



## Critical analysis of RBI as a regulatory body to financial sector

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### Abstract

India's central bank is the Reserve Bank of India (RBI). Reserve Bank of India monitors, formulates and implements India's monetary policy. Established in the year 1935, Reserve bank of India was nationalized in the year 1949<sup>[1]</sup>. Owned fully by the Government of India, Reserve Bank has 22 regional offices in various state capitals of India with its headquarters located in Mumbai. It has a majority stake in the State Bank of India<sup>[2]</sup>.

**Keywords:** RBI, regulatory, financial, regulations, company, inflation, capital

### Introduction

It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank. In accordance with the provisions of the RBI Act, 1934 with the main functions as:<sup>[3]</sup>

1. Operating monetary policy with the aim of maintaining economic and financial stability and ensuring adequate financial resources for development purposes
2. Meeting the currency requirement of the public;
3. Promotion of an efficient financial system;
4. Foreign exchange reserve management;
5. The conduct of banking and financial operations of the government<sup>[4]</sup>.

It can be summarised by the preamble as "...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage"<sup>[5]</sup>.

Since the onset of the process economic reforms, including the on-going liberalization and globalization of the economy, the role of the RBI as the Regulator of the financial sector has grown and diversified. Reserve Bank of India is regulator for all the banks in the country and as a regulator, apart from commercial banks, also supervises Co-operative banks, Non Banking Finance companies, Financial Institutions etc. Thus the entire institutional function of providing finance comes under the regulatory oversight of the RBI.

### Part I: Provision of banking regulation act 1966: An analysis

It is the Banking Regulation Act which deals with the regulation of the financial sector by the RBI while the RBI strictly deals with the functions of RBI which are enlisted above in a nutshell. If we have a close analysis of the Indian financial sector, we can conclude that it is the RBI which

regulates the policies, regulations, rules, etc. Let's take a closer look to the statutory provisions giving RBI the authority: The Banking Regulation Act was passed as the Banking Companies Act 1949 and came into force w.e.f 16.3.49. Subsequently it was changed to Banking Regulations Act 1949 w.e.f 01.03.66.

Section 21 gives RBI the power to decide policy in relation to advances to be followed by Banking Companies when it is necessary or expedient in public interest<sup>[6]</sup>. This power to decide the policy, once exercised, is binding on the Banking companies<sup>[7]</sup>. The section gives power to the RBI to decide on policy relating to purpose of advancement, margins to be maintained in respect of secured advances, maximum amount of advances or other financial accommodation, maximum amount to which guarantees will be given and the rate of interest and other related terms and condition. Amendment to the sub-section 2<sup>[8]</sup> provides certain more powers to the RBI which includes Section 21 of the Act was incorporated so as to enable RBI to give directions to banks regarding their loans policies and regulate facilities and check any speculative activities. Under this section and 54-A of the Act to RBI can issue directions having statutory force of law imposing prohibition on payment of interest on current accounts<sup>[9]</sup>.

Section 22 of the act deals with grant of licenses to the banks. This section originated with the demand for licensing of foreign banks doing business in India and was also recommended by the Indian Central Banking Enquiry Committee, mainly with the objective of prohibiting the entry of banks started in countries which discriminated against banks started in India. The above section however introduces a comprehensive system of licensing of Banks by the RBI; the grant of a license in case of banks incorporated in India is dependent upon the maintenance of a satisfactory financial condition coupled with an additional qualification in case of foreign banks, vide sub-section 3A; and conditional licensing. The requirement under this section can be classified under three heads:

- Necessity of licensing and mode of applying it
- Conditions for granting of licences and compliance with

further conditions

- Cancellation of licenses and appeals from such orders.

No banking company can commence or carry on business without obtaining a license granted to it by RBI. To obtain a license the condition in sub-section 3 of section 22 has to be fulfilled<sup>[10]</sup>. In case license is cancelled by RBI they have a right to appeal to the central govt which would be final<sup>[11]</sup>. The same can't be availed by a new banking company whose request for license is being turned down<sup>[12]</sup>. RBI also has a power to cancel the license on ground given in section 22(4)<sup>[13]</sup>.

In *Sajjan Bank P Ltd. V Reserve Bank*<sup>[14]</sup>, such restrictions and obligation put by the section are not violative of the fundamental right of carrying on business. Such powers are not vested with a mere officer of RBI<sup>[15]</sup>. Moreover, RBI has full authority to refuse or grant a license, and the same cannot be looked into by the court, if done on irrelevant grounds<sup>[16]</sup>.

Section 23 of the act puts restriction on opening and transfer of branches both on localised branches and foreign branches. Before granting the permission for this the RBI has to be satisfied regarding the financial conditions and history of the company, the general character, the adequacy of its capital structure and earning prospects and that public interest will be served by opening or change of location<sup>[17]</sup>. Moreover, RBI under this has the power to revoke the permission granted it is satisfied on reasonable grounds, only after the banking company is given a chance to be heard. This restriction is incorporated for maintenance of a satisfactory financial position and the observance of sound banking traditions by foreign branches of Indian banks. Opening of branch without permission is illegal<sup>[18]</sup>.

Section 27 puts an obligation for the banking companies to file returns to RBI in a prescribed form and manner showing its assets and liabilities as at the close of the business. Moreover, RBI has the power to ask for any statement or information relating to banking business<sup>[19]</sup>. This power is accepted by most of the countries including UK<sup>[20]</sup>. Moreover, every banking company, shall, not later than 20days after end of the month, furnish to the RBI monthly return<sup>[21]</sup>.

Moreover, within 30 days of closing, every banking company has to submit return disclosing information about all accounts which are not operated for more than 10 years<sup>[22]</sup>. This lets RBI regulate the financial sector, as it has the idea regarding the credit balance which is stagnant. In case of Fixed Deposits the period is supposed to be counted only after the maturity of the deposits<sup>[23]</sup>. Along with this RBI has the power to publish any information it obtains from Banking Regulation Act in a consolidation form as it may think fit, if it is necessary for public interest<sup>[24]</sup>.

Along with all the above powers RBI also performs controlling and guardian authority. Section 35-A of the act confers on RBI the power to give direction to Co-operative banks in public interest in interest of banking policy and to secure the proper management of banking business of any co-operative bank. The direction can be general in nature or to any specific bank, but it is binding in nature<sup>[25]</sup>.

### Other powers of RBI

RBI has the power to suspend any provision of the act if it

deems fit for a period of 60 days<sup>[26]</sup>. In absence of Governor of RBI, Deputy Governor can perform the same for a period of 30days<sup>[27]</sup>. It can extend the period up to 7years from 5years for disposing of non-banking assets by the banks, if it is in the interest of the depositors<sup>[28]</sup>.

RBI has the final authority to decide on the paid-up capital and reserves<sup>[29]</sup>. If any banking company wishes to form a subsidiary company for the purpose of carrying out a business solely outside India, has to obtain RBI's prior permission<sup>[30]</sup>.

RBI can prohibit any bank from granting any further loans or advances or impose such restrictions or give such direction if it appears from the returns submitted that the interest of the depositors are likely to suffer<sup>[31]</sup>. For remitting any debt due to the bank by its directors, prior approval of RBI is required<sup>[32]</sup>.

The RBI is expected look from the monthly returns to the compliance with regard to maintenance or percentage of assets in India by banking business<sup>[33]</sup>, and to maintenance of assets in India through quarterly returns<sup>[34]</sup>. Special audit of the banks can be performed whenever necessary<sup>[35]</sup>. Balance sheet and accounts have to be submitted by the banking companies to RBI every year end<sup>[36]</sup>.

The Reserve Bank may caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company<sup>[37]</sup>. RBI gives assistance to any banking company by means of the grant of a loan or advance to it<sup>[38]</sup>.

At any time, if it is satisfied that in the public interest or in the interest of banking policy or for preventing the affairs of the banking company being conducted in a manner detrimental to the interests of the banking company or its depositors it may<sup>[39]</sup>

1. Require the banking company to call a meeting of its directors for the purpose of considering any matter relating to or arising out of the affairs of the banking company, or require an officer of the banking company to discuss any such matter with an officer of the Reserve Bank<sup>[40]</sup>;
2. Depute its officers to watch the proceedings at any meeting of the Board of directors of the banking company; require that banking company to give an opportunity to the officers so deputed to be heard at such meetings and also require such officers to send a report of such proceedings to the Reserve Bank<sup>[41]</sup>;
3. Require the Board of directors of the banking company to give in writing to any officer specified by the Reserve Bank in this behalf at his usual address all notices of, and other communications relating to, any meeting of the Board, committee or other body constituted by it<sup>[42]</sup>;
4. Appoint one or more of its officers to observe the manner in which the affairs of the banking company or of its offices or branches are being conducted and make a report thereon<sup>[43]</sup>;
5. Require the banking company to make, within such time as may be specified in the order, such changes in the management as the Reserve Bank may consider necessary<sup>[44]</sup>

Section 10-BB of the act empowers the RBI to appoint

chairman of a Banking Company where the office appointed was on a whole time basis. RBI approves the appointment, re-appointment, remuneration and removal of the chairman or a director<sup>[45]</sup> or auditor<sup>[46]</sup> and any amendments of provisions in the Memorandum or articles or resolution of a general meeting or Board of Directors in that behalf<sup>[47]</sup>. RBI can impose penalty for contravening any provision, rule, regulation in the Act<sup>[48]</sup>.

According to Sec.18, every banking company shall maintain in form of cash reserves with itself of by way of current accounts with RBI or by way of net balance in current accounts. The sum has to be equal to 3% of total time and demand liabilities in India.

There is clear evidence that the financial sector reform process has exerted considerable positive influence on both stability and efficiency of the Indian financial sector though the impact has not been even across all segments.

Further, while assessing the autonomy of the RBI, one should recognise that RBI is not a pure monetary authority but is responsible for several other functions also, as a central bank. The developments in the recent past lead one to the conclusion that, de facto, there has been enhancement of the autonomy of the RBI. A safe and sound financial sector is a prerequisite for sustained growth of any economy. Globalization, deregulation and advances in information technology in recent years have brought about significant changes in the operating environment for banks and other financial institutions. These institutions are faced with increased competitive pressures and changing customer demands. These, in turn, have engendered a rapid increase in product innovations and changes in business strategies. While these developments have enabled improvement in the efficiency of financial institutions, they have also posed some serious risks. Banks play a very useful and dynamic role in the economic life of every modern state.

### **Part III: Contribution of RBI to India**

The economic importance of commercial banks to developing countries may be viewed thus:

- Promoting capital formation
- Encouraging innovation
- Monetisation
- Influence economic activity
- Facilitator of monetary policy

#### **Promoting capital formation**

A developing economy needs a high rate of capital formation to accelerate the tempo of economic development, but the rate of capital formation depends upon the rate of saving<sup>[49]</sup>. RBI makes sure the banks afford facilities for saving and, thus encourage the habits of thrift and industry in the community. They mobilize the ideal and dormant capital of the country and make it available for productive purposes<sup>[50]</sup>. RBI regulates the policies of money lending, interest etc. to make sure promotion of capital formation takes place.

#### **Encouraging Innovation**

The entrepreneur in innovation is largely dependent on the manner in which bank credit is allocated and utilized in the process of economic growth<sup>[51]</sup>. Bank credit enables entrepreneurs to innovate and invest, and thus uplift economic

activity and progress<sup>[52]</sup>. RBI has the power to decide policy in relation to advances to be followed by Banking Companies which makes sure there is availability of attractive policies for investors etc.

#### **Monetisation**

Banks are the manufactures of money and they allow many to play its role freely in the economy<sup>[53]</sup>. Banks monetize debts and also assist the backward subsistence sector of the rural economy by extending their branches in to the rural areas<sup>[54]</sup>. RBI keeps a check on opening of branches to providing them with licenses. Moreover, for remitting any debt due to the bank by its directors, prior approval of RBI is required.

#### **Influence economic activity**

Banks are in a position to influence economic activity in a country by their influence on the rate interest etc.<sup>[55]</sup>. They can influence the rate of interest in the money market through its supply of funds<sup>[56]</sup>. Banks may follow a cheap money policy with low interest rates which will tend to stimulate economic activity. In order to regulate any disaster in the financial status of the country RBI plays a very important role.

#### **Facilitator of monetary policy**

Thus monetary policy of a country should be conducive to economic development. But a well-developed banking system is on essential pre-condition to the effective implementation of monetary policy. Under-developed countries cannot afford to ignore this fact. A fine, an efficient and comprehensive banking system is a crucial factor of the developmental process of economy. RBI plays a very important role in regulating all the banks, policies, branches etc. which makes sure stability and transparency in the banking system of India. This ultimately leads to a very well established and governed banking system in India.

### **Part IV: Conclusion**

Physical products, from toasters and lawnmowers, to infant car seats and toys, to meat and drugs, are routinely inspected and regulated for safety. The market for consumer credit is not operating efficiently in certain areas. Evidence abounds that consumers are sold credit products that are designed to obscure their risks and to exploit consumer misunderstanding. Without regulatory intervention, market distortions and inefficiencies will continue to grow, imposing substantial costs on Indian families and on the economy. For all the above we need an apex regulatory body. RBI does the same!

The RBI has over the years been responding to changing economic circumstances. To conclude, the role of RBI has been redefined through gradual evolution and adaptation, along with some statutory changes, and not through any radical restructuring. Further, while assessing the autonomy of the RBI, one should recognise that RBI is not a pure monetary authority but is responsible for several other functions also, as a central bank. The developments in the recent past lead one to the conclusion that, de facto, there has been enhancement of the autonomy of the RBI. As regards monetary policy framework, the objectives remained the same but the framework has been changed from time to time in a gradual fashion in response to the evolving circumstances.

## References

1. Tannan ML. Tannan's banking: law and practice in India. 2005; pp. 163.
2. Id.
3. Id.
4. Id.
5. Reserve Bank of India Act, 1934.
6. Parameswaran R, Natarajan S, Kandasami KP. Banking Law and Practice. 2005; pp. 90.
7. Supra note 1, at 80.
8. Id.
9. RBI v State Bank of India 1996 (80) Com Cases 554; Indian Bank, Tiruvanmellai v V.A Balasubramania Gurukul AIR 1982 Mad 296.
10. Before granting any licence under this section, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that 6 [the following conditions are fulfilled, namely:--
  - a. 7 [that the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
  - b. that the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interests of its present or future depositor;]
  - c. 8 [that the general character of the proposed management of the company will not be prejudicial to the public interest or the interest of its depositors;
  - d. that the company has adequate capital structure and earning prospects;
  - e. that the public interest will be served by the grant of a licence to the company to carry on banking business in India;
  - f. that having regard to the banking facilities available in the proposed principal area of operations of the company, the potential scope for expansion of banks already in existence in the area and other relevant factors the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth;
  - g. any other condition, the fulfilment of which would, in the opinion of the Reserve Bank, be necessary to ensure that the carrying on of banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.]
11. Sec. 22(5)
12. Sec. 22(6).
13. (4) 2 [The Reserve Bank may cancel a licence granted to a banking company under this section- (i) if the company ceases to carry on banking business in India; or i) if the company at any time fails to comply with any of the conditions imposed upon it under sub- section (1); or (iii) if at any time, any of the conditions referred to in sub-section (3) 1 [and sub- section (3A)] is not fulfilled: Provided that before cancelling a licence under clause (ii) or clause (iii) of this sub- section on the ground that the banking company has failed to comply with or has failed to fulfil any of the conditions referred to therein, the Reserve Bank, unless it is of opinion that the delay will be prejudicial to the interests of the company' s depositors or the public, shall grant to the company on such terms as it may specify, an opportunity of taking the necessary steps for complying with or fulfilling such condition.
14. AIR 1961 Mad 8
15. Co-operative Bank v M.S Co-operative Banks Ltd AIR 2004 SC 141.
16. Shivabai Zoverbhai Patel v RBI AIR 1986 Guj 19
17. Sec. 23(2)
18. SBISA Co-operative Bank Ltd v Tarun Kumar Saha 2000 Bankman 275 (Cal.)
19. Sec. 27(2)
20. Bank of England Act 1945
21. Sec. 24(3)
22. Sec. 26(1)
23. Sec. 26(2)
24. Sec. 27
25. Mohammed usman v Registrar of Co-operative societies AIR 2003 Ker 299
26. Sec. 4(1)
27. Sec.4(1)
28. Proviso of section 9
29. Sec. 11(6)
30. Sec. 19
31. Sec. 20(3)
32. Sec. 20-A
33. Sec.24
34. Sec. 25
35. (1-B) (1-C) (2) of Sec.30
36. Sec. 31
37. Sec. 36(1)
38. Sec. 36(1)(c)
39. Sec. 36(1)(d)
40. Sec. 36(1)(d)(i)
41. Sec. 36(1)(d)(i)
42. Sec. 36(1)(d)(i)
43. Sec. 36(1)(d)(i)
44. Sec. 36(1)(d)(i)
45. Sec. 35-B(1)(b)
46. Sec. 30 (1-A)
47. Sec. 35-B(1)(a)
48. Sec. 47-A
49. Pahlavani M, Verma R, Wilson E. The Role of Capital Formation and Saving in Promoting Economic Growth in Iran, 35th Australian Conference of Economists (ACE) 2006 Curtin University of Technology Perth, 2006
50. Id.
51. Plumtre AFW. The Rôle of Interest Rates and Bank Credit in the Economies of the British Dominions The Economic Journal. 1939; 49(194):222-236
52. Id.
53. Daniel L. Thornton, Monetizing the Debt, Economic SYNOPSES 2010 † Number 14 research.stlouisfed.org
54. Id.
55. Supra note 51.
56. Id.