



Legal & Regulatory Aspects of Banking

4th
Edition



INDIAN INSTITUTE OF BANKING & FINANCE



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LEGAL®ULATORY ASPECTS OF BANKING



INDIAN INSTITUTE OF BANKING & FINANCE

Kohinoor City, Commercial-II, Tower-1, 2nd & 3rd Floor,
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Established on 30th April 1928

VISION

- To be the premier Institute for developing and nurturing competent professionals in banking and finance field.

MISSION

- To develop professionally qualified and competent bankers and finance professionals primarily through a process of education, training, examination, consultancy/counselling and continuing professional development programs.

OBJECTIVES

- To facilitate study of theory and practice of banking and finance.
- To test and certify attainment of competence in the profession of banking and finance.
- To collect, analyse and provide information needed by professionals in banking and finance.

- To promote continuous professional development.
- To promote and undertake research relating to Operations, Products, Instruments, Processes, etc., in banking and finance and to encourage innovation and creativity among finance professionals so that they could face competition and succeed.

COMMITTED TO PROFESSIONAL EXCELLENCE

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LEGAL®ULATORY ASPECTS OF BANKING

(For JAIIB/Diploma in Banking & Finance
Examination)

4th Edition



Indian Institute of Banking & Finance





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FOREWORD

The Banking and Financial Sector has seen a paradigm shift in the last decade and the winds of change will continue to shape the future of this sector. To keep pace with the changes and to grow professionally, continuous learning is a sine qua non.

Tomorrow belongs to those who prepare for it today.

The capacity to learn is a gift,

The ability to learn is a skill,

The willingness to learn is a choice.

— Brian Herbert

The Mission of the Indian Institute of Banking & Finance is to develop professionally qualified and competent bankers and finance executives primarily through a process of education, training, examination, counseling and continuing professional development programs. In line with the Mission, the Institute has been offering a bouquet of courses and examinations for capacity building of the banking personnel. These courses are contemporary and supported by appropriate e-learning and recorded video lectures making the distance learning wholesome.

The flagship courses/examinations offered by the Institute are the JAIIB, CAIIB and the Diploma in Banking & Finance (DB&F).

The courses on JAIIB/DB&F continue to have three subjects namely;

1. Principles & Practices of Banking
2. Accounting & Finance for Bankers
3. Legal & Regulatory Aspects of Banking

The Institute publishes dedicated courseware for every paper/subject it offers. The Institute is committed to revise and update the syllabus and courseware, for each one of its examinations from time to time, to ensure that the course

content/coverage is appropriate and provides the latest inputs to the candidates and bankers appearing for its examinations.

Given that the courseware cannot be published every half year, the Institute has the practice of keeping the candidates informed about the latest developments by placing important updates/Master Circulars/Master Directions on its website and through publications like IIBF Vision, Bank Quest, etc. Yet, the rapid changes that have happened in the last few years have necessitated updating of the courseware.

The courseware on Legal & Regulatory Aspects of Banking has now been updated. It follows the same modular approach adopted by the Institute in the earlier editions/publications. The book should, however, not be considered as the only source of information / reading material while preparing for the examination due to rapid changes witnessed in all the areas affecting banking & finance. The students have to keep themselves abreast with the current developments by referring to economic dailies, articles, books and government publications / websites etc. Questions will be based on the recent developments related to the syllabus but may not have appeared in the book.

The courseware has been updated with the help of Subject Matter Experts (SMEs) drawn from the field and vetted by practitioners to ensure accuracy and correctness. The Institute acknowledges with gratitude the valuable services rendered by the SMEs in updating/vetting the courseware.

We welcome suggestions for improvement of the courseware.

Mumbai
2021

(Biswa Ketan Das)
Chief Executive Officer

RECOMMENDED READING

The Institute has prepared comprehensive courseware in the form of study kits to facilitate preparation for the examination without intervention of the teacher. An attempt has been made to cover fully the syllabus prescribed for each module/subject and the presentation of topics may not always be in the same sequence as given in the syllabus.

Candidates are also expected to take note of all the latest developments relating to the subject covered in the syllabus by referring to Financial Papers, Economic Journals, Latest Books and Publications in the subjects concerned.

PAPER 3 – LEGAL & REGULATORY ASPECTS OF BANKING

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Legal Framework of Regulation of Banks

Business of Banking; Constitution of Banks; RBI Act, 1934; Banking Regulation Act, 1949; Role of RBI; Govt. as a Regulator of Banks; Control over Cooperative Banks; Regulation by other Authorities.

Control Over Organization of Banks

Licensing of Banking Companies; Branch Licensing; Paid up Capital and Reserves; Shareholding in Banking Companies; Subsidiaries of Banking Companies; Board of Directors; Chairman of Banking Company; Appointment of Additional Directors; Restrictions on Employment; Control over Management; Corporate Governance; Directors and Corporate Governance.

Regulation of Banking Business

Power of RBI to Issue Directions; Acceptance of Deposits; Nomination; Loans and Advances; Regulation of Interest Rate; Regulation of Payment Systems; Internet Banking Guidelines; Regulation of Money Market Instruments; Banking Ombudsman; Reserve Funds; Maintenance of CRR, SLR; Assets in India.

Returns Inspection, Winding up, Mergers & Acquisitions

Annual Accounts & Balance Sheet; Audit & Auditors; Submission of Returns; Preservation of Records and Return of Paid Instruments; Inspection and Scrutiny; Board for Financial Supervision; Acquisition of Undertakings; Amalgamation of Banks; Winding up of Banks; Penalties for offences.

Public Sector Banks and Cooperative Banks

SBI and its Subsidiaries; Regional Rural Banks; Nationalized Banks;

Application of BR Act to Public Sector Banks; Disinvestment of Shares by Govt.; Cooperative Banks

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Need, Approach for Financial Sector Legislative Reforms; Important Reforms

Recent Legislative Changes in RBI Act

Recent Legislative Changes in RBI Act, Need thereof

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Types of Borrowers; Limited Liability Partnership

Types of Credit Facilities

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Secured and Unsecured Loans, Registration of Firms and Incorporation of Companies

Definition of Secured and Unsecured loans; Need for Secured Loans; Registration of Firms; Consequences of Non-registration of Firms; Incorporation of a Company

Indemnities

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Bank Guarantees

Definition and Types of Bank Guarantees; Banker's Duty to Honour Guarantee; Precautions to be taken for Issuance of Bank Guarantee; Precautions to be taken for Payment under Bank Guarantee; Invocation & Enforcement

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General Considerations of Letters of credit; Parties to a Letter of credit; Types of Letters of credit; Documents under a Letter of credit; UCPDC 600; Banks obligation for payment of Letter of credit

Deferred Payment Guarantees

Purpose of DPGs; Methods of Payment

Laws Relating to Bill Finance

Class of Bills and Laws Governing Bills; Classification of Bills; Categories of Bill Finance; Bill Finance and Legal Position of Banker

Various Types of Securities

Types of Securities; Escrow Arrangements; Trust and Retention Arrangements.

Laws Relating to Securities and Modes of Charging I

Mortgage; Types of Mortgage; Enforcement of Mortgages

Laws Relating to Securities and Modes of Charging II

Lien; Pledge; Hypothecation; etc.

Registration and Satisfaction of Charges

Definition of Charge; Procedure for Registration of Charge; Effect of Non-registration of Charges; Provisions of Law relating to Registration of Charges

Case Laws on Responsibility of Paying Bank

Negotiable Instruments Act and Paying Banks; Liability of Paying Banker; Payment in due course; Payment in Good Faith; Whether Payment under Mistake Recoverable

Case Laws on Responsibility of Collecting Bank

Statutory protection to Collecting Bank; Duties of Collecting Bank

MODULE C – BANKING RELATED LAWS

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Objective of the Act, Constitution of Tribunal, Procedure to be followed,

Enforcement process

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Constitutional Validity; Definitions; Regulation & Reconstruction; Enforcement of Security Interest; Central Registry; Offences & Penalties; Miscellaneous Provisions

Banking Ombudsmen Scheme

Purpose; Extent; Definitions; Establishment; Powers; Procedure for Redressal Grievance

Bankers Books Evidence Act, 1891

Applicability; Definition; Important Provisions

The Legal Services Authorities Act, 1987

Lok Adalats- Organisation; Jurisdiction; Disposal of Cases; Awards

The Consumer Protection Act, 1986 and CERSAI

Preamble, Extent & Definitions; Consumer Protection Councils; Consumer Disputes Redressal Agencies; Objectives and important provisions of Central Registry of Securitisation Asset Reconstruction and Security Interest of India

The Law of Limitation

Definition; Computation of Limitation; Important Provisions in schedule to the Limitation Act

Tax Laws

Income Tax; Commodity Transaction Tax; Goods and Services Tax

Negotiable Instruments Act, 1881

Applicability; Definition; Important Provisions

Payment & Settlements Systems Act, 2007

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The Sale of Goods Act, 1930

Features; Sale & Agreement to Sell; Conditions and Warranties; Express & Implied; Rights of Unpaid Seller

Indian Partnership Act, 1932

Definition & Types of Partnerships; Relation of partners to one another & to third Parties; Minor admitted to benefits of partnership; Dissolution of a firm; Effect of non registration; Limited liability partnerships-formation, registration, rights and liabilities of partners

Definition and Features of a Company

Definition & Features of a Company; Distinction between Company and Partnership

The Companies Act, 1956 (now Companies Act, 2013)

Definition, Features & Types of companies; Memorandum and Articles of Association; Doctrine of Ultra Vires, Constructive Notice, Indoor Management; Membership of Company Acquisition, Cessation, Register, Rights & Duties of Members, Prospectus; Directors; Winding up of Companies

Foreign Exchange Management Act, 1999

Important Terms; Powers of RBI, Regulation and Management; Directorate of Enforcement

Transfer of Property Act, 1882

Sale, Mortgage of Immovable Property; Types of Mortgages; Sale with and without court intervention; Lease of Immovable Property

The Right to Information Act, 2005

Applicability; Definition; Important Provisions

Right To Information and Obligation of Public Authorities

Obligations; Procedure; Disposal; Appeal; Orders; Penalties

The Prevention of Money Laundering Act, 2002

Obligations; Records to be Maintained; Procedure for Maintaining & Furnishing Information; Maintenance & Verifications of Records of Identity of Clients

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MODULE A

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UNIT 1

LEGAL FRAMEWORK OF REGULATION OF BANKS

STRUCTURE

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.0 OBJECTIVES

The objectives of this unit are to understand:

- the definition and nature of the business of banking;
- the constitution of different types of banks;
- the regulatory scheme of the RBI Act and the BR Act;
- the role of the Reserve Bank and the Central Government as regulators and
- the special position of public sector banks and co-operative banks.

.1 INTRODUCTION

Banking in India is mainly governed by the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The Reserve Bank of India and the Government of India exercise control over banks from the opening of banks to their winding up by virtue of the powers conferred under these statutes.

All the regulatory provisions are not uniformly applicable to all banks. The applicability of the provisions of these Acts to a bank depends on its constitution; that is, whether it is a statutory corporation, a banking company or a co-operative society. In this unit, we look at the definition of banking, the constitution of different types of banks and applicability of regulatory laws, the general framework of the regulatory laws and the role of regulators namely, the Reserve Bank of India and the government.

.2 BUSINESS OF BANKING

Definition of Banking: Banking is defined in Section 5(b) of the Banking i. Regulation Act as the acceptance of deposits of money from the public for the purpose of lending or investment. Such deposits may be repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. Thus, a bank must perform two essential functions: (a) acceptance of deposits from the public and (b) lending or investment of such deposits. The deposits may be repayable on demand or for a period of

time as agreed by the banker and the customer. In terms of the definition, the banker can accept deposits of money and not anything else. Further, accepting deposits from the public implies that a banker accepts deposits from anyone who offers money for such purpose. However, a banker can refuse to open account for undesirable persons and further, the opening of accounts is subject to certain conditions like proper identification and compliance with KYC norms.

The “Know Your Customer” guidelines issued by the Reserve Bank require banks to follow certain customer identification procedure for opening of accounts for protecting the banks from frauds, etc., and also for monitoring transactions of a suspicious nature for the purpose of reporting to appropriate authorities for taking anti-money laundering measures and combating financing of terrorism.

- Deposits Withdrawable by Cheque: Under Section 49A of the Banking Regulation Act, no organisation other than a bank is authorised to accept deposits withdrawable by cheque. The Savings Bank Scheme run by the government, a Primary credit society and any other person or firm notified by the government are exempted from this prohibition.
- iii. Acceptance of Deposits by Non-banking Entities: There are also non-banking companies, firms and other unincorporated associations of persons and individuals who accept deposits from the public. Acceptance of deposits by non-banking financial companies is regulated by the Reserve Bank under the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and other directions issued by it under Chapter IIIB of the Reserve Bank of India Act.

- Licence for Banking: In India, it is necessary to have a licence from the Reserve Bank under Section 22 of the Banking Regulation Act for commencing or carrying on the business of banking. Every banking company has to use the word “bank” as part of its name (vide, Section 7 of the Act) and no company other than a banking company can use the words “bank”, “banker”, banking as part of its name. Further, no firm, individual or group of individuals is permitted to use the words “bank”, banking or banking company as a part of the name or for the purpose of business. Subsidiaries of banks and association of banks in certain cases, as also Primary Credit Societies are exempted from this restriction.

Permitted Business: Although, traditionally, the main business of banks is v. acceptance of deposits and lending, the banks have now spread their wings far and wide into many allied and even unrelated activities. The forms of business permissible under Section 6(1) of the Banking Regulation Act, apart from banking business, are summarised below:

- (a) (i) Borrowing, raising or taking up of money;
- (ii) Lending or advancing of money either against security or security;
- (iii) Drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupon bills of lading, railway receipts, warrants, debentures, certificates and other instruments and securities whether transferable or not;
- (iv) Granting and issuing of letters of credit, travellers' cheques and notes;
- (v) Buying, selling and dealing in bullion and specie;
- (vi) Buying and selling of foreign exchange including foreign bank notes;
- (vii) Acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, other securities and investments of all kinds;
- (viii) Purchasing and selling of bonds, scrips and other forms of securities on behalf of constituents or others;
- (ix) Negotiating of loans and advances;
- (x) Receiving of all kinds of bonds, scrips or valuables on deposit or in custody or otherwise;
- (xi) Providing of safe deposit vaults and
- (xii) Collecting and transmitting of money and securities
- (b) Acting as an agent of the government, local authority or any other person and carrying on agency business.
- (c) Contracting for public and private loans and negotiating and issuing

same.

- (d) Insure, guarantee, underwrite, participate in managing and carrying any issue of state, municipal or other loans or of shares, stock, debenture or debenture stock of companies and lend money for the purpose of such issue.
- (e) Carry on and transact every kind of guarantee and indemnity business
- (f) Manage, sell and realise any property which may come into its possession in satisfaction of any of its claims.
- (g) Acquire, hold and deal with any property or any right, title or interest in any such property which may form the security for any loan or advance
- (h) Undertake and execute trusts.
- (i) Undertake the administration of estates as executor, trustee or otherwise
- (j) Establish, support and aid associations, institutions, funds, trusts, etc. for the benefit of its present or ex-employees; grant money for charitable purposes.
- (k) Acquire, construct and maintain any building for its own purpose.
- (l) Sell, improve, manage, develop, exchange, lease, mortgage, dispose of or turn into account or otherwise deal with all or any part of the business of any person or company, when such business is of a nature described in Section 6.
- (m) Acquire and undertake the whole or any part of the business of any person or company, when such business is of a nature described in Section 6.
- (n) Do all such things which are incidental or conducive to the promotion and advancement of the business of the company.
- (o) Do any other business specified by the Central Government as the lawful business of a banking company. The Central Government has accordingly specified leasing and factoring as permissible businesses for banks.

Prohibited Business: Section 8 of the Banking Regulation Act prohibits a

vi. banking company from engaging directly or indirectly in trading activities and undertaking trading risks. Buying or selling or bartering of goods directly or indirectly is prohibited. However, this is without prejudice to the business permitted under Section 6(1) of the Act. Accordingly, a bank can realise the securities given to it or held by it for a loan, if need arises for the realisation of the amount lent. It can also buy or sell or barter for others in connection with: (a) bills of exchange received for collection or negotiation and (b) undertaking the administration of estates as executor, trustee etc. Goods for the purpose of this Section means every kind of moveable property, other than actionable claims, stocks, shares, money, bullion and specie and all instruments referred to in Clause (a) of sub-Section (1) of Section 6.

As regards immovable properties, Section 9 prohibits a banking company from holding such property, howsoever acquired, except as is required for its own use, for a period exceeding seven years from the acquisition of the property. The Reserve Bank may extend this period by another five years, if it is satisfied that such extension would be in the interest of the depositors of the banking company. The banking company shall be required to dispose of such property within the permitted period.

.3 CONSTITUTION OF BANKS

Banks in India fall under one of the following categories:

i.

- (a) Body corporate constituted under a special statute;
- (b) Company registered under the Companies Act, 1956 (Companies 2013) or a foreign company;
- (c) Co-operative society registered under a central or state enactment or operative societies.

Public Sector Banks: The public sector banks including nationalised ii. banks, State Bank of India and its associates (subsidiaries) and the Regional Rural Banks fall in the first category. By the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 the Central Government nationalised (took over the business undertakings) of certain banking companies and vested them in newly created statutory bodies (corresponding new banks) constituted under Section 3 of the 1970/1980 Act. The State Bank of India was constituted under the State Bank of India Act, 1955 and the six associate/subsidiary banks were constituted under the State Bank (Subsidiary Banks) Act, 1959 or other statutes (See Para 5.2.6 of Unit 5). All the associates/subsidiaries now stand merged with parent bank i.e. State Bank of India. The regional rural banks are constituted under the Regional Rural Banks Act, 1976. These banks are governed by the statutes creating them as also some of the provisions of the Banking Regulation Act and the Reserve Bank of India Act. The details are discussed in Unit 5.

- iii. Banking Companies: A banking company, as defined in Section 5(c) of the Banking Regulation Act is a company which transacts the business of banking. Such company may be a company constituted under Section 3 of the Companies Act, 1956 or incorporated under the Companies Act, 2013 or a foreign company within the meaning of Section 591 (u/s 379 of Companies Act, 2013) of that Act. All the private sector banks are banking companies. These banks are governed by the Companies Act, 1956 or Companies Act 2013 in respect of their constitution and by the Banking Regulation Act and the RBI Act with regard to their business of banking.

Banking company under PMLA means a banking company or a co-operative bank to which the Banking Regulation Act, 1949 applies and includes any bank or banking institution referred to in section 51 of that Act. Banking Company includes:

- (a) All nationalized banks, private Indian banks and private foreign bank
- (b) All co-operative banks viz. primary co-operative banks, state operative banks and central co-operative banks
- (c) State Bank of India (All subsidiaries merged with SBI)
- (d) Regional Rural Banks.
- (e) Differentiated Banks

Co-operative Banks: A co-operative bank is a co-operative society iv. registered or deemed to have been registered under any Central Act for the time being in force relating to the multi-state cooperative societies, or any other central or state law relating to co-operative societies for the time being in force. If a co-operative bank is operating in more than one state, the Central Act applies. In other cases, the state laws apply. The Banking Laws (Application to Co-operative Societies) Act, 1965 extended certain provisions of the Banking Regulation Act and the Reserve Bank of India Act to the co-operative banking sector. After the Supreme Court held in Apex Co-operative Bank's case (AIR 2004 SC 141) that multi-state co-operative societies cannot be licensed as co-operative banks, the Banking Regulation (Amendment) and Miscellaneous Provisions Act, 2004 was enacted to permit licensing of multi-state co-operative banks. A multi-state co-operative bank under this Act means a multi-state co-operative society which is a primary co-operative bank.

.4 RESERVE BANK OF INDIA ACT, 1934

The Reserve Bank of India Act, 1934 was enacted to constitute the i. Reserve Bank of India: (i) to regulate the issue of bank notes, (ii) for keeping reserves for securing monetary stability in India and (iii) to operate the currency and credit system of the country to its advantage. The Act came into force on 6th March 1934. The Act has been amended from time to time to meet the demands of changing times.

The Act deals with the constitution, powers and functions of the Reserve ii. Bank. It does not directly deal with regulation of the banking system except for Section 42, which provides for cash reserves of scheduled banks to be kept with the Reserve Bank, with a view to regulating the credit system and ensuring monetary stability. Further, Section 18 of the Act provides for direct discount of bills of exchange and promissory notes when a special occasion arises, making it necessary or expedient for the purpose of regulating credit in the interests of trade, industry and agriculture. The Act, in short, deals with:

(a) incorporation, capital, management and business of the bank;

- (b) the central banking functions like issue of bank notes, monetary con acting as banker to government and banks, lender of last resort;
- (c) collection and furnishing of credit information;
- (d) acceptance of deposits by non-banking financial institutions;
- (e) general provisions regarding reserve fund, credit funds, publicatio bank rate, audit and accounts and
- (f) penalties for violation of the provisions of the Act or the directions is thereunder.

.5 BANKING REGULATION ACT, 1949

- The Banking Regulation Act, 1949 was enacted to consolidate and amend
- i. the law relating to banking and to provide for a suitable framework for regulating the banking companies. Initially, the Act provided for regulation of banking companies only, but in 1965 the Act was amended to cover co-operative banks as well with certain modifications (see Section 56). However, the Act, as provided in Section 3, does not apply to primary agricultural credit societies and co-operative land mortgage banks. The provisions of the Act are applicable to banking companies in addition to other laws which are applicable to such companies, unless otherwise specifically provided in the Act. Thus, Companies Act, 1956/2013, which deals with the incorporation and working of companies, is applicable to banking companies except where special provisions are made in the Banking Regulation Act in that regard. The last amendments to Banking Regulation Act, 1949 were effected in 2012 (enacted on 10.01.2013) and Banking Regulation (Amendment) Act, 2017 on 25.08.2017. by inserting two new sections viz. 35AA and 35AB authorizing the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016. The former amendment has been superseded by the latter amendment in 2017.

The Act regulates entry into banking business by licensing as provided in ii. Section 22 thereof. The Act also puts restrictions on the shareholding, directorship, voting rights and other aspects of banking companies. There are several provisions in the Act regulating the business of banking such as restriction on loans and advances, rates of interest to be charged, requirement as to cash reserve and maintenance of percentage of assets, etc. There are provisions regarding audit and inspection and submission of balance sheets and accounts. The Act provides for control over the management of banking companies and also deals with the procedure for winding up of the business of the banks and penalties for violation of its provisions. In short, the Act deals with:

- (a) regulation over business of banking companies;
- (b) control over the management of banking companies;
- (c) suspension and winding up of banking business and
- (d) penalties for violation of the provisions of the Act.

iii. The Amending Act (2012) has introduced the setting up of a Depositor Education and Awareness Fund to take over inoperative deposit account(s) which have not been claimed or operated for a period of ten years or more, within a period of three months from the expiry of the said period of ten years.

1.6 RESERVE BANK AS A CENTRAL BANK AND REGULATOR OF BANKS

i. The Reserve Bank was constituted under Section 3 of the Reserve Bank of India Act, 1934 for taking over the management of currency from the Central Government and carrying on the business of banking in accordance with the provisions of the Act. Originally, under the RBI Act, the Bank had the responsibility of:

- (a) regulating the issue of bank notes;
- (b) keeping of reserves for ensuring monetary stability and
- (c) generally, to operate the currency and credit system of the country to the advantage.

The Reserve Bank is a body corporate having perpetual succession and
ii. common seal and shall sue and be sued in its name. The whole capital of the bank is held by the Central Government. The Bank has its central office in Mumbai and offices in Mumbai, Kolkata, Delhi and Chennai, and branches at most of the state capitals and some other cities.

The Reserve Bank functions under the general superintendence and
iii. directions of the Central Board of Directors. The bank has to abide by the directions given by the Central Government in public interest after consultation with the Governor of the bank. The board shall consist of a Governor and not more than four Deputy Governors to be appointed by Central Government and other directors nominated by the Central Government. Apart from the Central Board, the bank has also local boards situated at Mumbai, Kolkata, Delhi and Chennai, which perform any duty delegated to them by the Central Board. The Governor has the power of general superintendence and direction of the affairs of the bank and exercises all powers of the bank unless otherwise provided in the regulations made by the Central Board.

The Reserve Bank is the sole authority for issue and management of
iv. currency in India under Section 22 of the RBI Act. The bank may issue notes of different denominations from ₹ 2 to ₹ 10,000 as the Central Government may decide on the recommendations of the Central Board of the bank. Such notes shall be a legal tender at any place in India.

The Reserve Bank is the banker to the Central Government under Section
v. 20 of the Act, and accordingly it is obligatory to undertake banking business for the Central Government. In the case of state governments, their banking business is undertaken by the bank based on agreements as provided in Section 21A. The Reserve Bank provides ways and means of advances to the Central and State governments. These are temporary advances to meet immediate needs when there is interval between expenditure and flow of revenue.

The role of the Reserve Bank as regulator of banking sector is mainly by
vi. virtue of the provisions of the Banking Regulation Act, 1949. In exercise of the powers under that Act the bank regulates the entry into banking business by licensing, exercises control over shareholding and voting rights of shareholders, exercises controls over the managerial persons and

regulates the business of banks. The bank also inspects banks and exercises supervisory powers and may issue directions from time to time in public interest and in the interest of the banking system with respect to interest rates, lending limits, investments and various other matters.

The major powers of the Reserve Bank in the different roles as regulator vii. and supervisor can be summed up as under:

- (a) power to issue banking licenses;
- (b) power of appointment and removal of banking boards/personnel;
- (c) power to regulate the business of banks;
- (d) power to give directions;
- (e) power to inspect and supervise banks;
- (f) power regarding audit of banks;
- (g) power to collect, collate and furnish credit information;
- (h) power relating to moratorium, amalgamation and winding up and
- (i) power to impose penalties.

1.7 GOVERNMENT AS A REGULATOR OF BANKS

The Reserve Bank is the primary regulator of banks. But the Central i. Government has also been conferred extensive powers under the RBI Act and BR Act either directly or indirectly over the banks.

The government holds the entire capital of the Reserve Bank and appoints ii. the Governor and the members of the Central Board and has the power to remove them. The government has also the power to issue directions to the Reserve Bank under Section 7(1) of the RBI Act whenever considered necessary in public interest after consultation with the Governor. Thus, the government can exercise control over banks by influencing decision-making by the Reserve Bank and has also got appellate authority in respect of several matters in which the Reserve Bank has been conferred the power to decide at the first instance. Thus, under the Banking Regulation Act appeal lies with the Central Government on removal of

managerial personnel under Sections 10B and 36AA of the BR Act. Under the existing provisions contained in the Banking Regulation Act 36AA, the Reserve Bank of India has inter alia power to remove any director or other officers of a banking company, but such power is not adequate if the entire Board of Directors of a banking company is functioning in a manner detrimental to the interest of the depositors or the banking company itself. Under the Amending Act, a new Part II AB to the BR Act has been inserted after Part II A, wherein the RBI has been conferred with power to supersede the Board of Directors of a banking company for a total period not exceeding 12 months and appoint an administrator to manage the banking company during the said period. Similarly, there are also provisions for appeal in respect of cancellation of banking licence (under Section 22) and refusal of certificate regarding floating charge on assets (Section 14A).

iii. The government has the power to suspend the operations of the Banking Regulation Act or to give exemption from any of the provisions of the Act on the representation/recommendation of the Reserve Bank under Sections 4 and 53 of the Act, respectively. The government has also the power to notify other forms of business which a bank may undertake under Section 6(1) (o) of the Act. Rule-making powers under Sections 52 and 45Y are vested in the Central Government. There are also other provisions under which the Central Government exercises powers as under:

- (a) Approval for formation of subsidiary for certain business under Section 19;
- (b) Notification with reference to accounts and balance sheet under Section 29;
- (c) Issue of direction for inspection of banks under Section 35;
- (d) Power to acquire undertakings of banks (Section 36AE);
- (e) Appointment of court liquidator;
- (f) Suspension of business and amalgamation of banks under Section 45.

The above provisions confer wide powers on the Central Government to regulate banks. These are in addition to the powers conferred on the

government as majority shareholder or full owner of public sector banks under the statutes constituting them.

Financial Intelligence Unit – India (FIU-IND) was set by the Government of India vide O.M. dated 18th November 2004 as the central national agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions. FIU-IND is also responsible for coordinating and strengthening efforts of national and international intelligence, investigation and enforcement agencies in pursuing the global efforts against money laundering and related crimes. FIU-IND is an independent body reporting directly to the Economic Intelligence Council (EIC) headed by the Finance Minister. FIU-IND is not a regulatory authority.

Functions of FIU-IND

- (a) Collection of Information: FIU-IND Act as the central reception point for receiving Cash Transaction reports (CTRs), Cross Border Wire Transfer Reports (CBWTRs), Reports on Purchase or Sale of Immovable Property (IPRs) and Suspicious Transaction Reports (STRs) from various reporting entities.
- (b) Analysis of Information: Analyze received information in order to uncover patterns of transactions suggesting suspicion of money laundering and related crimes.
- (c) Sharing of Information: Share information with national intelligence/law enforcement agencies, national regulatory authorities and foreign Financial Intelligence Units. FIUs exchange information with other FIUs on the basis of reciprocity or mutual agreement consistent with procedures understood by the requested and requesting party.
- (d) Act as Central Repository: Establish and maintain national data base on cash transactions and suspicious transactions on the basis of reports received from reporting entities.
- (e) Coordination: Coordinate and strengthen collection and sharing of financial intelligence through an effective national, regional and global network to combat money laundering and related crimes. (f) Research and Analysis: Monitor and identify strategic key areas on money laundering trends, typologies and developments.

.8 CONTROL OVER CO-OPERATIVE BANKS

A co-operative bank is a co-operative society engaged in the business of

- i. banking and may be a primary Co-operative bank, a district central co-operative bank or a state co-operative bank. Cooperative banks operating in one state only are registered under the State Co-operative Societies Act concerned. The formation of such banks as well as their management and control over personnel is regulated by the co-operative law of the state. The Registrar of co-operative societies under the Co-operative Societies Act exercises a wide range of powers on co-operative societies from registration to winding up.

In the case of co-operative banks operating in more than one state, the

- ii. Multi-State Co-operative Societies Act, 2002 is applicable. In that case, the Registrar appointed by the Central Government takes the place of the Registrar appointed by the State Government in other cases.

With the introduction of Section 56 in the Banking Regulation Act, 1949

- iii. with effect from 1965, cooperative banks have come under the regulatory purview of the Reserve Bank. While the formation and management of co-operative societies operating in one state only (including those conducting banking business) are under the control of the State Government, licensing and regulation of banking business rests with the Reserve Bank. Thus, there is a dual control of State Governments and the Reserve Bank over these banks. Banking Regulation (Amendment) Ordinance 2020 has received President of India's assent on 26th June 2020 to give more powers to the RBI to restructure Co-operative Banks, provide more control over management and allow RBI to frame the revival plan for these Banks and protect the interests of the depositors. Besides, Cooperative Banks will now be permitted to raise capital through public/private issues, preferential shares, debentures. The amendments however do not affect the existing powers of the state registrars of cooperative societies under the state laws. The amendment brings 1482 urban and 58 multi state cooperative banks under the purview of RBI.

In the case of co-operative banks which are registered under the Deposit
iv. Insurance and Credit Guarantee Corporation Act, the Reserve Bank has
the power to order their winding up. The circumstances in which Reserve
Bank may require winding up are mentioned in Section 13D of the Act.

.9 REGULATION BY OTHER AUTHORITIES

Banks may be subject to the control of other regulatory agencies in the
i. conduct of their business. For instance, a banking company will be
subject to the control of the authorities under the Companies Act in
respect of company matters. Similarly, a bank is answerable to labour
authorities in respect of the terms and conditions of service of its
workmen, opening and closing of its premises, engagement of contract
labour, etc. Banks are also liable to pay income tax like cash transaction
tax, service tax, etc., and other taxes and have to follow the rules and
regulations in that regard.

As provided in Section 6 of the Banking Regulation Act, banks may
ii. undertake certain non-banking business in addition to the business of
banking. In that regard also, banks may be subject to the regulatory
control of other agencies. For instance, in the case of dealings in securities
like shares and debentures, banks are subject to regulation by the
Securities Exchange Board of India under the Securities Contract
(Regulation) Act, 1956 read with the Securities and Exchange Board of
India Act, 1992. If the Bank desires to raise capital through public issue, it
has to comply with SEBI guidelines. In case of Insurance Business by
IRDA and in case of Mutual Fund and Merchant Banking Business by
RBI, SEBI.

The study herein is, however, largely confined to the regulation of banks
by the Reserve Bank and the Central Government under the Reserve
Bank of India Act and the Banking Regulation Act.

.10 LET
US
SUM
UP

1. Banking means acceptance of deposits of money from the public for lending or investment. Such deposits may be repayable on demand or may be for a period of time as agreed to, by the banker and the customer, and may be repayable by cheque, draft or otherwise. Apart from banking, banks are authorised to carry on other business as specified in Section 6 of the Banking Regulation Act. Banks are, however, prohibited from undertaking any trading activities.
2. Banks are constituted as companies registered under the Companies Act, 1956/2013, statutory corporations constituted under Special Statutes or Co-operative societies registered under the Central or State Co-operative Societies Acts. The extent of applicability of the regulatory provisions under the Banking Regulation Act and the Reserve Bank of India Act to a bank depends on the constitution of the bank.
3. Reserve Bank of India is the central bank of the country and the primary regulator for the banking sector. The government has direct and indirect control over banks. It can exercise indirect control through the Reserve Bank and also act directly in appeals arising from decisions of the Reserve Bank under the various provisions of the Banking Regulation Act. In public sector banks like the State Bank of India, nationalised banks and the regional rural banks, 50% or more of their shares are held by the Central Government. Central Government has substantial control over the management of these banks. Only certain provisions of the BR Act are applicable to these banks as indicated in that Act. Co-operative banks operating in one state only are registered under the State Co-operative Societies Act and are subject to the control of the State Government as also the Reserve Bank. In the case of non-banking business of the banks, they are subject to control by other regulatory agencies.

.11 KEYWORDS

Banking; Banking Company; Body Corporate; Co-operative Bank; Nationalised Bank; Regional Rural Bank; Public Sector Bank.

.12 CHECK YOUR PROGRESS

1. State which of the following statements are True?

(i) A public sector bank is a body corporate created under a special statute.

(ii)

A banking company is registered under the Banking Regulation Act.

(iii)

Co-operative banks are registered under the Multi-State Co-operative Societies Act or a State Co-operative Societies Act.

(iv) Subsidiaries of the State Bank were companies registered under Companies Act.

a. (i) and (ii)

b. (i) and (iii)

c. (i), (ii) and (iii)

d. (i), (ii), (iii) and (iv)

2. Under which Act Reserve Bank was constituted?

a. Banking Regulation Act

b. RBI Act

c. Companies Act

d. None of the above

3. Which of the following is/are false?

Central Government can give direction to the Reserve Bank.

(i)

All kinds of business of banks are regulated only by the Reserve Bank.

(ii)

(iii) Central Government is the primary regulator of banks.

(iv) State governments have no control over co-operative banks.

a. (i) and (ii)

b. (ii) and (iii)

c. (iii) and (iv)

d. (ii), (iii) and (iv)

4. Co-operative banks operating in different states are registered under the following:

a. State Co-operative Societies Act

b. Multi-State Co-operative Societies Act

c. RBI Act

d. Banking Regulation Act

.13 ANSWER TO 'CHECK YOUR PROGRESS'

1. b. (i) and (iii)

2. b. RBI Act

3. d. (ii), (iii) and (iv)

4. a.

UNIT 2

CONTROL OVER ORGANISATION OF BANKS

STRUCTURE

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.0 OBJECTIVES

The objectives of this unit are to understand the laws that govern banking companies, in respect of:

- Licensing and branch licensing
- Paid up capital and reserves
- Shareholding and rights of shareholders
- Formation of subsidiaries and holding of shares of other companies
- Constitution and regulation of board of directors
- Exercise of control by the Reserve Bank and the Government over the appointment and removal of chairman, managerial and other personnel
- Corporate governance

.1 INTRODUCTION

The Banking Regulation Act provides for regulation of the organisation of banking companies. To start with, there are restrictions at the entry point, by way of licensing and then the requirement of permission for opening or shifting of branches. There are further regulations over the paid-up capital and reserves, shareholder's rights, constitution of the board of directors, appointment of chairman and formation of subsidiaries. Apart from the above, there are also controls over the managerial and other personnel, including the power to remove unsuitable persons and to appoint suitable persons. In this unit, we study various provisions of the Banking Regulation Act providing for controls over the organisation and management of banking companies.

.2 LICENSING OF BANKING COMPANIES

- License Requirement from RBI: To commence or carry on, the banking
- i. business in India, a company requires a licence from the Reserve Bank under Section 22 of the Banking Regulation Act, 1949. Commencing or

carrying on a banking business without a licence is prohibited. When the Act came into force, the banking companies, which were then in existence were required to apply for licence within six months from the commencement of the Act. But, such banking companies were permitted to continue business, unless and until their applications for licence were rejected by the Reserve Bank. The requirement of licence was meant to ensure the continuance of only those banks, which were established and operating on sound lines and to prevent indiscriminate formation of banking companies.

Discretion of Reserve Bank: The granting of licence by the Reserve Bank
ii. may be subject to such conditions as the RBI may think fit in each case. As held by the Gujarat High Court in *Shivabhai vs RBI Ahmedabad* (AIR 1986 Guj 19), Reserve Bank has the discretion to grant or refuse the licence and when such decision based on relevant material and germane considerations, the decision cannot be assailed. Only if the decision is based on extraneous considerations or is perverse, the court will intervene.

It is open to the RBI to consider the defects or improvements revealed in an inspection held under Section 35 of the BR Act while disposing of an application for licence (See *Sajjan Bank Pvt. Ltd. vs RBI*, AIR 1961 Mad 8). The refusal of licence to a company would make it ineligible to undertake banking business, but it would still be open to the company to carry on other business like money lending.

iii. Conditions to be Satisfied: Before granting a licence under Section 22, Reserve Bank may have to be satisfied by an inspection of the books of the banking company or otherwise in respect of the following matters:

- (a) Whether the company is or will be in a position to pay its present future depositors in full as 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 future depositors;
- (c) Whether the general character of proposed management of the company will not be prejudicial to public interest or the interest of depositors;
- (d) Whether the company has an adequate capital structure and earning prospects;

- (e) Whether public interest will be served by grant of licence to company;
- (f) Whether considering the banking facilities available in the proposed of operation, the potential scope for expansion of business by b. already in existence in that area and other relevant factors, the grant licence would be prejudicial to the operation and consolidation banking system, consistent with monetary stability and economic growth;
- (g) The fulfilment of any other condition which the Reserve Bank considers relevant in public interest or in the interest of depositors.

Although Section 11 of BR Act specifies the minimum capital and reserve requirements of a banking company, the Reserve Bank can stipulate a higher requirement of capital for licensing a banking company as under Section 22. The Reserve Bank has to be satisfied that the company has an adequate capital structure and earning prospects.

Foreign Banks: In the case of companies, incorporated outside India iv. applying for a licence, apart from the conditions specified in the case of domestic companies, three additional conditions have been stipulated for consideration by the Reserve Bank. These are:

- (a) Whether carrying on of banking business by the company in India will be in public interest;
- (b) Whether the government or the law of the country, in which the company is incorporated discriminates in any way against banking companies registered in India;
- (c) Whether the company complies with provisions of the BR Act applicable to foreign companies.

Local Area Banks: The Reserve Bank has recognised the concept of local v. area banks and licensed a few (four) such banks. These are banking companies operating only in a limited geographical area. The licence issued to these banks would restrict their operations to the specified local area to ensure adequate banking services in that area.

Cancellation of Licence: Sub-Section (4) of Section 22 of the Banking vi. Regulation Act authorises the Reserve Bank to cancel the licence granted to any banking company. The cancellation of licence may be on any one

or more of the following grounds:

- (a) The company ceases to carry on banking business in India;
- (b) The company at any time fails to comply with any of the conditions imposed under the sub-Section (1) of Section 22 of Banking Regulation Act;
- (c) The company does not fulfil at any time, any of the conditions referred in the sub-Section (3) or 3(A) of Section 22 of Banking Regulation Act

Before cancellation of a licence for non-compliance with any of the conditions as above, the company has to be given an opportunity for taking necessary steps for complying with or fulfilling the conditions. However, in cases where the Reserve Bank is of the opinion that delay will be prejudicial to the interests of depositors or the public, the requirement of opportunity can be dispensed with. As observed by the Madras High Court in *Sajjan Bank Pvt. Ltd. vs RBI* (AIR 1961 Mad. 8), the Reserve Bank has a wide range of administrative discretion under the Act, which it is competent to exercise and it cannot be said that there is an excessive delegation of power. A banking company, whose licence is cancelled, can appeal to the Central Government within a period of 30 days from the date of the order rejecting licence.

- vii. Old private banks: The banks, which were not nationalized due to small size and other reasons at the time of bank nationalization that took place during 1969 and 1980 are known to be the old private-sector banks.
- viii. New Private Banks: Over the last two decades, to extend the geographic coverage of banks and to improve access to banking services, the Reserve Bank of India (RBI) licensed private sector banks in two phases. There are totally 22 private sector banks in India (April 2020).
- ix. Small Finance Banks: Major changes from the earlier Guidelines on Small Finance Banks dated November 27, 2014, are (i) The licensing window will be open on-tap; (ii) minimum paid-up voting equity capital / net worth requirement shall be ₹ 200 crore; (iii) for Primary (Urban) Co-operative Banks (UCBs), desirous of voluntarily transiting into Small Finance Banks (SFBs) initial requirement of net worth shall be at ₹ 100 crore, which will have to be increased to ₹ 200 crore within five years from the date of commencement of business. Incidentally, the net-worth

of all SFBs currently in operation is in excess of ₹ 200 crore; (iv) SFBs will be given scheduled bank status immediately upon commencement of operations; (v) SFBs will have general permission to open banking outlets from the date of commencement of operations; (vi) Payments Banks can apply for conversion into SFB after five years of operations, if they are otherwise eligible as per these guidelines.

.3 BRANCH LICENSING

- Apart from the requirement of licence for commencing or carrying on
- i. banking business, banks have to obtain the prior permission of Reserve Bank for opening a new place of business or changing location of the existing place of business. Under Section 23 of the Banking Regulation Act, Place of businesses for this purpose includes any sub-office, pay office, sub-pay office or any place at which deposits are received, cheques cashed or moneys lent. However, changing the location of an existing place of business within the same city, town or village would not need such permission. These restrictions also apply to foreign branches of banking companies incorporated in India. Opening of a temporary place of business up to one month, for purpose of affording banking facilities for any exhibition, mela, conference or like occasion, is exempt. However, the temporary branch has to be within the limits of the city, town or village where there is an existing branch or in the environs thereof. The present guidelines from RBI provide that Banks should submit their request for new branches, administrative offices, ATMs once in a year, for consideration of RBI as against the earlier practice of making individual applications for each and every branch. When approved, the permission would be valid for a period of one year before which the branches/offices should be operationalized.

For granting permission under Section 23, the Reserve Bank may require

- ii. to be satisfied of the following:

- (a) Financial condition and history of the bank;
- (b) General character of its management;
- (c) Adequacy of capital structure and earning prospects;

(d) Public interest.

This may be done by an inspection of the bank under Section 35 or otherwise.

While granting permission for opening or shifting a branch, the Reserve Bank may impose any conditions which it thinks fit necessary. If any bank fails to comply with such conditions, the permission may be revoked after giving an opportunity to the bank to show cause.

In the case of Regional Rural Banks, the applications for permission have to be routed through the National Bank (NABARD), and the national bank has to offer its comments on merits to the Reserve Bank. There are 43 RRBs in India as on 1.4.2020.

.4 PAID-UP CAPITAL AND RESERVES

Section 11 of the Banking Regulation Act provides for certain minimum requirements as to paid-up capital and reserves of banking companies. Any company wanting to commence banking business has to comply with these requirements. The amounts stipulated have reference to the places of business. 'Place of businesses for this purpose means any office, sub-office, sub-pay office and any place at which deposits are received, cheques cashed or moneys lent. In the case of any dispute regarding computation of paid-up capital and reserves of any banking company, the decision of the Reserve Bank shall be final.

- Foreign Banks: Under sub-Section (2) of Section 11 of the BR Act, a
- i. foreign bank (banking company incorporated outside India) operating in India, has to deposit and keep deposited with the Reserve Bank, an amount of ₹ 15 lakh and if it has a place of business in Mumbai or Kolkata or both, ₹ 20 lakh. The amount has to be kept in cash or unencumbered approved securities or partly in both. Apart from this, an amount of twenty per cent of the profit for each year, in respect of business transacted through the branches in India as disclosed in the profit and loss account, has to be deposited with the Reserve Bank. The securities deposited can be replaced by other unencumbered approved securities or cash deposited can be similarly replaced by securities. The

Central Government can exempt any foreign bank from this requirement on the recommendation of the Reserve Bank for a specified period if the amounts deposited already by it are considered adequate. On the cessation of business by any foreign bank for any reason, these deposits shall form the assets of the company on which the creditors in India shall have the first charge.

Indian Banks: In case of banking companies incorporated in India, the requirements of minimum paid-up capital and reserves under Section 11(3) are as follows:

- (a) If it has a place of business in more than one state, ₹ 5 lakh and if places of business include Mumbai, Kolkata or both, ₹ 10 lakh.
- (b) If the place of business is in only one state and does not include Mumbai or Kolkata, ₹ 1 lakh for its principal place of business, plus ₹ 10,000 for other places of business, in the same district in which the principal place of business is situated, plus an additional ₹ 20,000, for each place of business elsewhere; in total not exceeding ₹ 5 lakh. If the bank has one place of business, the amount is limited to ₹ 50,000.

For banking companies commencing business after the commencement of the Act, paid-up capital is stipulated as ₹ 5 lacs.

- (c) If places of business are in one state only, but one or more of them are Mumbai or Kolkata, ₹ 5 lakh, plus ₹ 25,000 for each place of business outside these cities and the aggregate not exceeding ₹ 10 lakh.

During 2005, RBI stipulated the minimum capital requirement for a new Private Bank at ₹ 300 crores as a part of Corporate Governance guidelines and as a policy of Foreign Direct Investment.

iii. Paid-up Capital, Subscribed Capital and Authorised Capital: Apart from the above, Section 12(1) of the Banking Regulation Act stipulates that the subscribed capital of a banking company shall not be less than half of its authorised capital; and the paid-up capital shall not be less than half of its subscribed capital. If capital is increased, this requirement has to be complied within a period not exceeding two years as allowed by the Reserve Bank.

In terms of Section 12(i) (ii) of the Banking Regulation Act, Banking

Companies are permitted to issue equity shares or equity shares and preference shares (whether perpetual or irredeemable or redeemable). However, the issuance of preference shares should be in accordance with the guidelines framed by the Reserve Bank.

.5 SHAREHOLDING IN BANKING COMPANIES

Voting rights of shareholders: There is no specified ceiling on a person's holding of shares in a banking company under the Banking Regulation Act or any other law. However, Section 12(2) of the Act puts certain restrictions on voting rights of shareholders. Accordingly, no shareholder can exercise voting rights in respect of the shares held by him/her in excess of ten per cent. (which may be increased up to twenty percent by Reserve Bank) of the total voting rights of all the shareholders of the banking company. Restriction on the transfer of shares or registration of such transfers has now been placed under Section 12 B of the Banking Regulation Act, where prior approval of Reserve Bank would be required if the acquisition together with voting rights exceed five percent or more of the paid up share capital of the banking company. Further, Section 12(3) bars suits or other proceedings against registered shareholders by any other person claiming title, except by a transferee of shares, in accordance with the law or on behalf of minors or lunatics for whom the registered shareholder holds the shares. The provisions of the Companies Act also govern transfer of shares of banking companies.

Acknowledgement by Reserve Bank: Reserve Bank has instructed banking companies that, when they receive more than five percent of their paid up share capital for transfer to one party, such banks must refer the matter to the Reserve Bank. The banks shall not transfer the shares without receiving Reserve Bank's acknowledgement and in case the transfer of such shares are registered, Reserve Bank may by order direct that the transferee shall not be entitled to exercise voting rights in poll in any of the meeting of such bank. This is with a view to ensure that the control of banking companies is in the hands of fit and proper persons. It has been made mandatory for applicants to obtain prior approval from the Reserve Bank to acquire five percent or more of the share capital of a