of four types based on the ownership. They are public sector banks, private sector banks, foreign banks and cooperative banks.

1) Public Sector Banks are those banks in which majority stake (i.e., more than 50% of the shares) is held by the government of the country. The words such as “The” or “Ltd” will not be found in their names because the ownership of these banks are with the government and the liability is unlimited in nature. Some examples of public sector banks in India include Andhra Bank, Canara Bank, Union Bank of India, Allahabad Bank, Punjab National Bank, Corporation Bank, Indian Bank and so on.

2) Private Sector Banks are those banks which are owned by group of private shareholders. They elect board of directors which manages the affairs of the banks. Some examples of private banks in India include The Lakshmi Vilas Bank Ltd., The Karur Vysya Bank Ltd., The City Union Bank Ltd., HDFC Bank, Axis Bank and son.

3) Foreign Banks are those banks which belong to foreign countries and have their incorporated head office in foreign countries and branch offices in other countries. The share capital of the foreign banks will be fully contributed by the foreign investors. Some examples of foreign banks in Indian include ABM Amro bank, Standard Chartered Bank, JP Morgan Chase Bank and so on.

4) Cooperative Banks are those banks which are run by following cooperative principles of service motive. Their main motive is not profit making but to help the weaker sections of the society. Some examples of cooperative banks in India include Central Cooperative Banks, State Cooperative Banks.

Based on the Functions

Banks can be of various types based on the functions they perform. They include savings banks, commercial banks, industrial banks, agricultural development banks, land mortgage/development banks, cooperative banks, exchange banks, indigenous banks, consumer banks, central bank.

1) Saving Banks are established to encourage savings habit among the people. There are no separate banks called savings banks but postal department perform the functions of savings bank. People can save even very small amount in these banks and these banks discourage withdrawals by limiting the number of withdrawals during a year. The amount collected from the customers is invested in securities such as bonds, government securities, etc. The main objective of these banks is to promote thrift and savings among the people. People who prefer these banks include salaried people and low income groups. At present, in India all the commercial banksact as savings banks besides providing various other services.

2) Commercial Banks are established to help the people who carry out trade and commerce, i.e., businessmen. They mobilize deposits from public and lend short-term loans to businessmen in the form of overdrafts, cash credit, etc for their commercial activities. As the commercial activities are of paramount importance to economic development, the commercial banks play a key role in promoting commercial activities in the country. Normally they do not provide long-term loans but provide short to medium term loans to traders for their working capital needs. Apart from lending, they also provide a host of services such as cheque collection, discounting bills of exchange, facilitating money transfer, etc. These commercial banks are subject to Reserve Bank of India's regulation.

3) Industrial Banks / Investment Banks are those banks which provide long term loans to industries for the purpose of expansion and modernization. They raise capital by issue of shares and debentures and provide long term loans to industries. These banks are also responsible for the development of backward areas for which they promote industries in those places. In India, examples for industrial banks include Industrial Finance Corporation of India (IFCI), earlier Industrial Credit and Investment Corporation of India (ICICI- Now universal bank) and earlier Industrial Development Bank of India (IDBI-now universal bank).

Investment bank is a financial and banking organization, which provides both financial as well as advisory banking services to their clients. Besides this, they also deal with research, marketing and sales of a range of financial products like commodities, currency, credit, equities etc. As investment banks, they contribute to share capital and/or takepart in capital issue management for promoting the companies by underwriting their issues and facilitate public to buy those shares. The industrial activities are promoted by these banks and they also mobilize long term deposits. In India, Bank of America, JP Morgan and BNP Paribas are some of the leading investment banks.

4) Agricultural/Land Development Banks are those banks which are known as Land Mortgage or Agricultural Banks as they provide finance to agricultural sector. They provide long term loan for

agriculture for the purposes of purchase of new land, purchase of heavy agricultural machinery such as tractor, repayment of old debt, conservation of soil and reclamation of loans. In India, Government of India has guaranteed the debentures issued by agricultural/land development banks. In Tamil Nadu, we have Tamil Nadu Cooperative Land Development bank. They follow the principles of cooperative banks and help the weaker sections. Commercial banks do not take active part as they view agricultural financing as risky one and hence, Agricultural Development Banks play a key role in this activity.

5) Co-operative Banks are those banks which are registered under the Cooperative Societies Act 1912. These banks collect share capital from the public and lend to economically weaker sections. They provide financial assistance to farmers, salaried class, small scale industries, etc. They can be found in rural and urban areas and the functions are similar to commercial banks except that they charge less interest for the loans and advances.

6) Regional Rural Banks are those banks which are established by the Government under the Regional Rural Banks Act of 1976 with a specific purpose to provide credit and other facilities to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in rural areas. Each RRB operates within the specified local areas.

7) Exchange Banks are also called as foreign exchange banks and they are incorporated outside the country but carry out business in India. They provide foreign exchange subject to the rules and regulations of the country in which they are operating. They also provide finance to exporters and letter of credit/guarantee toimporters. They help in remitting of funds from one country to another country, discount foreign bills, buy and sell gold silver, promote foreign trade. Examples of exchange bank include Bank of America, Hong Kong Bank, etc.

8) Indigenous Banks refer to money lenders and Sahukars. The money lenders using their own funds and deposits mobilized from public, grant loans to the needy people. They are more popular in villages and small towns. Usually, they act as traders and bankers simultaneously. In India, we have well known Indian communities such as Marwaries, Multani run their indigenous banks.

9) Consumers Banks operate only in advanced countries like USA and Germany. The primary objective of these banks is to provide loans to customers to purchase consumer durables like Car, TV, Washing Machine, Furniture, etc. The consumers repay the loans in easy installments.

10) Central / Federal / National Bank is a leader of all the banks in a country. Every county has a central bank. The prime responsibility of a Central Bank is to regulate the banking system and control mon-etary policy. These banks are called as banker to the bankers as they give financial accommodation to commercial banks. They are non-profit making institutions and they also act as banker to the gov-ernment, issue currency notes, etc. They maintain foreign exchange reserves of the country and all the government accounts are main-tained with them. They help in money circulation in the economy and provide financial accommodation to the government in case of necessity through purchase of treasury bills in the money market. In India, Reserve Bank of India, in USA, Federal Reserve (a group of central banks), in UK, Bank of England are the central bank.

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