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# **REFORMS IN THE INDIAN BANKING SYSTEM**

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## **ABSTRACT**

Reform measures in India were sequenced to improve the operation efficiency, to create an enabling environment for banks to overcome the external constraints and operate with greater flexibility and to upgrade the health and financial soundness of banks so as to meet internationally accepted standards of performance. The market developments along with Liberalization & Globalization have transformed banks in a much higher pace with technology acting as a catalyst. The first phase of the bank sector reforms was completed where the strategy was broadly similar to that followed in other countries, to the extent that it focused on imposing prudential norms, increasing competition to promote greater efficiency and improving regulatory supervision to meet Basel I standards formulated by the committee of the Bank of International Settlement. The second generation reforms which are on progress, concentrate on reforming the structure of the bank industry for strengthening the very foundation of the banking system, technological up gradation and human resource development. The major global challenges would be the implementation of Basel II, enhancing corporate governance, alignment of regulatory and accounting requirements, outsourcing risks and application of advanced technology. Banks are striving hard to combat the competition they face globally and hence will have to prepare themselves for the greater challenges lying ahead in future.

This study makes an effort to present the different phases and changes witnessed in the Indian Banking System and an insight into the future ahead. It focuses on the necessity for introducing reforms in the present Indian banking laws, to be in par with global expectations, the opportunities, the global challenges ahead and the role of technological innovation that could be the changing agent in the coming years.

**Keywords:** Indian banking system, Globalisation, Technology, Reformation, Financial sector

## I. INTRODUCTION

An effective and sound banking system is the key to achieve a healthy and prosperous economy in a country. In India, to make this happen, a considerable amount of attention and efforts have been put into account on how the banking system should not only be made hassle free but also be able to meet new challenges posed by any external and internal factors. India's banking system has made several outstanding reaching to its credit in which the most striking is its extensive reach. In fact, the Indian banking system is no longer confined to only metropolitan or cosmopolitans, it has reached even to the remote corners of the country. The banking business around the world has witnessed several changes over time and has started practicing a developed system. Important reforms will have to be implemented soon if Indian banking is to be put on a sound footing against a background of increasing global integration of the Indian economy. The Indian thinking on financial reforms was greatly influenced by global developments and practices. For instance, The World Bank played a crucial role in supporting India's economy with financial aid packages even before its independence. The World Bank and India can change their relationship by embracing the "Reform to Transform India" approach that encompasses governance changes and altering lending conditions imposed on countries<sup>1</sup>. The banking sector in India has provided a mixed response to the reforms initiated by RBI and the Govt. of India since 1991. The Indian banking system is growing in a robust manner as it has responded positively in the field of profitability, productivity, assets quality i.e. reduction of NPAs, norms of prudential regulations of accounting, enhancing the role of market forces, income recognition, provisioning and exposure, and the up gradation of technology<sup>2</sup>. The financial sector reforms have brought the Indian financial system closer to the global standards and still have a long way to go to catch up with their counterparts.

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<sup>1</sup> Arun Jaitley, Minister of Finance, Corporate Affairs and Information & Broadcasting, India, Statement at the Thirty Third Meeting of International Monetary and Financial Committee

<sup>2</sup> "India Development Update", World Bank Report 151554

## II. CHANGES IN THE BANKING LAWS

### 1. LEGISLATIVE REFORMS

Modern Banking in India started with the first bank, 'General Bank of India', though conservative, was established in 1786.

- First Phase: from 1786 to 1969 British Period up to Nationalization
- Second Phase: Nationalization of Indian Banks and up to 1991
- Third Phase: Indian Banking system with the advent of policy of LPG, that is, Policy of Liberalization, Privatization and Globalization in India after 1991 and till date

These are the major enactments and amendments that have been made to the various banking related aspects during the last decade to highlight the dynamic nature of legislation.

- Reserve Bank of India Act,1934: Amended in 2006 to provide legality to some OTC derivative transactions and to give explicit regulatory powers to RBI over derivatives and money market instruments.
- The Banking Regulation Act,1949: Amended in 2007 to eliminate the lower cap requirements for Statutory Liquidity Ratio (SLR) maintenance and conferring ample powers in stipulating the prescribed SLR and to manage liquidity in the market on the RBI.
- The State Bank of India Act,1955: Amended in 2007 to enable transfer of ownership from RBI to Government of India and amended in 2010 to provide for enhancement of capital, issue of preference shares, raise capital by public issue, preferential allotment, private placement, rights issue and to issue bonus shares to the existing shareholders, etc.
- The State Bank of India(Subsidiary Banks)Act,1959: Amended in 2007 to similarly facilitate enhancement of capital, raise resources from the market and raise capital through rights issue.
- The Banking Companies(Acquisition and Transfer of Undertakings)Act,1970: Amended in 2006 for nationalised banks to issue preference shares in accordance with the

guidelines framed by RBI and to raise capital by preferential allotment or private placement or public issue with the approval of RBI.

- The Negotiable Instruments Act, 1881: Amended in 2002 for introducing the concepts of “electronic cheque” and “cheque truncation” by enhancing the definition of “cheque”.
- The Securities Contracts (Regulation) Amendment Act, 2007: Passed for providing effective legal framework for listing and trading of securitised debt instruments
- The Government Securities Act, 2006: Legislated to consolidate and amend the laws and management of Government securities by the RBI. The procedure for settlement of claims of legal representatives, for admissibility of computerised information as evidence, for effectively dealing with misuse of Statutory General Ledger (SGL) accounts and the pledging and hypothecation of Government securities are simplified.
- The Credit Information Companies (Regulation) Act, 2005: It Empowers the RBI to regulate the Credit Information Companies (CIC) and to facilitate efficient distribution of credit and matters concerned or incidental to it.
- The Banking Codes and Standards Board of India (BCSBI): In November 2003, RBI constituted a committee on Procedures and Performance Audit of Public Services<sup>3</sup> to address the issues relating to availability of adequate banking Services to the common man.

## 2. MAJOR REFORMS

(i) Entry of new banks: In order to introduce and enhance more competition, the guidelines on entry of new private sector banks were announced

(ii) Regulatory supervision: The Banking Regulation (Amendment) Act, 2017 was passed to authorise the RBI to issue directions to any banking company under the provisions of the Insolvency and Bankruptcy Code (IBC), 2016 for initiating insolvency resolution process in respect of defaulting corporate borrowers.

(iii) SLR AND CRR: Banks are required by law to keep a prescribed percentage of demand and

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<sup>3</sup> Under the Chairmanship of Shri S.S. Tarapore (former Deputy Governor)



time liabilities as SLR by way of investment in government securities and CRR in form of balance with the RBI for obligations

(iv)Deregulation of Interest Rates: After a series of relaxations, in October,1997 interest rates on deposits other than those on savings accounts and foreign currency deposits (FCNR(B)) were fully deregulated.

(v)Legal reforms for recovery of NPA: The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993 for setting up of Debt Recovery Tribunals (DRTs) to deal with only recovery suits filed by banks. The introduction of DRTs was a major reform and it paved the way for landmark cases. For instance:

- In United Bank of India v. DRT, the SC held that if the bank had alleged in the suit that an amount was due to it from the borrower or the respondent, since the liability on part of the respondent had developed during the course of their business activity and the same was still subsisting. It is ample enough to cover such amount within the ambit and scope of the definition of debt under the DRT act and is recoverable under the act.<sup>4</sup>
- In Gv Films v. UTI, it is held that the payment made by the bank by a mistake is a debt.<sup>5</sup>
- In Bank of India v. Vijay Ramniklak, it was held that if an Employee commits fraud and misappropriation. The amount that would be recoverable from him could not be held as Debt under the DRT Act.<sup>6</sup>
- In Allahabad Bank v. Canara Bank, it was held that DRT is said to be a special Act for recovery of the debt due to banks and financial institutions. DRT has an overriding effect over the provisions of Companies Act,1956, hence leave of the company court is not required even if the company is under winding up proceedings.<sup>7</sup>

(vi)Ownership and governance: the State Bank of India Act,1955 was amended to facilitate partial private shareholding. The Banking Companies Acquisition and Transfer of Undertakings Act,1970/1980 was also amended for nationalised banks to access capital market if the

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<sup>4</sup> (1999) 4 SCC 69

<sup>5</sup> (2000) 100 Compo Cases 257 (Mad) (HC)

<sup>6</sup> AIR 1997 Guj. 75

<sup>7</sup> AIR 2000 SC 1535

government stake remained at least at 51%

(vii)Customer service: The Ombudsman scheme was introduced under the aegis of the RBI in 1995 to enable customers to seek relief in respect of complaints about services offered by commercial banks.

(viii)Improving the information flow:

Credit Information Bureau Limited (CIBIL) was set up in 2000 for tracking credit history of retail customers who are given credit score based on repayment of loans. The Credit Information Companies (CICs) Regulation Act, 2005 was passed and the Regulations and Rules were framed in 2000 where the banks report information on repayment of retail loans to CICs.

(ix)Financial Inclusion: Group lending was introduced through Self- Help Groups (SHGs). The unique identification (Aadhaar) concept received legal backing in 2016 which was introduced in 2009 and is now linked to bank accounts. The Supreme Court held that such linking is not mandatory with the exception of getting government subsidies.<sup>8</sup>

### **III. SCOPE FOR REFORMATION**

The Banking Regulation Act dates back to the year 1949 with amendments to ensure certain lacunas, still it contains certain rules and regulations that do not fit well with the current banking system. RBI has many powers including supervisory ones. Though taking any action against the public sector banks requires prior consultation from the government. The need of the hour is not just efficient provisions but a more vigilant attitude from the RBI as the present laws have not been sufficient for years. The Indian banking sector needs reforms not just on paper but also in reality and its proper implementation as well.

Multiple acts: The prudential regulations are ownership neutral. A single, harmonized and uniform legislation which can extend its applicability holistically to all banks would provide transparency, comprehensiveness and clarity to enhance the ease of regulations and supervisions

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<sup>8</sup>Saurav Harsh Son Of Shri Harish vs State Of Rajasthan on 28 November, 2018

done by the Reserve Bank. There is a need to figure out the overlaps and conflicts between the primary laws governing the banking sector and other applicable laws.

**Management of banks:** While RBI can under certain circumstances remove the managerial and other persons from the banks and appoint additional directors, etc. This might be ineffective where super-session of the Board is warranted and in like circumstances. Hence, the authority for directing an order at any time that those persons who contravenes these provisions and who are unqualified to hold the equity or voting power must be vested with the RBI.

**Deposit collection activity:** The collection of deposits from members/shareholders is not treated as acceptance of public deposits. Deposits are received by enrolment of the members on tap and by collecting nominal amounts from those members, hence exposing such depositors to stern risks. Banking Regulation Act is inapplicable in case of co-operative societies and out of the regulatory purview of the Reserve Bank. The exemption from these provisions of the Banking Regulation Act ought not to be made applicable to plug this imperative loophole.

**Financial conglomerates:** In India, banks are entitled to carry on certain financial activities under the bank subsidiary model and the performance of the subsidiaries affects the balance sheet of the bank. As the varied activities carried on by the entities in the group fall within the regulatory jurisdiction of multiple regulators, the risk to the system as a whole posed by such financial conglomerates is difficult to assess. RBI as the regulator of banks needs to be empowered to obtain information, with respect to each systemic issue of the entities functioning under the umbrella of a bank.

**Non-operative bank holding company:** Big and complex entities pose supervisory issues to the regulators and pose serious systemic risks. We need effective resolution mechanisms to ensure orderly winding up of these systemically important entities in case of crisis. A non-operative bank holding company structure can be used to deal with financial conglomerates. The non-operative holding company needs to be regulated on par with the a bank and has to be placed under the regulatory and supervisory authority of RBI while the functional regulator of each subsidiary may regulate and supervise the business.

Minimum capital requirements: The minimum capital prescribed in the Banking Regulation Act for banks is too low and The Reserve Bank prescribes minimum capital requirement in case of private sector banks from time to time. Minimum capital requirements prescribed under the “Ownership and Governance” guidelines and that being prescribed for new banks in private sector are way above the current provisions of the Act. It would be appropriate to empower Reserve Bank to stipulate the capital requirements and other quantitative parameters instead of prescribing quantitative limits in the respective Acts.

Migration to IFRS: As part of the efforts to ensure convergence of the Indian Accounting Standards (IAS) with the International Financial Reporting Standards (IFRS), the formats of financial statements undergo changes consequent its introduction. Reserve Bank should prescribe the format of the balance sheet, profit and loss account, etc.<sup>9</sup>

Bilateral netting issues: In respect of the interest rate and foreign exchange derivatives, and gold, various banks had requested RBI to allow bilateral netting of counterparty credit exposure. Enacting a single legislation which covers all aspects of banks’ functioning while possibly provide differential legislative framework for corporate governance issues on account of ownership differences would be more efficient.

Bank resolution: The legal framework should address the resolution mechanism from a practical point of view and must have at least these characteristics:

- Early intervention before insolvency
- Speed of intervention/resolution
- Ability to transfer or merge operations
- Effective write-down of shareholders’ rights
- Protection of on-going business

Mergers: The BR Act which empowers RBI to sanction a scheme for voluntary amalgamation of banking companies is not available with respect to cooperative banks.

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<sup>9</sup>Given in Third Schedule of the B. R. Act.

Consumer protection and globally compatible secrecy laws: RBI has framed the Banking Ombudsman Scheme by statutory directions under the BR Act for speedy relief of consumer grievances. Further, unless the secrecy laws in our jurisdiction are compatible with global standards, it would be impossible to receive from or share information with overseas regulators.

#### IV. FUTURE IMPLEMENTATIONS

Regulating the banking business can bring fairness through government control and their advantages and limitations depend upon the financial conditions, economic policies, and existing legal framework of the country on the subject.

##### 1. BASEL III:

It's a worldwide regulatory benchmark on market liquidity risk, bank capital adequacy and stress testing<sup>10</sup>. The objective is to improve the banking sector's ability to absorb ups and downs arising from financial and economic instability

- Improve risk management ability and governance of banking sector
- Strengthen banks' transparency and disclosures

##### 2. THE BANKING REGULATION (AMENDMENT) BILL, 2020:

The Bill<sup>11</sup> seeks to amend the Banking Regulation Act, 1949, with regard to cooperative banks but not to certain cooperative societies. The Bill amends the provision to state that the Act will not apply to:

- (i) primary agricultural credit societies
- (ii) cooperative societies in which the long term financing for agricultural development is a primary business.

The Bill delivers that a cooperative bank may provide equity shares, special shares or preference shares on the face value or at a premium to its members or to any other person residing within its area of operation and the RBI may for up to five years supersede the Board of Directors of a

<sup>10</sup> Agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11

<sup>11</sup> Introduced in Lok Sabha by the Minister of Finance, Ms. Nirmala Sitharaman, on March 3, 2020

multi-state cooperative bank under certain conditions and through notification may exempt cooperative banks from certain provisions of the Act.<sup>12</sup>

## V. LANDMARK CASES

- RC Cooper v Union of India<sup>13</sup> [also known as the Bank Nationalization Case]

The grounds for this judgement were that:

- (1)the Act makes hostile discrimination preventing the 14 banks from carrying business whereas other Indian and foreign banks may continue to carry business
- (2)the Act under Article 19 restricts the banks from carrying on business
- (3)the Act violates Article 31(2) which provides for guarantee of compensation as the compensation herein is not in accordance with relevant principles.

- Confederation v. Union of India<sup>14</sup>

It was observed that the object of Banking Companies(Acquisition and Transfer of Undertakings)Act was to nationalize the banks to deliver the largest good to the largest number of people.

- Life Insurance Corporation v. Escorts Limited<sup>15</sup>

It was held that the custodian general of foreign exchange is the RBI.

- Sajjan Bank (P) Ltd. v. Reserve Bank<sup>16</sup>

It has been held that the provisions of Section 22 of Banking Regulation Act,1949 is not in violation of the fundamental right to carry on the business of banking of any person since it merely prescribes the system of licensing with an object of regulation of business of banking.

- Whistler v. Forster<sup>17</sup>

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<sup>12</sup><https://www.livemint.com/news/india>

<sup>13</sup> 1970 3 SCR 530

<sup>14</sup> (1989) 4 SCC 90

<sup>15</sup> AIR 1986 SC 1370

<sup>16</sup> AIR 1961 Mad 8

It was observed that the title of a negotiable instrument passes by endorsement and delivery according to the Law of Merchant. A title so obtained is right in rem (against the entire world) provided the instrument is taken for value and without notice of any fraud.

- Ashok YeshwantBadeve v. SurendraMadhavraoNighojakar<sup>18</sup>

Held that a cheque is considered as a cheque only on the date written on it and not a post dated cheque on the date it is drawn. The post-dated cheque remains a bill of exchange till that date.

- Sampellysatyanarayanna Rao v. Indian Renewable Energy Development Agency Limited<sup>19</sup>

Ruled that a dishonoured post dated cheque described as a collateral for the resettlement of a loan instalment in the loan agreement falls within the scope of section 138 of the Negotiable Instruments Act, 1881 and as such the drawer who issues the cheque as a collateral for payment of instalments without adequate balance in the account shall be held criminally liable for dishonouring such cheques.

- UCO Bank v. Dipak Debbarma<sup>20</sup>

The members of scheduled tribes of the state (the respondents) contended that section 187 of the Tripura plans revenue and land reforms act, 1960 was violated when the sale notification was issued by the bank under SARFAESI Act, 2002. It was held that even if prohibited by state law, under certain circumstances, the banks can sell tribal land to non-Tribes.

- Union bank of India and Anr. v. State of West Bengal and others<sup>21</sup>

The court held that the bank as a secured creditor cannot maintain an application under section 14 of the SARFAESI subsequently to the sale of an immovable property under SARFAESI Act on the basis of symbolic possession in order to obtain actual physical

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<sup>17</sup> 143 ER 441

<sup>18</sup> (2001)3 SCC 726

<sup>19</sup> AIR 2016

<sup>20</sup> Ibid.

<sup>21</sup> W.P. No. 21814 (W) of 2017

possession of the property after issuance of a sale certificate.

## VI. CONCLUSION

India's banking sector is sufficiently capitalised and well-regulated as the financial conditions and the economy in the present moment is compatible with any country in the world. Indian banks evidently withstood the global downturn efficiently and have the capability to recover quickly from difficult conditions. India is known to be one of the fastest growing economies in the world and still the poor status of the banking sector is witnessed. The Banking Regulation Act was introduced to strengthen the root level of the banking structure within India with the primary objective to free the banking system from its lacunas and promote its growth and development, however, the ground reality is different. If the Act is not equipped well, it won't serve its objectives. The pertinent concern is the blend that the financial system in India including banking, insurance, capital, taxation, etc. each has many regulators and separate mandate. The financial system and banking particularly is still characterised by considerable fragmentation of legislation, regulation and enforcement. The policy related frictions might arise from the diversity of different legislations and the overlapping of the regulatory jurisdictions. Among financial jurisdictions there might be a possibility of risk of legal arbitrage. These circumstances call for the need to rewrite and streamline the financial sector laws, rules and regulations and to bring them in harmony with the requirements of India's fast growing financial sector. The current legislations were drafted in the contemporaneous setting and should be amended from time to time to incorporate changes in the milieu. Amending old provision or enacting new law is a continuous process to remain aligned to changing circumstances. In the emerging scenario and amid global economic worries, the task of preventing financial risks has become more important and challenging which, on completion, would immensely benefit the financial sector in India and economy at large.

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