BANKING REGULATIONS

OBJECTIVES OF RBI

⇒ The Reserve Bank of India (RBI) was constituted under the Reserve Bank of India Act, 1934 and started functioning with effect from April 1, 1935.

Year	Event
1934	**The British enacted the Reserve Bank of India Act**
1935	**Reserve Bank of India was established on 1st of April in Calcutta**
1937	**Reserve Bank of India was permanently moved to Mumbai**
1949	**Got nationalized after independence. The bank was held by private stakeholders before this.**

⇒ RBI is the oldest among the central banks operating in developing countries, though it is much younger than the **Bank of England and the Federal Reserve operating as the central banks in developed countries viz. UK and USA** respectively.

⇒ The **Governor and four Deputy Governors of RBI are appointed by the Union Government**. The control of the RBI vests in the Central

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Board of Directors, that comprises the Governor, four Deputy Governors and 12 Directors nominated by the Union Government and 4 others - one each from local board.

⇒ The RBI's internal management is based on functional specialization and coordination amongst about various departments, with headquarters at Mumbai, which is the financial capital of the country.

The chief objectives of the RBI are to **sustain the confidence of the public in the system, protect the interests of the depositors, and offer cost-effective banking services** like cooperative banking and commercial banking to the people.

The main objectives of RBI:

a) To maintain monetary stability such that the business and economic life of the country can deliver the welfare gains of a mixed economy.
b) To maintain financial stability and ensure sound financial institutions so that the economic units can conduct their business with confidence.
c) To maintain stable payment systems, so that the financial transactions can be safely and efficiently executed.
d) To ensure that credit allocation by the financial system broadly reflects the national economic priorities and social concerns

e) To regulate the overall volume of money and credit in the economy to ensure a reasonable degree of price stability.
f) To promote the development of financial markets and systems to enable itself to operate/regulate efficiently.

ROLE AND FUNCTIONS OF RBI

I. Monetary Authority
II. Issuer of Currency
III. Banker and Debt Manager to Government
IV. Banker to Banks
V. Regulator of the Banking System
VI. Manager of Foreign Exchange
VII. Maintaining Financial Stability
VIII. Regulator and Supervisor of the Payment and Settlement Systems
IX. Developmental Role

Monetary Authority

⇒ Monetary policy refers to the **use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit.**

⇒ The goal of a monetary policy is to achieve specific economic objectives, such as low and stable inflation and promoting growth. The main objectives of monetary policy in India are:

a) Maintaining price stability

b) Ensuring adequate flow of credit to the productive sectors of the economy to support economic growth
c) Financial stability

⇒ This means that RBI monitors and analyses the movement of a number of indicators including **interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows and fiscal position**, along with trends in output based on policy perspectives.

DIRECT INSTRUMENTS

(a) ***Cash Reserve Ratio (CRR):*** It is the **percentage of deposits that a bank has to keep as reserves** with the RBI.

- When the Government increases CRR, the bank has to keep a larger percentage of its deposits as reserves. It has lesser funds available to lend. It's capacity to lend decreases. Hence, the money supply also decreases. (CRR ↑ ⇒ money supply ↓).

Penalty for non-maintenance of CRR

(i) In case of default in maintenance of CRR requirement on a daily basis which is presently 95 per cent of the total CRR requirement, penal interest will be levied for that day **at the rate of three per cent per annum above the Bank Rate on** the amount by which the amount actually maintained falls short of the prescribed minimum on that day and if the shortfall continues on the next succeeding day/s, penal interest will be recovered at the **rate of five per cent per annum above the Bank Rate.**

(ii) In cases of default in maintenance of CRR on average basis during a fortnight, penal interest will be levied as envisaged in sub-section

(3) of Section 42 of Reserve Bank of India Act, 1934.

Scheduled Commercial Banks are required to furnish the particulars such as date, amount, percentage, reason for default in maintenance of requisite CRR and also action taken to avoid recurrence of such default.

(b) Statutory Liquidity Ratio (SLR): It is the percentage of deposits that a bank has to invest in risk-free assets such as cash, gold, or Government securities.

- When the Government increases SLR, the bank has to keep a larger percentage of its deposits in cash, gold, and Government securities. It has a lesser amount to lend to consumers and businesses. Hence, the money supply decreases. (SLR ↑ ⇒ money supply ↓).

Penalties

If a banking company fails to maintain the required amount of SLR, it shall be liable to pay to RBI in respect of that default, the penal interest for that day at the **rate of three per cent per annum above the Bank Rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate**

of five per cent per annum above the Bank Rate for the number of days of default on the shortfall.

Refinance facilities: Sector-specific refinance facilities are provided to banks.

INDIRECT INSTRUMENTS

Liquidity Adjustment Facility (LAF): Consists of daily infusion or absorption of liquidity on a repurchase basis, through repo (liquidity injection) and reverse repo (liquidity absorption) auction operations, using government securities as collateral.

Under LAF-Repo rate, Banks can borrow from RBI at the Repo-rate by pledging government securities over and above the statutory liquidity requirements.

Repo/Reverse Repo Rate: A reverse repo is a rate at which banks keep their excess funds with the RBI against the collateral of Government securities on an overnight basis.

- If the reverse-repo rate increases, banks find it more profitable to keep their funds with RBI. Hence, lending activities decline (Reverse repo rate ↑ ⇒ money supply ↓).

Open Market Operations (OMO): It is the buying and selling of Government securities by the RBI.

- If the RBI has to increase the money supply, it purchases government securities from the market. If the RBI has to decrease the money supply, it sells Government securities in the market.

- **Marginal Standing Facility (MSF):** This is a mechanism by which Commercial banks can borrow from the RBI against Government securities for emergency needs on an overnight basis. Thus, it is similar to the Liquidity Adjustment Facility (LAF).
- It is used by the banks when they need additional funds, and they cannot use LAF as they do not have Government securities to keep as collateral.
- In this, **banks can sell Government security from their SLR quota also.**
- The MSF rate is always higher than the Repo rate. There is a limit to the borrowings under MSF. Banks can borrow up to 1 % of their deposits under this facility. (MSF rate $\uparrow \Rightarrow$ money supply $\downarrow$).

Market Stabilisation Scheme (MSS)

- Under MSS, if there is an excess money supply in the economy, RBI intervenes by selling Government securities (like Treasury Bills, Cash Management Bills & Dated securities.).
- This helps to withdraw the excess liquidity from the system. But, unlike OMO, the money raised through the selling of securities is kept in a separate account known as an MSS account.
- The amount kept in the MSS account is only used for the redemption of securities issued under the MSS.

Issuer of Currency

- The Reserve Bank of India is responsible for providing the public with a sufficient supply of currency notes and coins.
- The quality of currency notes and coins is also taken care of by the RBI.
- RBI is in charge of issuing and exchanging of currency and coins.
- Also, the destruction of currency and coins that are not fit for circulation.
- Coins in circulation at present are in denominations of 50 paise, 1, 2, 5 and 10 Rupee, and Notes in circulation are in denominations of 7 5, 10, 20, 50, 100, 500 and 2000.

Banker and Debt Manager to Government

- As a banker to the central government, the Reserve Bank maintains Government's accounts, receives money into and makes payments out of these accounts and facilitates the transfer of government funds.
- By Statute RBI is banker to Central Government and it also acts as the banker to those state governments that have entered into an agreement with it.

The role as banker and debt manager to government:

a) Undertaking banking transactions for the central and state governments to facilitate receipts and payments and maintaining their accounts.

b) Managing the governments' domestic debt with the objective of raising the required amount of public debt in a cost-effective and timely manner.

c) Developing the market for government securities to enable the government to raise debt at a reasonable cost, provide benchmarks for raising resources by other entities and facilitate transmission of monetary policy actions.

d) At the end of each day, the electronic system automatically consolidates all of the government's transactions to determine the net final position. If the balance in the government's account shows a negative position RBI extends a short-term, interest-bearing advance, called a Ways and Means Advance- WMA-the limit or amount for which is set at the beginning of each financial year in April.

Banker to Banks

All banks maintain account with RBI to facilitate transfer of funds and settle interbank transactions such as borrowing from and lending to other banks and customer transactions.

As the banker to banks RBI focuses on:

a) Enabling smooth, swift and seamless clearing and settlement of inter-bank obligations.
b) Providing an efficient means of funds transfer for banks.
c) Enabling banks to maintain their accounts with it for purpose of statutory reserve requirements.
d) Acting as lender of the last resort.

Lender of the last resort: The Reserve Bank provides liquidity to banks which are unable to raise short- term liquid resources from the inter-bank market. Like other central banks, the Reserve Bank considers this as a critical function because it protects the interests of depositors, which in turn, has a stabilizing impact on the financial system and on the economy as a whole.

Regulator of the Banking System

As the regulator and supervisor of the banking system, the Reserve Bank **protects the interests of depositors, ensures a framework for orderly development and conduct of banking operations conducive to customer interests and maintains overall financial stability** through preventive and corrective measures.

Different departments of the Reserve Bank oversee the various entities that comprise India's financial infrastructure. RBI oversees:

a) Commercial banks and all-India development financial institutions
b) Urban co-operative banks
c) Regional Rural Banks (RRBs), District Central Co-operative Banks and State Co-operative Banks
d) Non-Banking Financial Companies (NBFCs)
e) Small Finance Banks and Payment Banks

RBIs Regulatory Role:

- As the nation's Banking regulator, the Reserve Bank performs various functions such as **licensing, prescribing capital requirements, monitoring governance, setting prudential regulations to ensure solvency and liquidity of the banks, prescribing lending to certain priority sectors of the economy, regulating interest rates in specific areas, setting appropriate regulatory norms related to income recognition, asset classification, provisioning, investment valuation, exposure limits,** etc.
- To achieve this objective, the Reserve Bank makes use of several supervisory tools, they are on-site inspections, off-site surveillance, making use of required reporting by the regulated entities and thematic inspections, scrutiny and periodic meetings.

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Corporate Governance

- The Reserve Bank's policy objective is to ensure high-quality corporate governance in banks. It has issued **guidelines stipulating 'fit and proper criteria for directors of banks.**
- In terms of the guidelines, **a majority of the directors of banks are required to have special knowledge or practical experience in various relevant areas.** The Reserve Bank also has powers to appoint additional directors on the board of a banking company.

Manager of Foreign Exchange

- The Reserve Bank is responsible for administration of the Foreign Exchange Management Act, 1999 and it regulates the market by **issuing licences to banks and other select institutions to act as Authorised Dealers in foreign exchange.**
- The Reserve Bank plays a key role in the regulation and development of the foreign exchange market and assumes three broad roles relating to foreign exchange:

a) Regulating transactions related to the **external sector and facilitating the development of the foreign exchange market.**

b) Ensuring **smooth conduct and orderly conditions in the domestic foreign exchange market.**

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c) Managing the foreign currency assets and gold reserves of the country. The Foreign Exchange Department (FED) is responsible for the regulation and development of the market.

Regulator and Supervisor of Payment and Settlement Systems

The Payment and Settlement Systems Act of 2007 (PSS Act) gives the **Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country**. Payment and settlement systems play an important role in improving overall economic efficiency.

- They consist of all the diverse arrangements that RBI uses to **systematically transfer money through-currency, paper instruments such as cheques and various electronic channels.**

Various systems used are as under:

(a) Retail payment systems: Facilitating cheque clearing, electronic funds trans-fer, through National Electronic Funds Transfer (NEFT), settlement of card payments and bulk payments, such as electronic clearing services. Operated through local clearing houses throughout the country.

(b) Large value systems: Facilitating settlement of inter-bank transactions from financial markets.

These include: Real Time Gross Settlement System (RTGS) for funds transfers, Securities Settlement System for the government securities market, Foreign Exchange Clearing: for transactions involving foreign currency.

Maintaining Financial Stability

In 2009, the Reserve Bank set up a **dedicated Financial Stability Unit mainly to, put in place a system of continuous monitoring of the macro financial system.**

The department's role and activity includes:

a) Conduct of macro-prudential surveillance of the financial system on an ongoing basis
b) Developing models for assessing financial stability in going forward
c) Preparation of half yearly financial stability reports
d) Development of a database of key variables which could impact financial stability, in co-ordination with the supervisory wings of the Reserve Bank
e) Development of a time series of a core set of financial indicators
f) Conduct of systemic stress tests to assess resilience

Developmental Role

- Development role of RBI includes ensuring **credit availability to the productive sectors of the economy, establishing institutions designed to build the country's financial infrastructure, expanding access to affordable financial services and promoting financial education and literacy.**

- Some of the institutions established by the RBI include:

a) Deposit Insurance and Credit Guarantee Corporation (1962), to provide protection to bank depositors and guarantee cover to credit facilities extended to certain categories of small borrowers.

b) Unit Trust of India (1964), the first mutual fund of the country

c) Industrial Development Bank of India (1964), a development finance institution for industry

d) National Bank for Agriculture and Rural Development (1982), for promoting rural and agricultural credit

e) Discount and Finance House of India (1988), a money market intermediary and a primary dealer in government securities

f) National Housing Bank (1989), an apex financial institution for promoting and regulating housing finance

g) Securities and Trading Corporation of India (1994), a primary dealer.

Setting up of a New Bank

- The Banking Regulation Act, 1949 requires a **company or entity to obtain a license from the Reserve Bank of India to start the business of banking in India**.
- Before granting a license under Section 22, Reserve Bank may have to be satisfied by an inspection of the books of the banking company in respect of the following aspects:

a) Whether the company is or will be able to pay its present and future depositors in full as and when their claims accrue
b) Whether the affairs of the company are being conducted or likely to be conducted in a manner detrimental to the interests of its present and future depositors
c) Whether the company has an adequate capital structure and earning prospects.
d) Whether public interest will be served by grant of license to the company

e) Other issues relating to branch expansion, unbanked area and other aspects.

- In respect of foreign banks, (which are incorporated outside India), application for a license to the Reserve Bank of India to open banks/branches in India

BRANCH LICENSING

- **The opening of branches by banks is governed by the provisions of Section 23 of the Banking Regulation Act, 1949**.
- In terms of these provisions, RBI issues Branch Authorisation policy **from time-to-time Banks have to refer to these guidelines of the Reserve Bank for opening of branches and administrative offices, change of premises, shifting of branches to other locations**, etc.

REGULATORY RESTRICTIONS ON LENDING

There are certain regulatory restrictions on lending by banks in terms of RBI directives or the Banking Regulation Act, 1949 (BRA) as follows:

a) No advance or loan can be granted against the security of the bank's own shares or partly paid shares of a company.
b) No bank can hold shares in a company:
   I. As pledgee or mortgagee in excess of the limit of 30 per cent of the Paid-up capital of that company or 30 per cent of the Bank's Paid-

up capital and Reserves, whichever is less (Section 19(it) of the Banking Regulation Act).

II. In the management of which Managing Director or Manager of the Bank is interested (Section 19(iii) of the Banking Regulation Act).

c) Bank's aggregate investment in shares, Certificate of Deposits (CDs), bonds, etc., should not exceed the limit of 40 per cent of Bank's net owned funds as at the end of the previous year.

d) No bank shall grant loans against (a) CDs (b) Indian Depository Receipts.

e) Banks shall desist from sanctioning loans against FDs issued by other banks.

f) **Banks shall adhere to the RBI guidelines relating to the level of credit, margin and interest rate etc**. for loans against the security of commodities covered by the Selective Credit Control Directives of RBI. No loan shall be granted by banks to:

- The Bank's directors or firms in which a director is interested as a partner/manager/employee/ guarantor (certain exemptions allowed).
- Relatives of other bank's directors ('relatives' defined by RBI)- Such loans can be sanctioned by higher authorities or the Bank's Board as per RBI guidelines.

g) **No additional facilities should be granted by any bank/FI to the listed wilful defaulters**. In addition, the entrepreneurs/promoters of companies where banks/FIs have identified siphoning/diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance from the scheduled commercial banks.

INCLUSION OF URBAN COOPERATIVE BANKS IN THE SECOND SCHEDULE TO THE RESERVE BANK OF INDIA ACT, 1934

- As per the government's notification, with effect from April 01, 2013, only those primary co-operative banks whose demand and time liabilities are not less than Rs 750 crore would be treated as a 'financial institution' for the purpose of inclusion of UCBs in the Second Schedule of the Reserve Bank of India Act, 1934.

GUIDELINES ON CREDIT FLOW TO WOMEN

- RBI has stated that the strategy for increasing women's access to the formal financial sector should be a long-term goal with flexibility to adapt to local needs and situations.

The following action points are required to be taken up by banks in order to reach potential women entrepreneurs and encourage them to avail credit and credit plus services from banks:

1) *Redefining of Banks' policies / Long term plans*

⇒ Banks should redefine its policies by taking into account women's requirements in a focused and integrated manner.

⇒ Banks should have a Charter for women which must be published. They should prepare long term plans and within that area plans with a view to outreach credit to women. **To start with, banks should earmark at least 2 per cent of their net bank credit for women and raise it to 5 per cent in 5 years' time.**

⇒ Banks must ensure that the benefits under various poverty alleviation and employment promotion schemes go to the women in the prescribed ratio.

2) Setting Up Women Development Cells

⇒ Women development cells should be set up at the banks' head office as well as in their regional offices where information, counselling/guidance and other credit related services for women entrepreneurs are readily available.

⇒ The cell at the head office should **function under the Executive Director of the Bank**.

⇒ The cell should preferably be **handled by women officers/staff and act as data collecting centre for information about women entrepreneurs and for monitoring the status of applications received and extent of credit disbursed**. The cell should also disseminate information to women entrepreneurs about various credit related schemes and facilities available with the bank particularly for self-employment.

⇒ Banks should have a target for covering at least 20 women per branch for lending and 20 for training.

3) *Simplification of procedural formalities*

⇒ Banks should ensure that the managerial staff assist women entrepreneurs in understanding the banks' procedural formalities in a simple manner.

⇒ They should also give assistance in the preparation of project reports and completion of other paper work.

4) *Orientation of Bank officers/staff on gender concerns/credit requirements of women*

⇒ Banks should also organize workshops of two-three days duration for its branch managers/staff on different aspects of handling credit requirements of women.

⇒ Banks should also invite members of Non-Government Organisations (NGOs) or women social workers to these workshops for active interaction so that the problems being faced by the women entrepreneurs could be better understood by bank staff in an informal manner.

5) *Publicity campaign for creating awareness about credit facilities*

⇒ Banks should launch Awareness Programmes/Publicity Campaigns about schemes available for women. **Attractive publicity material such as posters, charts, can be specially designed in a simple manner so that women are able to understand it easily**.

⇒ For the large numbers of illiterate and semi-literate women, particularly in the rural and semi-urban areas, the banks should make efforts to inform them **through audio-visual methods/slides and charts about the different schemes under which finance is available.**

⇒ Banks should interact with schools/colleges/universities for publicizing schemes and programmes for women.

⇒ In the present computer age, banks should make **use of creating web-sites through which wider publicity could be given about various schemes/ credit facilities available with the bank for women entrepreneurs**. This would help all sections of the society to have easy access to such information particularly the young, educated urban women who are using computers.

6) *Entrepreneurship Development Programmes/ Training facilities for Women*

⇒ Banks should finance training courses for women, particularly in the area of information technology.

⇒ There is a need for more training institutes particularly in the rural areas to cater to the training requirements/skill upgradation of rural women.

⇒ During school/college vacations banks should involve teachers/students in training programmes for women.

⇒ Government organizations should give preference to purchase of goods made by women entrepreneurs.

7) Specialised branches for Women

⇒ Over the next one year, at least one specialized branch for women would be opened in every district of the country. RBI will proportionally allocate the numbers of such branches to be opened by each bank.

8) Motivational strategies to enthuse bank officials/staff

⇒ Banks should use motivational strategies to enthuse their managers/staff to achieve targets for women. Their work in this area should be given appropriate recognition.

⇒ Banks can give annual awards to the 3 best performing branches in achieving targets plus providing credit related services to women.

9) *Monitoring system*

⇒ A monitoring system **should be in place for submitting regular reports on the credit flow to women.** It should be an item on the calendar for Review being submitted to the Board of Directors of the bank.

⇒ RBI should also monitor and give suitable directions to banks from time to time.

10) *Data collection*

⇒ Separate data about credit flow to women is not presently available.

⇒ **Data should be generated by banks and quarterly reports submitted to RBI who should process the information and create a separate data base for women.**

⇒ Data for women should be collected separately for amounts advanced through micro-credit, credit to small scale industries and credit to medium/large industries.

11) *Strengthening of existing schemes*

⇒ There should be greater interaction between NABARD/SIDBI and banks. Existing schemes and programmes being implemented by them should be further strengthened both in terms of coverage as well as volume of credit. Other facilities offered under these schemes e.g., **Training/orientation should also get more attention.**

⇒ There is no direct alliance between SIDBI and banks. SIDBI should explore the possibility of having a tie-up with banks for women's schemes.

12) *Increasing the limit for issue of loans waiving the collateral security*

⇒ Banks should therefore implement the recent measures taken by Government/RBI for increasing the limit for issue of loans without insisting on collateral security from the requirement of issue of loans without collateral from Rs. 1 lakh to 5 lakh. Banks may also consider whether loans beyond & 5 lakhs i.e., at least upto & 10 lakhs could be offered without collateral.

13) *Involving NGOs/SHGs/Women's Cooperatives*

⇒ A large number of well-known NGOs are operating throughout the country. In many areas smaller NGOs are also working at the grass roots level. **Banks can establish contacts with the local NGOs and liaise with them to identify the needs of women and give credit related information and guidance services.**

⇒ Financial institutions viz. NABARD and SIDBI are already involving the Women's self-help groups for reaching out to women entrepreneurs.

14) Mahila Rural Co-operative Banks

⇒ Mahila Rural Cooperative Banks on the lines of Mahila Urban Cooperative banks should be set up for assisting women in the semi-urban and rural areas. RBI may issue licenses for such banks liberally.