BANKING AND INSURANCE

UNIT 1

THE INDIAN FINANCIAL SYSTEM

The Indian financial system comprises multiple components and the structure that clarifies the involvement of the rules and policies to keep up with the investment and the savings. India is among the largest economies and in the 5th position based on its nominal GDP. The Indian financial system is related to the pecuniary facilities for the trade and transfer systems. The independent pillars of the financial context in India comprise 'insurance', 'liabilities', 'banking', 'transactions', 'capital and stock markets', 'claims', and 'investments'. The financial system of India comprises production, capital collection, mobilization, allocation, and encouragement of savings. The financial system of India is formative but ideal for managing the whole structure of the overall economy. Along with the ideal effects, the challenges are visible in this context as well.

Structure of Indian financial system

The structure of the Indian financial system comprises a total of two elements- i) organized markets and ii) unorganized markets.The financial system is related to the institution that involves the financial markets and services related to the institution for enabling the corporate activities to facilitate the transfer of finance and management of accounts. The classification of the structure of the Indian financial system provides the aspects related to the financial institutions and their intervention. An ordinary financial system comprises 4 parts such as i) money, ii) financial instruments, iii) financial institutions, and iv) central banks. The institution of the Indian financial system has maintained the 'profit-making public sector undertaking' since 1969 that has supported the **structure of the Indian financial system** and functional structure of the commercial banks.

Components of Indian financial system

The components of Indian financial system have a total of 5 parts,

- ***Financial institution***- It is one of the prime components of the Indian financial system that mediate between the lenders and the money borrowers. The various commercial markets are the key components that intensify the savings of the lenders. Financial institutions are known for their establishment of safe investment-related ideas. The process of both short and long durations of the liability is also a part of this context. The financial institution has two types that have major involvement in society; banking and non-banking sectors.

- ***Financial assets-*** the financial money has different parts and those are,

- *Call money*- In the Indian financial system, the concept of call money is related to assurance that indicates the next day payment of a lent loan.

- *Notice money*- this asset indicates the lending format of loan for more than 1 day and less than a period of 14 days.

- *Term money*- this is related to mature money that is a fixed amount that is going to mature within 14 days from the deposit day.

- *Treasury bills*- maturity money and its activation for less than a year and that deposit sum belong to the government as a security token. Based on the bills related to Indian finance this loan format is granted as executed.

- *Deposit certificate*- Electronic funds are managed with this kind of asset management format for both deposit and withdrawal.

- *Commercial proofs*- this is used for corporate sectors and for the short period of debts.

- ***Financial service***- the main objective of the financial service is related to counselling for convincing people about selling and purchasing a property. Financial service comprises,

- *Banking*- Account opening, providing loans, accepting debits, credit and debit card distribution are under this sector.

- *Insurance*- Different kinds of insurance for sales and purchase and for the brokerage deals these sectors are well-known.

- *Investment*- Asset investment and deposit are related to this part.

1. *Foreign exchange*- This financial sector deals with currency exchanges, fund transfers, and so on.

- ***Financial market***- Financial market deals with the bond exchange, share, investment, and so on. This market of India has 4 types,

- *Capital market*- Deals with trade transactions and has three specific types,

1. Corporate Securities
2. Government Securities
3. Long Term Loan

- *Money market*- Deals with short time investments and has two major areas,

1. Organized Money Market
2. Unorganized Money Market

- *Foreign exchange market*- Responsible for foreign money management.

- *Credit market*- It involves individuals and organizations for short and long-term loans.

- ***Money***- Involved with purchase and sales factors.

The **Indian financial system** is complicated for the structural presentation of the policies and regulations that are generally ideal for engaging the concept of personal and commercial investments. The financial system in India is versatile and every component has sub-components that critically handle all kinds of economic involvement of both deposit and withdrawal. The financial system of India comprises both investors' and services users' involvement so the betterment of the service for service users could be initiated. The prime characteristics of the Indian financial system compromise the monopoly of finance and provide a brief aspect related to the capital market.

Role of Government as regulator of banks.

The government, through its regulatory bodies, plays a crucial role in maintaining the stability and integrity of the banking system. This involves ensuring the soundness of financial institutions, protecting depositors' interests, and promoting a stable and efficient financial environment. Regulatory oversight helps prevent financial crises, encourages responsible lending practices, and fosters public confidence in the banking sector.

Government's regulatory role:

1. Ensuring Financial Stability:

- **Prudential Regulations:**

  Governments set standards for capital adequacy, liquidity, and risk management that banks must adhere to. This ensures banks have sufficient capital to absorb losses and maintain operations during economic downturns.

- **Supervision and Monitoring:**

  Regulatory bodies conduct regular inspections and audits of banks to assess their financial health, compliance with regulations, and risk management practices.

- **Resolution Mechanisms:**

Governments establish frameworks for resolving failing banks to minimize disruption to the financial system and protect depositors.

2. Protecting Depositors:

- **Deposit Insurance:**

  Deposit insurance schemes, often government-backed, protect depositors' funds up to a certain limit in case of bank failure.

- **Consumer Protection:**
  Regulations aim to ensure fair treatment of customers, prevent fraud, and provide mechanisms for addressing consumer complaints.

3. Promoting Efficient and Stable Banking System:

- **Entry and Exit:**

  Regulatory frameworks govern the licensing and operation of banks, as well as the process for closing or merging failing institutions.

- **Competition and Innovation:**

  Regulations can promote competition among banks while ensuring that new products and services are introduced responsibly and safely.

- **Monetary Policy:**
  Central banks, often part of the government structure, use monetary policy tools to influence interest rates, money supply, and credit conditions to promote economic stability and growth.

4. Addressing Systemic Risks:

- **Oversight of Systemically Important Institutions:**

  Governments pay particular attention to large and complex banks that could pose a systemic risk if they fail.

- **Cross-Border Regulation:**
  In an interconnected global financial system, governments work with international bodies to harmonize regulations and address risks that can spill across borders.

Examples of Regulatory Bodies:

- **Reserve Bank of India (RBI):**

  In India, the RBI is the primary regulatory and supervisory authority for the banking sector, responsible for maintaining financial stability and regulating banking operations.

- **Other Financial Regulators:**
  Depending on the country, there may be separate regulatory bodies for insurance, securities markets, and other financial institutions.

Challenges and Considerations:

- **Striking the right balance:**

  Regulatory frameworks need to be robust enough to prevent crises and protect the public, but not so burdensome that they stifle economic growth and innovation.

- **Adapting to change:**

  Financial markets are constantly evolving, and regulations must be updated to address new risks and challenges.

- **International cooperation:**
  Financial systems are increasingly interconnected, requiring governments to work together to address cross-border risks and ensure consistent regulatory standards.

RBI as regulator of banks

The Reserve Bank of India (RBI) takes its name from the Banking Regulation Act, 1949, formerly known as the Banking Companies Act, 1949. Regional rural banks, cooperative banks, Commercial banks, local area banks, non-banking financial companies and development financial institutions (DFIs) make up India's financial system. In this article, we attempt to understand the role of RBI as a regulator and how it safeguards public trust in the national financial system. The aim of the Reserve Bank of India is to provide the best facilities to all banks of India. It settled with the National Payments Corporation of India for settling the payment system throughout the country.

Role of RBI

- The primary duty of the RBI is to implement monetary policy
- The Central Government's Monetary Policy Committee (MPC), established under Section 45(B), determines the policy interest rate required to achieve the inflation target
- The RBI also conducts economic research to promote economic growth
- It is in charge of the nation's currency's design, production, and overall management, ensuring an adequate supply of clean and genuine notes
- Section 22 of the RBI Act empowers the bank to issue currency notes, except for one rupee note, which the Ministry of Finance issues
- The Government of India is the coin-issuing authority, and the Reserve Bank receives coins on demand

- **Banking Regulation**

  The Banking Regulation Act of 1949 formed the RBI as a regulator and supervisor of the banking sector. Its goals included safeguarding depositors' interests, ensuring orderly banking operations, and promoting the overall health of the banking system.

- Reserve Bank of India provides the licence to the banks
- After this licence, they have the authority to regulate their bank in India
- Foreign banks also have to take permission from the RBI to establish their branch in India
- RBI provides approval to the different operations like policy formulation, implementation of Prudential Norms, Basel – II and III frameworks, validation of quantitative models on Credit and so forth
- So, all the banks running currently in India must have permission from RBI first to modify their operational process
- RBI also decides the salary packages of Whole-Time Directors and Part-Time Chairpersons of Private Sector Banks and Chief Executive Officers of Foreign Banks operating in India
- RBI also handles all the issues of Indian banks. Issues related to the liquidation of banking companies, customer service policy issues, Anti-Money Laundering, Combating Financing of Terrorism and so forth
- It handles all types of issues and provides appropriate guidance to resolve them

Regulation Acts

According to Section 20 of the Reserve Bank of India Act 1934, the RBI must handle the Central Government's receipts and payments and carry out the exchange, remittance, and other banking operations, including managing the Union's public debt. Furthermore, according to Section 21 of the said Act, the RBI can conduct Union Government business in India. RBI conducts all the transactions which are held between the two State Governments. Section 21 A facilitates the agreement which was held between two state governments before any transactions.

The Function of RBI as a Regulator of the Money Market

The function of the RBI as a regulator of the money market is to regulate and manage the country's foreign exchange.

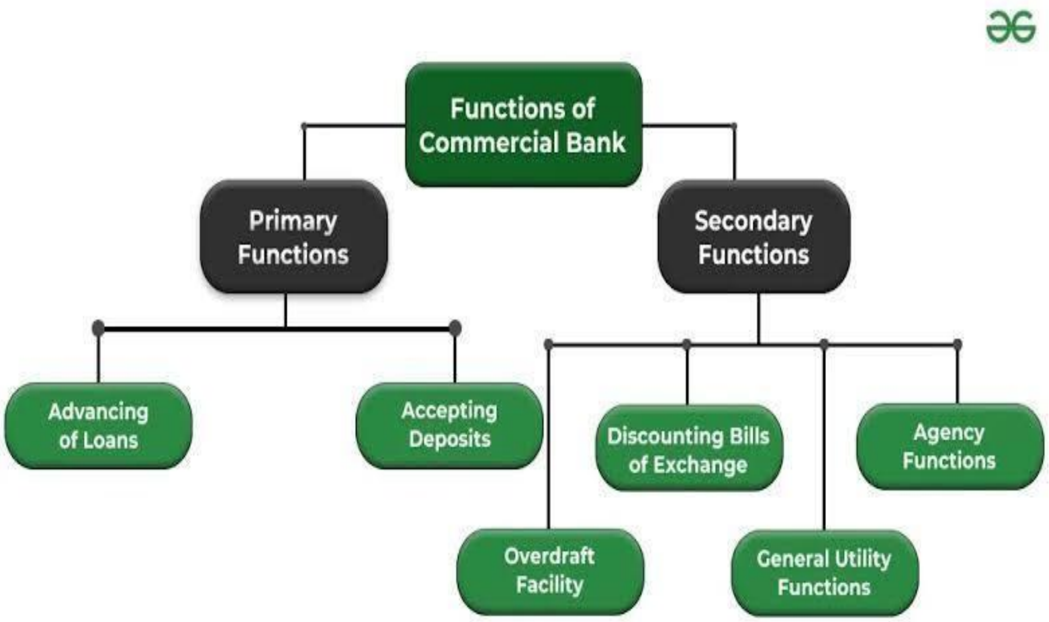
It is in charge of the country's currency and gold reserves.

The foreign exchange rate reflects the demand for and supply of foreign exchange resulting from trade and capital transactions on any given day.

RBI works as a regulator of the money market. It also regulates the Financial Markets Department (FMD). It also checks and regulates all the functions which are done under the foreign exchange market. It facilitates this foreign regulation by selling and buying foreign currency, which helps in reducing the volatility during the time of excess demand for foreign currency in the market.

The Indian banking system has the Reserve Bank of India at its zenith. Since the beginning, the role of RBI as a regulator has been directing, observing, managing, controlling, and advancing the predetermination of the financial system in India. It is the operational hub of the Indian money-related system. The headquarters of the Reserve Bank of India is situated in Mumbai. The whole functioning of RBI is regulated by the Ministry of Finance of India. All the policies and functions done on the banks of the whole of India are done under the inspection of RBI. So, the RBI is the biggest regulatory body in India.

Role and Functions of Banks



Banks primarily accept deposits, provide loans, and facilitate transactions. They also offer various financial services like savings accounts, credit cards, and currency exchange. Banks act as intermediaries, connecting savers with borrowers and playing a crucial role in the economy.

Primary Functions:

- **Accepting Deposits:**

  Banks receive various types of deposits from individuals and businesses, such as savings accounts, current accounts, fixed deposits, and recurring deposits.

- **Granting Loans and Advances:**

  Banks provide loans and advances to individuals and businesses, including overdrafts, cash credits, term loans, and bill discounting.

- **Facilitating Transactions:**
  Banks enable various transactions, such as check payments, wire transfers, and online banking transactions.
  Secondary Functions:

- **Agency Services:**

  Banks act as agents for their customers by collecting payments, purchasing and selling securities, and remitting funds.

- **Utility Services:**

  Banks offer services like safe deposit lockers, foreign exchange dealings, and issuing letters of credit.

- **Other Services:**
  Banks also provide services like wealth management, safe deposit boxes, and currency exchange.
  Other Important Roles:

- **Channeling Savings to Investment:**

  Banks play a vital role in the economy by channeling funds from savers to borrowers and investors.

- **Creating Credit:**

  Banks create credit by lending money, which helps stimulate economic activity.

- **Maintaining Monetary Stability:**
  Banks, especially central banks, play a crucial role in maintaining economic stability by controlling the money supply and interest rates.
  In essence, banks are financial institutions that act as intermediaries, facilitating the flow of money and enabling various economic activities. They offer a wide range of services to individuals and businesses, contributing to the overall health and stability of the economy.

Reserve Bank of India Act, 1934

The Reserve Bank of India Act,1934 was enacted to constitute the Reserve Bank of India with an objective to

(a) regulate the issue of bank notes

(b) for keeping reserves to ensure stability in the monetary system

(c) to operate effectively the nation's currency and credit system The RBI Act covers: (i) the constitution (ii) powers (iii) functions of the Reserve Bank of India.

The act does not directly deal with the regulation of the banking system except for few sections like Sec 42 which relates to the maintenance of CRR by banks and Sec 18 which deals with direct discount of bills of exchange and promissory notes as part of rediscounting facilities to regulate the credit to the banking system.

The RBI Act deals with:

(a) incorporation, capital, management and business of the RBI

(b) the functions of the RBI such as issue of bank notes, monetary control, banker to the Central and State Governments and banks, lender of last resort and other functions

(c) general provisions in respect of reserve fund, credit funds, audit and accounts (d) issuing directives and imposing penalties for violation of the provisions of the Act Banking Regulation Act, 1949

The Banking Regulation Act, 1949 is one of the important legal frame works. Initially the Act was passed as Banking Companies Act,1949 and it was changed to Banking Regulation Act 1949. Along with the Reserve Bank of India Act 1935, Banking Regulation Act 1949 provides a lot of guidelines to banks covering wide range of areas.

Some of the important provisions of the Banking Regulation Act 1949 are listed below. –

The term banking is defined as per Sec 5(i) (b), as acceptance of deposits of money from the public for the purpose of lending and/or investment. Such deposits can be repayable on demand or otherwise and withdraw able by means of cheque, drafts, order or otherwise – Sec 5(i)(c) defines a banking company as any company which handles the business of banking – Sec 5(i)(f) distinguishes between the demand and time liabilities, as the liabilities which are repayable on demand and time liabilities means which are not demand liabilities – Sec 5(i)(h) deals with the meaning of secured loans or advances.

Secured loan or advance granted on the security of an asset, the market value of such an asset in not at any time less than the amount of such loan or advances. Whereas unsecured loans are recognized as a loan or advance which is not secured – Sec 6(1) deals with the definition of banking business – Sec 7 specifies banking companies doing banking business in India should use at least on work bank, banking, banking company in its name – Banking Regulation Act through a number of sections restricts or prohibits certain activities for a bank. For example: (i) Trading activities of goods are restricted as per Section 8 (ii) Prohibitions: Banks are prohibited to hold any immovable property subject to certain terms and conditions as per Section 9 .

Further, a banking company cannot create a charge upon any unpaid capital of the company as per Section 14. Sec 14(A) stipulates that a banking company also cannot create a floating charge on the undertaking or any property of the company without the prior permission of Reserve Bank of India Lesson 2 Regulatory Framework and Compliances 17 (iii) A bank cannot declare dividend unless all its capitalized expenses are fully written off as per Section 15.

Other important sections of Banking Regulation Act, 1949 Sections 11 and 12 deals with the Paid up Capital, Reserves and their terms and conditions, Sec 18 specifies the Cash Reserve Ratio to be maintained by Non-scheduled banks and Sec 19 (2) clarifies about the shareholding of a banking company. No banking company shall hold shares in any company, (either as pledge, or mortgagee or absolute owners of any amount exceeding 30% of its own paid up share capital plus reserves (or) 30% of the paid up share capital of that company whichever is less Section 24 specifies the requirement of maintenance of Statutory Liquidity Ratio (SLR) as a percentage (as advised by Reserve Bank of India from time to time) of the bank's demand and time liabilities in the form of cash, gold, unencumbered securities Other compliance requirements

Section 29 – Every bank needs to publish its balance sheet as on March 31st Section

30(i) – Audit of Balance sheet by qualified auditors Section 35 gives powers to RBI to undertake inspection of banks Other various sections deal with important returns which are to be submitted by banks to Reserve Bank of India – Return of bank's liquid assets and liabilities (Monthly) – Return of bank's assets and liabilities in India (Quarterly) – Return of unclaimed deposits of 10 years and above (Yearly) With changing time and requirements from time to time, various other compliance issues which need to be handled by banks, have been amended/incorporated relating to: – Nomination facilities – Time period for preservation of bank books/records

Various Committees on banking and their impact.

Various committees have played a crucial role in shaping India's banking sector, influencing everything from regulatory frameworks to customer service and financial inclusion. These committees, often appointed by the government or the Reserve Bank of India (RBI), analyze the sector's performance, identify areas needing reform, and propose recommendations for improvement. Their impact can be seen in the evolution of banking practices, the introduction of new technologies, and the expansion of financial services to previously underserved populations.

1. Narasimham Committee (1991 & 1998):

- **Focus:**

  Structural reforms in the banking system, including capital adequacy, bank mergers, and deregulation.

- **Impact:**
  Recommended measures to strengthen public sector banks, reduce SLR (Statutory Liquidity Ratio) and CRR (Cash Reserve Ratio), and improve bank supervision. These recommendations led to significant changes in banking operations, including the adoption of Basel norms and increased focus on risk management.

2. Financial Sector Legislative Reforms Commission (FSLRC):

- **Focus:**

  Comprehensive review of financial sector laws and regulations to create a more efficient and robust system.

- **Impact:**
  Proposed a new legal framework for financial regulation, aiming to simplify and modernize existing laws.

3. Nachiket Mor Committee:

- **Focus:** Financial inclusion and access to banking services for all citizens.
- **Impact:** Recommended measures to promote digital financial services, microfinance, and the use of technology to reach remote areas.

4. P J Nayak Committee:

- **Focus:** Governance of banks, particularly public sector banks.
- **Impact:** Recommended improvements in board composition, management structures, and accountability in public sector banks.

5. Goiporia Committee:

- **Focus:** Improving customer service in banks.
- **Impact:** Made recommendations to enhance customer satisfaction, including faster processing of transactions, better grievance redressal, and improved communication.

6. Other Notable Committees:

- **Khusro Committee:** Addressed agricultural credit systems.
- **RV Gupta Committee:** Focus on small savings and agricultural credit.
- **Marathe Committee:** Focused on urban cooperative banks.

Overall Impact:

- **Modernization:**

Committees have driven the modernization of the Indian banking sector through the adoption of new technologies, improved risk management practices, and a focus on international best practices.

- **Financial Inclusion:**

  Recommendations from committees like the Nachiket Mor Committee have significantly contributed to expanding access to financial services for unbanked and underbanked populations.

- **Regulatory Framework:**

  Committees have played a crucial role in shaping the regulatory landscape of the banking sector, leading to stronger prudential norms and improved supervision.

- **Mergers and Consolidation:**

  Some committees have recommended the merger of weak public sector banks to create stronger entities, which has been implemented in recent years.

- **Technological Advancements:**
  Committees have encouraged the use of technology in banking, leading to the adoption of digital payments, mobile banking, and other innovative solutions.

By examining the recommendations of these committees and the subsequent actions taken by the government and RBI, it's clear that they have played a vital role in shaping the Indian banking sector into what it is today.

Recent Development in Indian Financial ystem:

Recent developments in the Indian financial system include a surge in digital payments, particularly through UPI, and the growth of fintech companies, with India now having the third-largest fintech ecosystem globally. There's also a focus on financial inclusion through initiatives like the Pradhan Mantri Jan Dhan Yojana and India Post Payments Bank. Additionally, the Indian capital market has seen strong performance, driving capital formation and wealth creation, while the insurance and pension sectors continue to evolve.

1. Digitalization and Fintech:

- **UPI's dominance:**

  India's Unified Payments Interface (UPI) has revolutionized real-time payments and is expanding its global reach.

- **Fintech innovation:**

  The Reserve Bank of India (RBI) is fostering innovation through regulatory sandboxes and data science labs for fintech companies.

- **Growth of digital lending:**

  Fintech companies are leveraging digital platforms to expand access to credit, especially in the lending space.

- **Fintech ecosystem:**
  India boasts a large and rapidly growing fintech ecosystem, with over 2,000 DPIIT-recognized businesses.

2. Financial Inclusion:

- **Jan Dhan Yojana:**

  Government schemes like the Pradhan Mantri Jan Dhan Yojana have played a crucial role in expanding access to financial services for the unbanked and underbanked population.

  Pradhan Mantri Jan-Dhan Yojana (PMJDY) is National Mission for Financial Inclusion to ensure access to financial services, namely, a basic savings & deposit accounts, remittance, credit, insurance, pension in an affordable manner. Under the scheme, a basic savings bank deposit (BSBD) account can be opened in any bank branch or Business Correspondent (Bank Mitra) outlet, by persons not having any other account.

Benefits under PMJDY

a. One basic savings bank account is opened for unbanked person.
b. There is no requirement to maintain any minimum balance in PMJDY accounts.
c. Interest is earned on the deposit in PMJDY accounts.
d. Rupay Debit card is provided to PMJDY account holder.
e. Accident Insurance Cover of Rs.1 lakh (enhanced to Rs. 2 lakh to new PMJDY accounts opened after 28.8.2018) is available with RuPay card issued to the PMJDY account holders.
f. An overdraft (OD) facility up to Rs. 10,000 to eligible account holders is available.
g. PMJDY accounts are eligible for Direct Benefit Transfer (DBT), Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY), Pradhan Mantri Suraksha Bima Yojana (PMSBY), Atal Pension Yojana (APY), Micro Units Development & Refinance Agency Bank (MUDRA) scheme.

- **India Post Payments Bank:**

  The India Post Payments Bank (IPPB) was launched to provide accessible and affordable banking services through post offices, further enhancing financial inclusion.

- **Neo-banks and digital banking:**
  Digital-only banks are emerging, offering personalized financial solutions and contributing to the changing banking landscape.

3. Capital Market Growth:

- **Strong performance:**

  The Indian stock market has demonstrated strong performance, with consistent outperformance against emerging market peers.

- **Increased financialization:**

  There's been a rise in the financialization of domestic savings and a growing trend of wealth creation through capital markets.

- **Rise in IPOs:**

The number of initial public offerings (IPOs) has seen a significant increase, indicating robust capital formation in the real economy.

4. Insurance and Pension Sector:

- **Risk-based capital regime:**

  The Insurance Regulatory and Development Authority of India (IRDAI) is transitioning to a risk-based capital regime to better assess capital adequacy for insurance risks.

- **Universal coverage:**
  The insurance and pension sectors are working towards achieving universal coverage and strengthening the overall financial ecosystem.

5. Other Notable Trends:

- **Consumer credit growth:**

  There's been a noticeable increase in the share of consumer credit in overall credit extended by banks.

- **Non-bank financing:**

  Non-bank financing options are also gaining popularity as alternative sources of credit.

- **ESG investing:**

  Environmental, Social, and Governance (ESG) investing is gaining traction, with investors increasingly seeking to align their investments with their values.

- **Technological advancements:**
  Artificial intelligence, robotics, and block chain technologies are also playing a growing role in the Indian financial sector.

MICRO FINANCE INSTITUTIONS

The microfinance institution accompanies clients who do not have access to traditional banks. Like a bank, a microfinance institution is a provider of credit. However, the size of the loans are smaller than those granted by traditional banks. These small loans are known as microcredit.

Types of Microfinance Institutions (MFIs).

- Village Savings and Credit Associations (VISACAs),
- Finance Companies (FCs), and.
- Fiduciary Financial Institutions (FFIs).

ROLES OF MICRO FINANCE INSTITUTIONS

Like financial institutions in general—central banks, commercial banks, and others of the same kind—MFIs collect funds, manage deposits, but primarily channel funds in the form of loans to MSME players and provide business development services through consulting.

SMALL FINANCE BANKS AND PAYMENTS BANKS

Small Finance Banks (SFBs) and Payments Banks are both classified as differentiated banks in India. These are specialized banking licenses issued by the Reserve Bank of India (RBI) to cater to specific needs and segments of the population, differing from traditional universal banks.

- **Differentiated Banks:**

  These banks focus on specific customer segments or offer a limited range of products and services, unlike universal banks that provide a full suite of banking activities.

- **Small Finance Banks:**

  SFBs are designed to promote financial inclusion by providing basic banking services and loans to the underserved sections of society, such as small businesses, micro and small farmers, and low-income households.

- **Payments Banks:**

  Payments Banks are focused on facilitating payments and remittances, offering services like deposits (limited to a certain amount) and digital payment solutions, but they cannot offer loans.