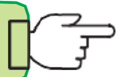
CHAPTER 8

BANKING COMPANIES

CHAPTER OVERVIEW



Banks are vital to the prosperity and well-being of any society or country. Banks enable a society to create the platform for the satisfaction of wants of its people by managing and maintaining the flow of money to carry out transactions.

For smoothly meeting cash payment requirement, banks have to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

The capital adequacy norms given in this unit are as per existing Basel II norms. The RBI requires Banks to maintain minimum capital risk adequacy ratio at prescribed rate on an ongoing basis.

Capital is divided into two tiers according to the characteristics/qualities of each qualifying instrument. Tier I capital consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses. Tier II capital on the other hand consists of certain reserves and certain types of subordinated debt.

The Banks have to classify their advances into two broad groups: 1. Performing Assets; 2. Non-Performing Assets. These classification is done based on the principle laid down by the RBI in Income Recognition and Asset Classification (IRAC) norms.

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Performing assets are also called as Standard Assets. The Non-Performing Assets is again classified into three groups and they are (i) sub-standard Assets (ii) doubtful assets & (iii) Loss Assets.

The banks have to maintain provisioning for Non-Performing Assets at the prescribed rates. A banking company also performs Discounting of bills; Collection of bills and Acceptances on behalf of customers

While preparing financial statements, banks have to follow various guidelines / directions given by RBI/Government of India governing the Financial Statements.

The chapter has been divided into 6 units for the purpose of convenience in understanding of the topic.

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UNIT 1: SOME RELEVANT PROVISIONS OF THE BANKING REGULATIONS ACT, 1949

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the legal definition of banking, the composition of management team of a bank and types of banks operating in India.
- Learn the conditions to be fulfilled for obtaining a license for banking activities in India.
- Learn the provisions relating to capital, reserve, liquidity norm (Capital Reserve Ratio & Statutory Liquidity Ratio), reserve fund and dividend payment.
- Try to relate such provisions with the financial information obtained from any banking companies.

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1.1 MEANING OF BANKING

Banks are vital to the prosperity and well-being of any society or country. Banks enable a society to create the platform for the satisfaction of wants of its people by managing and maintaining the flow of money to carry out transactions. The role of banks may be likened to the heart in a human being, circulating and managing money through the economy, thereby playing a crucial role for its good health.

Banks in India and their activities are regulated by the Banking Regulation Act, 1949.

Banking: Under Section 5(*b*) of the said Act "Banking" means,

- Accepting deposits of money from public for the purpose of lending or investing
- These deposits are repayable on demand or otherwise, and can be withdrawn by cheque, draft or otherwise.

Banking Company: Any bank which transacts this business as stated in section 5 (b) of the act in India is called a banking company. However merely accepting public deposits by a company for financing its own business shall not make it a bank.It may be mentioned that the Banking Regulation Act, 1949 is not applicable to a primary agricultural society, a co-operative land mortgage bank and any other co-operative society.

1.1.1 Types of banks

There are two main categories of Commercial Bank in India namely:-

1. Scheduled Commercial Bank
2. Scheduled Co-operative Bank

Scheduled Commercial Banks are again divided into five types and the Scheduled Co-operative Banks into two as given in the following chart.

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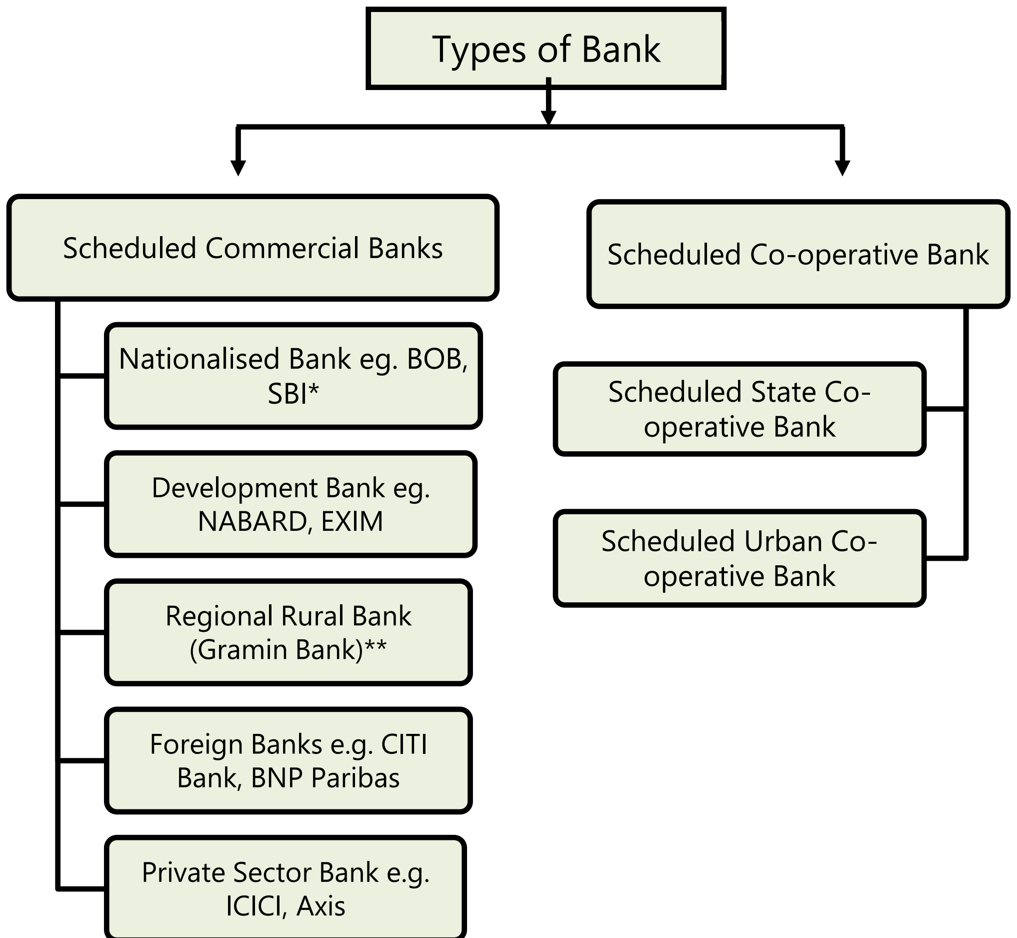

Scheduled Banks in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India(RBI) Act, 1934. After May 1997 there are no non-scheduled commercial banks existing in India. However, there are small to tiny non-scheduled Urban Co-operative Banks also known as Nidhi ond Schedule ots of the country.

The banks included in this schedule list should fulfil following two conditions:

1. The paid up capital and reserves in aggregate should not be less than ₹ 5 lakhs.
2. Any activity of the bank will not adversely affect the interests of depositors.

The Reserve Bank includes a bank in this schedule if it fulfils certain other conditions too.

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The RBI as the Central Bank is the 'Bank of Last Resort' i.e. when other commercial banks are in trouble RBI helps them out. The services provided by RBI to scheduled commercial banks include the following:

(a) The purchase, sale, and re-discounting of certain bills of exchange, or promissory notes.

(b) Purchase and sale of foreign exchange.

(c) Purchase, sale and re-discounting of foreign bills of exchange.

(d) Making of loans and advances to scheduled banks.

(e) Maintenance of accounts of the scheduled bank in its banking department and issue department.

(f) Remittance of money between different branches of scheduled banks through the offices, branches or agencies of Reserve Bank free of cost or at nominal rates.

1.2 RESERVE FUNDS

Every banking company incorporated in India is required to create a Reserve Fund and to transfer at least 25% of its profit to the reserve fund as per RBI notification (as against 20% prescribed in Banking Regulation Act). The profit of the year as per the profit and loss account prepared under Section 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.

If any banking company makes any appropriation from the reserve fund or share premium account, it has to report to the Reserve Bank of India the reasons for such appropriation within 21 days.

1.3 RESTRICTION AS TO PAYMENT OF DIVIDEND

Before paying any dividend, a banking company has to **write off completely** all its capitalised expenses including preliminary expenses, organisation expenses, share-selling commission, brokerage, and amounts of losses incurred by tangible assets. However, a banking company may pay dividend on its shares without writing off -

1. the depreciation in the value of its investment in approved securities in any case where such depreciation has not actually been capitalised or accounted for as a loss.

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2. the depreciation in the value of its investment in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company.
3. the bad debts in any case where adequate provision for such debts had been made to the satisfaction of the auditor of the banking company.

1.4 CASH RESERVE

For smoothly meeting cash payment requirement, banks have to maintain certain minimum ready cash balances at all times. This is called as Cash Reserve Ratio (CRR).

Cash reserve can be maintained by way of either a cash reserve with itself or as balance in a current account with the Reserve Bank of India or by way of net balance in current accounts or in one or more of the aforesaid ways.

Every Scheduled Commercial Bank has to maintain cash reserve ratio (i.e. CRR) as per direction of the RBI issued under Section 42(IA) of the Reserve Bank of India Act, 1934.

1.5 LIQUIDITY NORMS

Banking companies have to maintain sufficient liquid assets in the normal course of business called as Statutory Liquidity Ratio (SLR). This safeguards the interest of depositors and prevents banks from over-extending their resources, liquidity norms have been settled and given statutory recognition. Every banking company has to maintain the SLR in the form of: cash, gold and unencumbered approved securities.

The above assets have to be held at the close of business on any day and shall be valued at a price not exceeding the current market price of the above assets.

The percentage of SLR is changed by the Reserve Bank of India from time to time considering the general economic conditions. This is in addition to the Cash Reserve Ratio balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act.

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1.6 RESTRICTION ON ACQUISITION OF SHARES IN OTHER COMPANY

A banking company **cannot form any subsidiary** except for one or more of the following purposes:

1. The undertaking of any business permissible for banking company to undertake.
2. Carrying on business of banking, exclusively outside India with previous permission in writing, of the Reserve Bank.
3. The undertaking of such other business consider to be conducive to the spread of banking in India or to be otherwise useful or necessary in the public interest, which the Reserve Bank of India may permit with prior approval of the Central Government.

Other than formation of such subsidiary companies as mentioned above, a banking company cannot hold shares in any company either as pledge, mortgage, or absolute owner of an amount not exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

1.7 RESTRICTION ON LOANS AND ADVANCES

Under Section 20 of the Banking Regulations Act, a banking company shall not grant any loans or advances on the security of its own shares. Further, it cannot enter into any commitment for granting any loan or advance to or on behalf of -

(i) any of its directors.

(ii) any firm in which any of its directors is interested as partner, manager, employee or guarantor.

(iii) any company other than the subsidiary of the banking company, or a company which is entitled to dispense with the use of the word Ltd in its name under the Companies Act, or a Government company of which any of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest.

(iv) any individual in respect of whom any of its directors is a partner or a guarantor.

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1.8 PROHIBITION OF CHARGE ON UNPAID CAPITAL AND FLOATING CHARGE ON ASSETS

Under Section 14 of the Banking Regulation Act, no banking company shall create any charge upon any unpaid capital of the company, and any charge if created shall be invalid. A banking company also cannot create a floating charge on the undertaking or any property of the company or any part thereof unless the creation of such floating charge is certified in writing by the Reserve Bank as not being detrimental to the interest of the depositors of such company. Any charge created without obtaining the certificate from the RBI as above shall be invalid.

1.9 ACCOUNTS

At the end of each calendar year or at the expiration of twelve months ending on such date as the Central Government may specify in this regard, every banking company incorporated in India, in respect of business transacted by it, and every banking company incorporated outside India, in respect of business transacted by its branches in India, shall prepare with reference to that year or period, a Balance Sheet (Form A) and Profit and Loss Account (Form B) as on the last working day of that year or the period in the forms set out in the Third Schedule of Banking Regulation Act.

The Balance Sheet and the Profit and Loss Account must be signed by the manager or principal officer and by at least three directors or all directors if there are not more than three directors in case of a banking company incorporated in India. In case of a banking company incorporated outside India, the statement of accounts must be signed by the manager or agent of the principal office of the company in India. In addition to the above, the Reserve Bank of India has also issued Master Circular on Disclosures to be made in the Financial Statement of these Companies.

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