

Local Area Banks



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1. **Local Area Banks (LABs) were conceived in India primarily with which of the following core objectives?**

A

To compete directly with the major Public Sector Banks across the national level.

B

To focus exclusively on corporate financing and foreign exchange transactions in metro cities.

C

To promote rural savings and provide institutional credit for viable economic activities in local areas.

D

To act as a specialized institution for agricultural refinancing, similar to NABARD.

Solution

- **Core Objective:** The primary aim of setting up Local Area Banks (LABs) in 1996 was to establish a private-sector institutional mechanism for promoting rural savings and for the provision of credit for viable economic activities within a specific local area.
- **Geographic Focus:** They were intended to operate with jurisdiction over two or three contiguous districts, ensuring a deep focus on the local community's needs, contrasting with the wider reach of commercial banks.

- **Financial Inclusion:** A major goal was to bridge the gaps in credit availability and enhance financial inclusion in unbanked or underbanked rural and semi-urban areas, functioning like a localized private sector bank.
- **Private Initiative:** The scheme was floated to allow for private initiative in banking, which was a departure from the government-led establishment of Regional Rural Banks (RRBs).
- **Regulatory Status:** While local in operation, they were subject to the full regulatory framework of the RBI, including the Banking Regulation Act, 1949, and were eligible for inclusion in the Second Schedule of the RBI Act, 1934 (Scheduled Bank status).

2. **With respect to the regulation of interest rates, which of the following statements were applicable to LABs?**

I. Interest rates on deposits and advances were entirely deregulated, allowing flexibility.

II. The interest rate on savings accounts was determined solely by the RBI.

III. LABs were mandated to maintain an interest rate ceiling on all loans to the priority sector.

Which of the statements given above is/are CORRECT?

A Only I

B Only II

C Only III

D Only I and III

Solution

- **Deregulated Rates:** Statement I is correct. Following broad banking reforms, the interest rates on deposits (except for a short-term savings rate period) and advances were largely deregulated, giving LABs the necessary commercial freedom to set competitive rates tailored to their local market.

- **Savings Rate:** Statement II is incorrect. The interest rate on savings accounts has been deregulated by the RBI (since 2011), meaning banks (including LABs) are free to set their own rates.
- **Rate Ceiling:** Statement III is incorrect. In general, the RBI has moved away from mandating interest rate ceilings on most loans, including those to the priority sector, instead encouraging pricing based on the bank's cost of funds.
- **Competitive Edge:** This deregulation (I) allowed LABs to potentially offer slightly higher deposit rates to mobilize local savings, a key factor in their original business model.
- **Regulatory Normality:** The interest rate policy for LABs was generally kept in line with the policy for all domestic commercial banks

3. **Local Area Banks (LABs) operate with a geographically restricted area of operation. What was the typical area of operation specified in the initial guidelines?**

A A single large state.

B A metropolitan area and its surrounding suburbs.

C Two to three contiguous districts.

D A maximum of one district and its union territories

Solution

- **Geographic Limit:** The defining feature of LABs is their limited geographical reach, initially set at two or three contiguous districts.
- **Contiguous Districts:** The word 'contiguous' (meaning adjacent or touching) is crucial, ensuring that the bank's operations remain locally concentrated, allowing for better monitoring and focused lending.
- **Deepening vs. Widening:** The restricted area forces LABs to focus on deepening their engagement with the customer base in that specific region rather than spatial growth or widening their area across multiple regions.
- **Regulatory Flexibility:** While the initial limit was two or three, the RBI later enhanced the area to cover two more districts in the case

of some LABs, showing slight regulatory flexibility based on performance.

- Contrast with RRBs: While Regional Rural Banks (RRBs) also focus on rural areas, their area of operation is typically co-terminus with one or more districts of a state, but the structure and ownership of RRBs are fundamentally different (joint ownership of Central Govt, State Govt, and Sponsor Bank)

4. **Which central legislation governs the licensing, regulation, and overall control of Local Area Banks in India?**

A Companies Act, 2013

B Reserve Bank of India Act, 1934

C Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

D **Banking Regulation Act, 1949**

Solution

- **Primary Banking Law:** Like all commercial banks in India, the core functions, licensing, and overall control of Local Area Banks are governed by the Banking Regulation Act, 1949.
- **RBI Act, 1934:** The Reserve Bank of India Act, 1934, primarily deals with the RBI's functions and empowers it to regulate banks, and determines if a bank is a 'Scheduled Bank' (Second Schedule).
- **Companies Act:** LABs are required to be registered as public limited companies under the Companies Act, but this act governs their corporate structure, not their banking operations.
- **Regulation and Supervision:** The RBI exercises its powers of supervision and inspection over LABs based on the provisions of the

Banking Regulation Act, 1949, ensuring they adhere to prudential norms.

- **Uniform Application:** The application of the Banking Regulation Act, 1949, signifies that despite their local focus and smaller size, LABs are treated as full-fledged banking entities subject to the same strict regulatory standards as major commercial banks

5. Which of the following statements is **INCORRECT** regarding the **Priority Sector Lending (PSL)** requirements for **Local Area Banks**?

A

LABs are required to observe the PSL targets as applicable to other domestic commercial banks.

B

The overall PSL target is 40% of the Adjusted Net Bank Credit (ANBC).

C

LABs have to lend at least 10% of their Net Bank Credit to the Weaker Sections.

D

They are completely exempt from maintaining any PSL targets due to their small size and local focus.

Solution

- **PSL Requirement:** Local Area Banks are not exempt from Priority Sector Lending (PSL) norms; they are required to adhere to the same PSL targets as applicable to other domestic commercial banks.
- **Overall Target:** The overall PSL target is 40% of the Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBE), whichever is higher.
- **Weaker Sections Target:** They must adhere to the sub-target for Weaker Sections, which is mandated to be at least 10% of ANBC (or CEOBE).

- **Focus on Local Needs:** The obligation to meet PSL targets aligns with their core objective of promoting economic development in the local area, especially for agriculture, small industries, and other priority sectors.
- **Regulatory Parity:** Maintaining PSL parity ensures that LABs, despite being private sector initiatives, serve the social objective of directing credit to neglected sectors, thereby justifying their banking license

6. Which committee or policy announcement led to the idea and eventual establishment of Local Area Banks in India?

A Narasimham Committee (1998)

B Rangarajan Committee on Financial Sector Reforms

C Dr. K.C. Chakrabarty Committee on Regional Rural Banks

D Union Budget Speech of 1996-97

Solution

- **Origin Announcement:** The idea of promoting new private Local Area Banks was first announced by the then Finance Minister in the Union Budget Speech of July 22, 1996.
- **Policy Intent:** The announcement stated that the RBI had agreed to promote the setting up of new private local area banks with jurisdiction over two or three contiguous districts.
- **Rationale:** The intention was to provide an institutional mechanism for promoting rural savings and providing credit for viable local economic activities.
- **Implementation:** Following the budget speech, the Reserve Bank of India issued guidelines for the establishment of LABs in August 1996.

- **Historical Context:** This initiative was part of broader post-1991 financial sector reforms aimed at introducing competition and efficiency through private-sector participation, even in niche areas like local banking

7. **Which of the following entities were explicitly allowed to promote a Local Area Bank according to the initial RBI guidelines?**

A Only the Central Government or State Governments.

B Foreign banks or their subsidiaries.

C Only existing Regional Rural Banks (RRBs).

D **Individuals, corporate entities, trusts, or societies.**

Solution

- **Promoter Eligibility:** The RBI guidelines permitted various types of private entities to promote LABs, including individuals, corporate entities, trusts, and societies.
- **Private Sector Focus:** This wide scope for promoters underscored the policy's intent to encourage private-sector participation and local entrepreneurship in banking services.
- **"Fit and Proper" Criteria:** Promoters were, however, subject to the RBI's strict "fit and proper" criteria to ensure integrity and financial standing.
- **Capital Contribution:** Promoters were mandated to contribute a significant portion (initially 40%) of the minimum paid-up capital of ₹5 crore.

- **Exclusion of Government:** Unlike the establishment of Public Sector Banks or Regional Rural Banks, the government was not the designated promoter of LABs, reinforcing their private nature

8. **What is the maximum number of contiguous districts that a Local Area Bank was initially allowed to operate in?**

A One

B Three

C Five

D Seven

Solution

- **Initial Limit:** The initial and most defining limit on the area of operation for a Local Area Bank was a maximum of three contiguous districts.
- **Contiguous Nature:** The use of "contiguous" ensured that the bank's activities were confined to a close-knit, easily manageable geographical area.
- **Rationale:** This restriction was imposed to foster deep knowledge of local conditions, credit needs, and customer behavior, leading to a more effective credit delivery system.
- **Limited Branch Expansion:** The branch licensing policy was also governed by this limited geographic focus, restricting their expansion capacity compared to national banks.

- **Later Amendment (for some):** While the maximum remained three for most, the area of operation was later enhanced to cover two more districts (total five) in the case of some performing LABs.

9. **Which of the following is a key functional difference between a Local Area Bank (LAB) and a Regional Rural Bank (RRB)?**

A

RRBs are primarily focused on profit generation, while LABs focus on social banking

B

LABs are only regulated by the State Government, while RRBs are regulated by the Central Government.

C

LABs are promoted by the private sector, whereas RRBs are sponsored by a Public Sector Bank (PSB) with joint ownership.

D

RRBs are allowed to undertake foreign exchange transactions, which are strictly prohibited for LABs.

Solution

- **Ownership/Promoter:** The critical difference is in ownership: LABs are promoted by private sector entities (individuals, corporates, trusts), while RRBs are jointly owned by the Central Government (50%), State Government (15%), and a Sponsor Bank (35%).
- **Sponsor Bank Role:** RRBs have a Sponsor Bank, which is typically a Public Sector Bank, providing management and financial support, a structure absent in LABs.

- **Legal Status:** Both are Scheduled Commercial Banks, but LABs are registered under the Companies Act, while RRBs are established under the RRB Act, 1976.
- **Operational Scope:** Both have a regional focus, but the underlying motivation and governance structure are vastly different, with RRBs being a government initiative for rural credit.
- **Conversion Path:** The RBI allowed the option for LABs to potentially convert to Small Finance Banks, demonstrating a specific regulatory path for the private, local-focused model

10. If a Local Area Bank is included in the Second Schedule of the RBI Act, 1934, what is the key advantage it gains?

- A** Exemption from all statutory reserve requirements (CRR and SLR).
- B** The ability to borrow funds from the RBI under the refinance facility.
- C** Permission to operate without any minimum capital adequacy ratio.
- D** Exemption from RBI supervision and inspection.

Solution

- **Scheduled Bank Status:** Inclusion in the Second Schedule confers the status of a Scheduled Bank, which is a sign of credibility and financial soundness.
- **Refinance Facility:** A Scheduled Bank is eligible to obtain loans and advances from the Reserve Bank of India (RBI) at the bank rate, using the refinance facility.
- **Clearing House:** It also makes the bank eligible for membership in the clearing house facility managed by the RBI or its agents.
- **Demand for CRR:** While gaining benefits, it also imposes an obligation: a Scheduled Bank must maintain the mandated Cash Reserve Ratio (CRR) with the RBI.
- **Deposit Confidence:** The scheduled status enhances public confidence in the bank, aiding its ability to mobilize deposits from

the local community

11. Which of the following Local Area Banks was the first to successfully convert its operations into a Small Finance Bank (SFB)?

A Coastal Local Area Bank Ltd.

B Subhadra Local Area Bank Ltd.

C Krishna Bhima Samruddhi Local Area Bank Ltd.

D Capital Local Area Bank Ltd.

Solution

- Conversion: Capital Local Area Bank Ltd. (based in Jalandhar, Punjab) was the first among the existing LABs to successfully convert into a Small Finance Bank (SFB).
- New Name: The converted entity is known as Capital Small Finance Bank Ltd., and it commenced operations as an SFB in 2016.
- RBI Policy: The conversion was part of the RBI's policy framework allowing well-run LABs to transition into the new SFB structure, which has a larger geographical reach (pan-India) and stricter licensing norms (e.g., higher initial capital).
- Significance: This conversion is historically significant as it marked the transition of one of the few surviving LABs to a more modern, broad-based small banking model in India.

- **SFB vs. LAB:** The SFB model requires a much higher minimum paid-up capital (initially ₹100 crore, later ₹200 crore for new entrants) and has a wider mandate, unlike the geographically restricted LAB model

12. **When Local Area Banks were established, which of the following regulations was applied to them regarding their deposit mobilization?**

A They were allowed to accept only Term Deposits, not Demand Deposits.

B They could only accept deposits from the Central and State Governments.

C They were allowed to undertake all types of banking activities, including accepting all types of public deposits.

D They could only accept deposits from the Promoter Group

Solution

- **Full Banking Activities:** LABs were granted a full banking license and were permitted to undertake all types of banking activities within their defined area of operation, which included accepting all forms of public deposits (Savings, Current, Fixed, and Recurring).
- **Purpose:** Mobilizing local savings was one of their core objectives, and accepting public deposits was crucial for their viability and the overall goal of financial inclusion.
- **DICGC Coverage:** Deposits in LABs are covered by the Deposit Insurance and Credit Guarantee Corporation (DICGC), the same as other commercial banks, providing confidence to depositors.
- **Cheque Issuance:** They were allowed to issue drafts and cheques and facilitate financial transactions for their customers, forming part of

the payment and settlement system.

- **Contrast with NBFCs:** This ability to accept all types of public deposits distinguishes them clearly from Non-Banking Financial Companies (NBFCs), which generally cannot accept demand deposits.

13. Analyze the following facts related to the discontinuation of the Local Area Bank scheme:

I. The RBI discontinued the licensing of new LABs around the year 2000.

II. The scheme was stopped primarily due to major fraudulent activities reported in all existing LABs.

III. Concerns over the viability and long-term sustainability of the small, concentrated banks contributed to the policy halt.

IV. The LAB scheme was replaced by the Regional Rural Bank (RRB) scheme immediately after its discontinuation.

Which of the statements given above is/are CORRECT?

A Only I and III

B Only I and IV

C Only II and III

D Only I, II, and III

Solution

- Policy Halt: Statement I is correct. The RBI ceased issuing new LAB licenses relatively early, around the year 2000, due to mixed results and policy review.

- **Reasons for Halt:** Statement III is correct. A major contributing factor was the challenge of viability and scalability for these small, geographically restricted private banks, which faced high operating costs and concentration risk.
- **Fraud and Replacement:** Statements II and IV are incorrect. While some LABs faced issues, the discontinuation was not due to major, widespread fraud across all existing LABs. The LAB scheme was later conceptually superseded by the Small Finance Bank (SFB) scheme (post-2014), not the RRB scheme.
- **Regulatory Discomfort:** Regulatory discomfort with the structure of many small, locally concentrated, private banks was also a key factor in the policy decision.
- **Survival:** A few LABs that had performed well were allowed to continue operating under the original charter, demonstrating that the policy was a withdrawal of new licenses, not a closure of all existing entities

14. **With respect to the distinction between Local Area Banks (LABs) and Regional Rural Banks (RRBs), consider the following:**

I. LABs are promoted by private entities, while RRBs are sponsored by a Public Sector Bank.

II. RRBs are established under the RRB Act, 1976, whereas LABs are registered under the Companies Act.

III. Both LABs and RRBs have the same shareholding structure (50:35:15 between Central Govt, Sponsor Bank, and State Govt).

IV. Both are allowed to operate across the entire country without any geographical restriction.

Which of the statements given above are CORRECT?

A Only I and II

B Only II and III

C Only I, II, and IV

D Only I, II, and III

Solution

- **Ownership/Promoter:** Statement I is correct. LABs are privately promoted and owned, whereas RRBs have a joint ownership

structure involving the Central Government, State Government, and a Public Sector Bank (Sponsor Bank).

- **Legal Basis:** Statement II is correct. LABs are corporate entities registered under the Companies Act, while RRBs are statutory bodies established under the specific RRB Act, 1976.
- **Shareholding:** Statement III is incorrect. The 50:35:15 ratio is the shareholding structure only for RRBs, not for the privately-owned LABs.
- **Geographical Scope:** Statement IV is incorrect. Both LABs (2-3 contiguous districts) and RRBs (one or more districts of a State) have a distinct geographically restricted area of operation.
- **Regulatory Status:** Despite their differences in ownership and legal basis, both LABs and RRBs fall under the category of Scheduled Commercial Banks and are regulated by the RBI

15. **Which of the following is a primary criticism often leveled against the Local Area Bank model that contributed to the discontinuation of new licenses?**

A They were too large and difficult for the RBI to supervise effectively.

B Their core focus was too heavily skewed towards large corporate financing, neglecting rural areas.

C **They faced viability issues due to intense competition and the challenge of managing credit risk in a small, concentrated area.**

D They primarily operated as an investment bank, which conflicted with the needs of the rural populace.

Solution

- **Viability Challenge:** A significant issue was the viability of the small-sized banks, which struggled to achieve the necessary scale and profitability due to their limited operational area and intense competition from large commercial banks.
- **Concentration Risk:** Their restriction to only 2-3 districts led to high concentration risk, meaning a local economic downturn or natural disaster in that small area could severely impact the bank's entire asset portfolio.

- **Regulatory Concerns:** The RBI was reportedly uncomfortable with the idea of small, private-sector banks, especially concerning the potential for local political interference and difficulty in consistent regulatory oversight across many small entities.
- **Operational Inefficiencies:** They often faced higher unit operating costs compared to larger banks, making it difficult to maintain competitive interest rates and offer advanced services.
- **Stagnation:** Many existing LABs struggled to significantly widen the gap in credit availability or scale up their operations, leading to policy re-evaluation and the eventual discontinuation of new licenses

16. How were the prudential norms related to Capital Adequacy Ratio (CRAR) determined for Local Area Banks?

A

A fixed, lower CRAR was prescribed, exempting them from the Basel norms.

B

The CRAR norms were identical to those applicable to other domestic Scheduled Commercial Banks.

C

CRAR was prescribed by the NABARD instead of the RBI.

D

They were only required to maintain a CRAR of 5% irrespective of the risk profile.

Solution

- **Regulatory Parity:** The RBI applied the principle of regulatory parity, meaning that the Capital Adequacy Ratio (CRAR) norms for Local Area Banks were identical to those applicable to other domestic commercial banks.
- **Risk Management:** This was crucial to ensure that, despite their smaller size, LABs maintained sufficient capital buffers to absorb unexpected losses and manage the risk profile of their assets.
- **Basel Alignment:** The CRAR norms are based on the international Basel Accords, and applying these to LABs ensured that they adhered to global standards for financial soundness.

- **Credit Risk:** Given their focus on local lending, including agriculture and small enterprises, a robust CRAR was necessary to mitigate the higher perceived credit risk in these sectors.
- **Minimum Requirement:** While the specific ratio has changed over time based on Basel implementation (e.g., initially 9%, later higher), the principle of uniform application with other commercial banks remained central to the LAB regulatory framework

17. A key function of LABs was savings mobilization. Which instrument ensures the safety of deposits mobilized by Local Area Banks?

A Securities and Exchange Board of India (SEBI)

B National Bank for Agriculture and Rural Development (NABARD)

C Deposit Insurance and Credit Guarantee Corporation (DICGC)

D National Housing Bank (NHB)

Solution

- **Deposit Safety:** The safety of deposits in Local Area Banks is primarily ensured by the Deposit Insurance and Credit Guarantee Corporation (DICGC).
- **DICGC Mandate:** DICGC, a subsidiary of the RBI, provides deposit insurance coverage for all bank deposits (Savings, Fixed, Current, Recurring) up to a specified limit (currently ₹5 lakh per depositor per bank).
- **Public Trust:** This insurance coverage is vital for building and maintaining public trust, especially in smaller, local private banks like LABs.
- **Applicability:** DICGC coverage applies to all Scheduled Commercial Banks, which includes Local Area Banks, reinforcing their status as part of the formal banking system.

- **Regulatory Requirement:** It is a statutory requirement that all eligible banks be registered with the DICGC, protecting the interests of the local community depositing their savings

18. **A Local Area Bank's operations are primarily confined to rural and semi-urban areas. In the context of credit disbursement, what is their expected primary target sector?**

A Large-scale corporate infrastructure projects.

B Financial services for Non-Resident Indians (NRIs).

C **Agriculture, small industries, and other local viable economic activities**

D Venture capital funding for technology start-ups.

Solution

- **Core Mandate:** The overarching mandate of LABs was to focus on providing credit to sectors crucial for local development, primarily agriculture, small industries (Micro, Small, and Medium Enterprises - MSMEs), and related services.
- **Priority Sector Focus:** This aligns directly with the requirement for LABs to meet the Priority Sector Lending (PSL) targets, which mandates a specific proportion of credit flow to these sectors.
- **Rural Linkage:** By operating in contiguous districts, typically including rural and semi-urban areas, their business model was inherently linked to the financing needs of local farmers and small entrepreneurs.

- **Contrast with Major Banks:** Unlike national banks that might have a diverse portfolio including corporate lending, LABs were intended to fill the credit gap at the grassroots level.
- **Economic Upliftment:** Their function was seen as a tool for economic upliftment and self-sufficiency within their confined area by ensuring credit reaches productive, viable local ventures

19. **The Local Area Bank (LAB) scheme was launched as a measure to promote the involvement of which sector in banking?**

A Private Sector

B Public Sector

C Co-operative Sector

D Foreign Sector

Solution

- **Policy Thrust:** The LAB scheme was a key part of the post-1991 financial liberalization efforts intended to promote private sector participation in the banking industry, especially at the local level.
- **Private Ownership:** LABs were conceptualized as privately promoted and privately owned banking institutions, distinct from the government-controlled Public Sector Banks or jointly-owned RRBs.
- **Efficiency and Competition:** The underlying belief was that private initiative would bring greater efficiency, competition, and innovation to local banking, addressing the credit and savings needs of rural populations more effectively.
- **Regulatory Sandbox (Conceptual):** The LABs, in a sense, served as an early experiment for small, local, private banking, paving the way for the later concept of Small Finance Banks.

- **Contrast with Social Banking:** While their objective was social banking (financial inclusion), the engine of delivery was through the private sector, blending profit motivation with social responsibility.

20. **If a Local Area Bank wants to open a new branch within its permitted area of operation, which body grants the final approval for branch licensing?**

A The local District Collector

B National Bank for Agriculture and Rural Development (NABARD)

C The State Government

D Reserve Bank of India (RBI)

Solution

- **Licensing Authority:** The power to grant licenses for new branches of all commercial banks, including Local Area Banks, rests solely with the Reserve Bank of India (RBI), as per the Banking Regulation Act, 1949.
- **Branch Policy:** The RBI's branch licensing policy for LABs was governed by the existing policy for commercial banks, though their geographical restriction limited the scope of expansion.
- **Supervisory Control:** This central authority over branch expansion is a key tool for the RBI to exercise regulatory and supervisory control over the banking system's growth and geographical spread.
- **Area Constraint:** While the RBI grants the license, the LAB must demonstrate that the proposed branch falls within the 2-3 contiguous

districts defined as its operational area.

- **Compliance:** Approval is subject to the bank meeting all prudential norms, including capital adequacy and satisfactory financial performance

21. Which of the following statements regarding the capital and deposit insurance of Local Area Banks (LABs) is accurate?

I. The minimum paid-up capital for a LAB was fixed at ₹5 Crore.

II. The deposits in LABs are covered by the Deposit Insurance and Credit Guarantee Corporation (DICGC).

III. LABs were required to maintain a higher Capital to Risk-weighted Assets Ratio (CRAR) compared to other commercial banks.

IV. The promoter contribution could be entirely through preference share capital.

Which of the statements given above are CORRECT?

A Only I and II

B Only II and III

C Only I, II, and IV

D Only II, III, and IV

Solution

- **Minimum Capital:** Statement I is correct. The initial minimum requirement for the paid-up capital of a LAB was ₹5 Crore.
- **Deposit Insurance:** Statement II is correct. As Scheduled Commercial Banks, the deposits held by LABs are mandatorily

insured by the DICGC (up to the prescribed limit, currently ₹5 lakh per depositor).

- **CRAR:** Statement III is incorrect. LABs were subject to the same CRAR norms as other domestic commercial banks, not a higher one, ensuring regulatory parity in capital adequacy.
- **Capital Type:** Statement IV is incorrect. The promoter contribution was mandated to be in the form of equity capital, not entirely preference shares, to ensure maximum commitment and risk absorption capacity.
- **Financial Stability:** The combination of a minimum capital requirement and DICGC coverage (I and II) was necessary to secure public confidence in these new, private-sector banks

22. Consider the provisions related to a Local Area Bank's interaction with the Reserve Bank of India (RBI):

I. LABs are directly under the supervision and inspection of the RBI.

II. A Scheduled LAB is eligible to borrow funds from the RBI under the refinance facility.

III. Non-Scheduled LABs are completely exempt from maintaining a Cash Reserve Ratio (CRR).

IV. The RBI grants the license to commence and carry on the banking business.

Which of the statements given above are CORRECT?

A Only I and II

B Only I, II, and IV

C Only II and III

D Only I, III, and IV

Solution

- **Supervision and Licensing:** Statements I and IV are correct. The RBI is the sole regulator that grants the banking license and conducts regular supervision and inspection of LABs under the Banking Regulation Act, 1949.

- **Refinance Facility:** Statement II is correct. Inclusion in the Second Schedule of the RBI Act makes a LAB a Scheduled Bank, granting it the key privilege of access to the RBI's refinance facilities (e.g., at the Bank Rate).
- **CRR Exemption:** Statement III is incorrect. All commercial banks, whether Scheduled or Non-Scheduled, are required to maintain a Cash Reserve Ratio (CRR). The only difference is where the Non-Scheduled banks hold the required balance (either with the RBI or in their own vault).
- **Regulatory Control:** The RBI exercises pervasive control over LABs, including branch licensing, corporate governance, and prudential compliance, reinforcing its position as the ultimate authority.
- **Functional Status:** The functions (I, II, IV) underscore that LABs are not mere deposit-taking institutions but full-fledged, RBI-regulated commercial banks

23. Which financial concept must Local Area Banks adhere to that requires a mandatory flow of credit to weaker sections within their operational area?

A Maintenance of Statutory Liquidity Ratio (SLR).

B Adherence to Capital Adequacy Ratio (CRAR).

C Targeted lending under Priority Sector Lending (PSL).

D Issuance of only secured loans.

Solution

- Targeted Lending: The requirement to provide a mandatory flow of credit to weaker sections is a crucial sub-target under the overarching Priority Sector Lending (PSL) norms.
- Weaker Sections Target: Currently, the target for lending to Weaker Sections for domestic commercial banks, and hence LABs, is 10% of ANBC (Adjusted Net Bank Credit) or CEOBE.
- Social Objective: This sub-target ensures that the bank's local focus translates into a genuine social objective of uplifting the most financially disadvantaged populations within its area of operation.
- Monitoring: The RBI rigorously monitors a bank's achievement of PSL targets, and failure can lead to penalties or other regulatory restrictions.

- **Local Impact:** For a LAB, meeting this sub-target is directly tied to its core mandate of promoting financial inclusion and economic development at the grassroots level

24. **What is the fundamental difference in the structure of Local Area Banks compared to Small Finance Banks (SFBs), which were later introduced?**

A

SFBs are restricted to a few districts, whereas LABs can operate pan-India.

B

SFBs can only accept term deposits, while LABs can accept all types of deposits.

C

SFBs were licensed much later (post-2014) with a wider geographical mandate and stricter capital norms than LABs.

D

LABs are government-owned, but SFBs are privately-owned.

Solution

- **Time of Licensing:** LABs were licensed starting from 1996, while Small Finance Banks (SFBs) were licensed much later, with guidelines issued in 2014-15.
- **Geographical Reach:** SFBs are licensed to operate pan-India (though they must have a high concentration in local areas initially), unlike LABs, which are restricted to 2-3 contiguous districts.
- **Capital Norms:** SFBs were launched with a significantly higher minimum paid-up capital requirement (initially ₹100 crore, later raised) compared to the ₹5 crore minimum for LABs, indicating stricter financial entry norms.

- **Conversion:** The RBI provided a path for existing LABs to convert to SFBs, indicating that SFBs were the successor and more robust model for small, private-sector banking.
- **Promoter Experience:** The SFB guidelines mandated prior experience in financial services, unlike the initial broader eligibility for LAB promoters, aiming for more specialized expertise

25. **What was the policy rationale for limiting the area of operation of Local Area Banks to only 2 or 3 contiguous districts?**

A To prevent them from becoming too profitable and creating monopolies.

B **To strictly limit the risk and credit exposure to a manageable local area, enabling greater operational efficiency.**

C To allow them to focus solely on international banking transactions.

D To reserve the largest states for the exclusive operations of RRBs.

Solution

- **Risk Management:** The primary policy rationale was to contain and limit the bank's credit risk and exposure to a small, manageable geographical area, thereby mitigating the systemic risk of a failed LAB spreading nationally.
- **Local Knowledge:** The small area encourages the bank management to acquire deep local knowledge of the economy, culture, and borrowers, which is crucial for effective credit appraisal and recovery.
- **Supervision:** A restricted area makes the bank easier for the RBI's regional offices to supervise and monitor effectively compared to a national bank with thousands of branches.

- **Cost Efficiency:** Operating locally was expected to allow for a lower-cost operational structure compared to large national banks, increasing efficiency in delivering small-ticket credit.
- **Concentration Risk Trade-off:** While limiting geographical risk, this restriction did introduce concentration risk (where a local shock affects the entire bank), which was a key reason for the eventual discontinuation of new licenses

26. Which of the following is a function that a Local Area Bank is explicitly allowed to perform within its area of operation?

A Minting of currency notes

B Acting as a treasury for the Central Government.

C Issuing drafts and cheques and providing remittance facilities.

D Regulating other financial institutions in the district.

Solution

- Core Banking Services: LABs are authorized to provide all core banking services, including the vital function of facilitating payments through the issuance of drafts and cheques and providing general remittance facilities.
- Payment System: This function confirms their status as a fully-integrated member of the country's payment and settlement system, unlike some other financial institutions like NBFCs.
- Lending and Deposits: Other allowed functions include the primary activities of accepting public deposits and extending credit to individuals, businesses, and institutions.
- Central Bank Functions: Functions like minting currency (A) and acting as a central treasury (B) are exclusive functions of the RBI or its agency banks, not LABs.

- **Local Convenience:** Providing remittance and payment services locally is essential for fulfilling their objective of improving access to formal financial services for the local population.

27. A Local Area Bank is tasked with mobilizing rural savings. Which term best describes the rate at which the RBI lends money to a Scheduled LAB for liquidity management?

A Bank Rate

B Marginal Standing Facility (MSF) Rate

C Repo Rate

D Statutory Liquidity Ratio (SLR)

Solution

- **Refinance Rate:** The Bank Rate is the penal rate at which the Reserve Bank of India is ready to buy or rediscount bills of exchange or other commercial papers.
- **Scheduled Bank Access:** A Scheduled LAB is eligible to borrow from the RBI at the Bank Rate when it requires long-term credit or refinance facilities.
- **MSF and Repo:** While the MSF and Repo Rate are used for short-term liquidity management (overnight/short-term), the Bank Rate is traditionally the rate associated with the RBI providing loans to Scheduled Banks under the provisions of the RBI Act.
- **Liquidity:** Access to RBI funding, even at the Bank Rate, is a critical safety net that reinforces the LAB's Scheduled Bank status and helps

in managing temporary liquidity mismatches.

- **Impact on Local Lending:** The cost of funds from the RBI can influence the overall interest rate structure that the LAB offers to its local customers and borrowers.

28. Which of the following is an example of an existing Local Area Bank in India?

A Punjab National Bank

B Capital Small Finance Bank Ltd.

C Coastal Local Area Bank Ltd.

D HDFC Bank

Solution

- Existing LAB: Coastal Local Area Bank Ltd. (operating in Andhra Pradesh) is one of the few Local Area Banks that was licensed and continues to operate under the original LAB license.
- Conversion Status: Capital Local Area Bank Ltd. is no longer a LAB, having converted into Capital Small Finance Bank Ltd. in 2016.
- Others: Punjab National Bank and HDFC Bank are major national-level Scheduled Commercial Banks. Jana Small Finance Bank is an SFB.
- Limited Number: The number of LABs that were ultimately licensed and are still operating under the original charter is very small (only a few exist).

- **Regulatory Oversight:** These surviving LABs continue to be regulated by the RBI, adhering to the framework set for the LAB category, despite the closure of the licensing window for new LABs

29. **What was the minimum promoter's contribution to the initial equity capital stipulated for Local Area Banks?**

A 10%

B 25%

C 40%

D 51%

Solution

- **Promoter's Stake:** The initial guidelines required the promoter's contribution to be a minimum of 40% of the initial paid-up capital of ₹5 crore.
- **Commitment:** This high percentage was mandated to ensure that the promoter group had a significant financial stake and a strong commitment to the bank's long-term viability and success.
- **Public Subscription:** The remaining part of the capital (up to 60%) was intended to be raised through public subscription, as they were registered as public limited companies.
- **Investor Confidence:** A strong initial capital base and promoter contribution were seen as essential for generating investor and public confidence in these new, local private banks.

- **Regulatory Similarity:** The concept of a high promoter lock-in/contribution is a common feature in the licensing of new niche banks (like Small Finance Banks) to ensure accountability

30. Evaluate the following differentiating factors for LABs compared to Small Finance Banks (SFBs):

I. SFBs have a much higher minimum paid-up capital requirement than the initial ₹5 Crore for LABs.

II. SFBs are allowed to operate on an all-India basis, unlike the geographical restriction for LABs.

III. LABs are not permitted to accept demand deposits, while SFBs can.

IV. Both LABs and SFBs are regulated by NABARD.

Which of the statements given above are CORRECT?

A Only I and II

B Only III and IV

C Only I, II, and IV

D Only II, III, and IV

Solution

- **Capital Requirement:** Statement I is correct. SFBs were licensed with a substantially higher minimum capital (initially ₹100 crore, later raised for new applicants) compared to the initial ₹5 crore for LABs.

- **Geographical Scope:** Statement II is correct. SFBs are allowed to operate all-India, albeit with a focus on local areas, while LABs are strictly restricted to 2-3 contiguous districts.
- **Deposit Acceptance:** Statement III is incorrect. Both LABs and SFBs are licensed as full-fledged commercial banks and can accept all types of deposits, including demand deposits (Savings and Current).
- **Regulatory Body:** Statement IV is incorrect. Both LABs and SFBs are regulated and supervised by the Reserve Bank of India (RBI), not NABARD (which regulates RRBs and Co-operative Banks).
- **Policy Evolution:** SFBs were introduced as a more robust and scalable model for small banking, correcting some of the perceived limitations of the earlier LAB structure



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