CHAPTER VIII
REORGANISATION OF THE BANKING STRUCTURE

The banking system, if it is to make an adequate contribution to the country’s economic development, must be sound in structure. Side by side with a change in outlook and the scope of business, there should be a remedy of its organisational defects. Such remedy should proceed along two lines. First, strengthening of the financial structure of banks and placing of weak or unsound units on a healthy footing; Secondly, securing a balanced growth of banking services throughout the country.

The Indian banking scene is characterised by strong, well-organised institutions working side by side with weak, inefficient units. The past history of Indian banking is not such as to ensure healthy, balanced growth all round. From time to time banks have sprung up which have purely been the fruits of the circumstances e.g. those grown up during the Swadeshi Movement, during the years of the First War and finally, during the second War. Many of these banks grew up without adequate financial resources and banking experience and, therefore, could not survive a change in the particular circumstances which gave them birth. Dispersal of banking facilities all over the country too has been highly uneven.

Bank failures - causes and remedies

One disturbing effect of the unbalanced and often unsound development of banks in India has been the occurrence of bank failures from time to time. Before 1913-14, the failures were of a sporadic and individual nature, although important banks were victims at times. Since 1913-14 we may point to several periods of banking crisis. The year 1913-14 was one such, another being the depression years of 1931-32. Another critical period was that during the immediate post Second War Years (1946-50) when much of the mushroom
banking growth of the war years and even some sound banks were wiped out.

Even in normal years, however, bank failures have not been unusual in India, one notable instance being the failure of two scheduled banks, including the Palai Central Bank, in 1960.

The record of bank failures in India has not been anything that may be called disastrous. These calamities were the evidence of stresses and strains through which a developing banking system must pass, but they did not have a crippling effect on Indian banking. Even during the years 1947-52, which might be regarded as critical years of Indian banking, the number of banks failed was 186 and deposits lost constituted about 8 per cent of total deposits. (1)

Secondly, it is usually the smaller and weaker units which have been the victims. Most of them were non-scheduled. Important exceptions were the Alliance Bank of Simla, the Travancore National and Quilon Bank in the twenties and thirties respectively, 8 scheduled banks in West Bengal during the post-war banking crisis, including the Nath Bank, Pioneer Bank, Mahalaxmi Bank, Dass Bank, Calcutta Commercial Bank etc., and recently, the Palai Central Bank in August 1960. Ordinarily, the failed banks were weak or new units, working with a poor capital and deposits structure.

Thirdly, bank failures never became nationwide. They were localised to particular regions, specially those where the banking business was heavily concentrated. The victims at various times were the states of Bengal, Bombay, Punjab and Travancore-Cochin or Kerala.

As against this bright side, we must remember that in the U.S. the number of bank failures, which was unusually large during the twenties and thirties, became since 1934, unusually low even for a period of prosperity.

(1) B.K. Dutt - Monetary Discipline and Indian Banking
Prof. Benoy Kumar Sarkar Memorial Lectures, Calcutta University, 1960.
in India in contrast, a disquieting feature is a regular number of failures every year. Between the years 1931 to 1933, in no year did the number of failures become less than 23 although these were years of quite rapid growth. The loss of capital on account of these failures may be estimated from the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of banks</th>
<th>Paid up capital</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>60</td>
<td>62,07,305</td>
<td></td>
</tr>
<tr>
<td>1952</td>
<td>31</td>
<td>15,79,667</td>
<td></td>
</tr>
<tr>
<td>1953</td>
<td>31</td>
<td>1,13,57,917</td>
<td></td>
</tr>
<tr>
<td>1954</td>
<td>27</td>
<td>47,50,971</td>
<td></td>
</tr>
<tr>
<td>1955</td>
<td>29</td>
<td>46,45,296</td>
<td></td>
</tr>
<tr>
<td>1956</td>
<td>19</td>
<td>19,76,745</td>
<td>54,65,617</td>
</tr>
<tr>
<td>1957</td>
<td>25</td>
<td>27,53,974</td>
<td>22,79,107</td>
</tr>
<tr>
<td>1958</td>
<td>23</td>
<td>32,93,641</td>
<td>1,74,47,560</td>
</tr>
</tbody>
</table>

Figures from Statistical Tables Relating to Banks.

Apart from inherent weaknesses of the banking system, such as lack of banking tradition and inefficiency of management, the Reserve Bank pointed out several other defects during the crisis of the forties. These were - lack of knowledge and experience among the directors, defective system of internal audit and inspection, habit of declaring dividends without making adequate provision for bad and doubtful debts, depreciation in investments and other unrealisable assets, low capital and reserves structure, uneconomic expansion of branches, extension of advances and investments irrespective of the resources of banks etc. Some banks held
shares in companies in which the directors themselves were interested and
these shares were often extremely illiquid in character. Large advances
were made to borrowers of questionable creditworthiness. The ratio of
paid up capital to subscribed and authorised capital was too low. To
all these were added the post war stock exchange crisis in Calcutta.

According to the Committee on State Industrial Finance Corporation for West
Bengal the banking crisis in West Bengal during the period 1943-50 was due
to three sets of factors: (1) Those arising out of general economic conditions,
including the cessation of War and consequent slackening of industrial
activities (2) Internal causes, including (a) lack of integrity on the part
of management (b) lack of experience and trained personnel (c) inadequate
capital resources (d) unsound investment policy (e) unsatisfactory lending
policy (f) Uneconomic branch banking, (3) Adventitious factors e.g. communal
disturbances and partition, Demonetisation, Ordinance and Income-tax
Investigation Tribunal causing the business community to withdraw deposits
from banks etc. Important among other factors analysed was the alleged
inadequacy of assistance from the Reserve Bank of India(1)

Before the thirties, there was no Central Bank to help joint stock
banks in distress, which accelerated their failure. Upto the forties, the
Reserve Bank’s machinery of helping distressed banks and of supervising or
regulating their activities was found to be extremely inadequate.

The Banking Companies Act, 1949, tried to remove many of the abuses
of the Indian banking structure. This was the first piece of comprehensive
banking legislation in the country. It laid down the minimum cash reserves
and capital structure to be maintained by banks, prohibited common

directorate, put restrictions on the nature of subsidiary companies and

(1) Report of the Committee on State Industrial Finance Corporation for
West Bengal (Law Committee Report) Aug, 1931, pp. 23-32
the types of loans or advances. Simultaneously, it increased the powers of the Reserve Bank over other banking companies to a considerable extent. It provided for the licensing of banking companies by the Reserve Bank of India, gave the Reserve Bank power to call for necessary information from banking companies; inspection of banking companies by the central banking authority for protecting the interests of depositors was another new development. The Reserve Bank could issue directives to banks regarding the advances and loans to be granted by them. The Reserve Bank could also exercise considerable authority over liquidation proceedings and schemes of amalgamation and arrangement among banks. Clause 35 largely increased to power and discretion of the Reserve Bank in the matter of giving aid to commercial banks. This clause was important because in the past in the event of major bank failures, the Reserve Bank of India had been accused of inadequate assistance given to banks. The Bank on its part, pleaded the insufficiency of its legal powers. Since 1949, these excuses were unacceptable. According to Dr. S.K. Basu, in view of the new powers and responsibilities with which the Reserve Bank of India was clothed under the Act of 1949, "if a major disaster was to overtake Indian banking, it would be due to the dereliction of duty or erroneous judgment on the part of the Reserve Bank" (1).

The decade of the fifties thus started with new hopes for Indian banking. Many unsound units had either been purged or amalgamated to form stronger units. Undesirable practices had been checked. The Reserve Bank's powers to regulate banks or to help them in distress had been largely extended. Yet one finds that quite a number of banks are going into liquidation regularly every year. The failed banks are usually not important.

from the point of view of their size and resources. Yet these failures, taking place in the context of rapid economic activity and growing banking business are matters of concern. The failure of two scheduled banks, particularly of the Palai Central Bank in 1960, raised a hue and cry. In itself, the Palai Bank was a 3 class medium sized bank. But being the largest commercial bank in the state of Kerala, its failure had considerable adverse reaction on the banking structure of the State. The failure of this Bank also seemed surprising because it was apparently a growing concern, paying regular dividends, with a growing volume of deposits and an increasing number of branches.

It is true that the Palai Bank episode was not followed by a countrywide run on banks, except for a purely temporary loss of confidence in two major Indian banks viz, the Punjab National Bank and the Indian Bank. The decline in the rate of growth of deposits in the latter half of 1960, which was attributed largely to the Palai Bank incident, also proved purely short-lived and it had other important reasons behind it. Yet such failures carry considerable weight because this is not just a stray case of failure, but part of a regular occurrence even during the hectic decade of the fifties.

Problems raised by bank failures and their remedies.

Apart from the immediate financial loss to depositors, bank failures pose a longrun problem affecting the development of banking facilities. Where the banking habit is very insufficiently developed and the efficiency or integrity of bank management is subject to question even in normal times, there is reasonably a lack of confidence in banks. Bank failures aggravate this want of confidence. In a growing economy where quick mobilisation of
resources is a vital necessity such loss of confidence in banks proves too costly. Moreover, failure of one bank may have chain reactions on many others. Even sound banks may become the victims of panic. The fact that most of the failing banks are small in size, is no consolation because small banks provide banking facilities to a large sector of the economy. Their close personal contact with their customers and with local conditions is a valuable asset.

Measures for solving the problems raised by bank failures may be both preventive and remedial in character. Preventive measures consist of a proper analysis of the causes of failures and their removal. Unless preventive steps are taken beforehand, the remedy may prove rather expensive. The immediate cause of bank failures is a loss of confidence in banks, resulting in hasty withdrawals of cash. This loss of confidence may sometimes be quite unreasonable, arising from a very minor cause. Any such sudden and unaccountable loss of confidence can be coped with only by the Central bank. Most of the depositors, however, lose confidence in a bank only when it fails to meet their demands for cash in full. This may be attributed to two reasons; viz., small size and weakness of resources of the bank; secondly, incompetent and/or dishonest management. Most of the banks which go into liquidation in India are small in size and have a low capital and reserves structure. According to Dr. Bhagat, the Deputy Finance Minister, the deposits of banks which might be regarded as a vulnerable, do not constitute even 4 per cent of total deposits of commercial banks. More than 95 per cent of the deposits are managed by sound well-run institutions. The mere fact of the smallness in size of a bank cannot lead to its failure. For, the Banking Companies Act, 1949 and subsequent amendments have made clear-cut provisions for the minimum size of capital and reserves, the cash reserve
ratio to be maintained, the types of advances and investments that may or may not be made etc. So the failure of a bank should also be accounted for by the inefficiency and lack of integrity of bank management.

In this connection, the Palai Bank incident made some startling revelations. The run on the Palai Bank started in 1960. But inspections conducted by the Reserve Bank as early as 1951 disclosed the situation to be dissatisfactory. Warnings were issued accordingly from time to time. The Bank's balance sheet showed a loss only during the year 1939, but the Reserve Bank had reasons to believe that it was incurring losses since much earlier. Yet dividends were being paid with a view, no doubt, to deceiving depositors and shareholders. During the Lok Sabha debate, a large part of the advances were revealed to be sticky and unrealisable or "doubtful" advances. Many of them could not even pay the interest due.

The Palai Bank tragedy made it clear that there cannot be any substitute for sound and honest bank management. The Bank was not weak so far as its capital structure and resources position were concerned. The failure came because of the unsatisfactory nature of its advances and low ratio of liquid assets to total advances.

Another thing that drew considerable attention in this connection was the role of the Reserve Bank. In his statement at the Lok Sabha on August 20, 1960, Mr. Morarji Desai, the Finance Minister said that there appeared to be a mistaken belief that because a bank was a scheduled bank, the Reserve Bank or someone else had guaranteed the proper working of the institution or had, in some way, underwritten its deposits. It is true that the real guarantee against bank failures is sound management. But with the wide powers of inspection and mandatory authority of the Reserve Bank, it should have been better able to enforce sound banking principles. From the statements made by the Advocate General of Kerala during the liquidation
proceedings and the statements of the Finance Minister in the Lok Sabha it appeared that successive inspections of the Bank in 1951, 1953 and 1959 disclosed the unsatisfactory state of advances. According to the Finance Minister, the Reserve Bank had all along been telling the Bank that its affairs must be improved. What seems inexplicable is that such an unsatisfactory state of affairs was allowed to continue for nine years. Mr. Ienar was quite right in asserting that when dealing with an erring bank drastic action could never be any solution. Taking action against a bank was a delicate job since it involved careful balancing of a number of considerations, closure of a bank meant a harsh blow to people's confidence in the whole banking mechanism. Yet the procrastination over nine years in taking a decision only helped to make matters worse. What is surprising is not so much that the Bank was allowed to do business, but that it was allowed to expand, opening two new branches even in 1960. Yet there are examples to show that the Reserve Bank has, in some cases, forced commercial banks to change their course of action. During the years 1955-57, the Reserve Bank took strong action against a few of the bigger scheduled banks and made them mend their ways. Thus inefficient and dishonest management, along with inadequate use of the Reserve Bank's powers, seem to be responsible for the Falal Bank crisis.

Apart from a greater degree of caution on the part of joint stock banks and the Reserve Bank of India, several other measures may be adopted for tackling with the frequent incidence of bank failures. One such measure is deposit insurance. It is both preventive and remedial in effect. Another preventive measure is strengthening the financial structure of small and weak units. Such units can enhance their financial strength through amalgamation among themselves or merger with bigger stronger banks. Moreover, legal provisions with regard to structure of capital and reserves may be
made more rigid and strictly enforceable. Finally, if all other means of remedying the defects of the banking system fail, the Government may take over all the joint-stock banks.

Insurance of Bank Deposits

The idea of deposit insurance as a measure against the losses arising on account of bank failure has been most successfully implemented in U.S.A. The Federal Deposit Insurance Corporation was a creation of the Banking Act of 1933 as amended in 1935 after the countrywide bank moratorium in early 1933.

Deposit insurance has both a preventive and a remedial aspect. It seeks to prevent that loss of confidence and hasty withdrawal of cash which are the immediate causes of the failure of a bank. The importance of this aspect of deposit insurance is very great in a country where confidence in the banking system is low even in normal times. Moreover, even strong banks cannot withstand a sudden loss of confidence and withdrawal of cash for long.

The second aspect of deposit insurance is a remedial one. In case a bank has failed, it tries to give bank depositors cash or deposits in other banks to the extent that their deposits are insured. In this way it tries to keep up the volume of deposits in case of an actual bank failure. Where bank failures are of a localised character, deposit insurance can help in maintaining the necessary liquidity.

It is true that deposit insurance removes only the immediate cause of bank failures, viz. loss of confidence in a bank and panicky withdrawal of cash. But it does not remove the root causes of such lack of confidence, e.g. weak financial condition, inefficiency and dishonesty of bank management. However, wide powers of inspection and supervision granted to the insuring authority go a long way in removing these ultimate causes of
bank failures too. Much would depend, however, upon the proper use of these powers. Actual facts prove that even the enormity of the legal powers of the Reserve Bank is not a sufficient guarantee of the proper working of banks. Experience has shown that deposit insurance in U.S.A. has improved the quality of banking instead of encouraging unsound banks as was originally feared. Because of the small number of bank failures the scheme has also proved self-supporting, instead of being a drag upon the Treasury.

Strictly speaking, bank failures do not form an insurable risk since they are mostly concentrated in a particular period. So we cannot calculate an annual average figure for the losses. Decisions about coverage and assessments of premium must, therefore, be somewhat arbitrary.

Deposit Insurance in India

The success achieved by the TDIC in U.S.A. and the frequent incidence of bank failures in India influenced thinking in favour of deposit insurance. The issue came up before the Rural Banking Enquiry Committee in 1930. The Shroff Committee also proposed a detailed scheme for the purpose.

There are some special reasons in favour of a scheme of deposit insurance in India. First, the majority of depositors in India are not in a position to judge the soundness or integrity of a bank; so they cannot exercise the necessary degree of vigilance. Secondly, in case the Reserve Bank of India does not fulfil its task properly, an alternative supervisory authority affords a necessary degree of protection. Thirdly, the psychological effects of deposit insurance in raising people's confidence in the banking system are not negligible.

Inspite of earlier thinking on the subject, the issue of deposit insurance was given serious thought only after the Palai Bank incident in 1960. Ultimately, it was due to this affair that the Government decided
to introduce deposit insurance and, accordingly, a bill was introduced in August, 1901. The Deposit Insurance Corporation Act was passed in December, 1961 and the Corporation came into existence in January 1962.

The Corporation has an authorised capital of Rs 1 crore fully paid up by the Reserve Bank. The Board of Directors of the Corporation consists of the following members: (1) the Governor of the Reserve Bank who is the chairman of the Corporation; (2) a Deputy Governor of the Bank; (3) an officer of the Central Government nominated by it and (4) two directors nominated by the Central Government in consultation with the Reserve Bank, with special knowledge of commerce, industry and finance.

The Corporation shall register every existing banking company. Registration will be cancelled in case the bank cannot function normally or independently. The inclusion of every bank is a significant step since a scheme of deposit insurance cannot be successful unless bigger banks join it. However, the DIC in U.S.A. has greater discretionary authority in this respect. It can deny insurance to a bank which it believes to be unnecessary or economically unsound. Insured status adds to the credit of a bank. Power to grant or withhold insurance gives the insuring organisation an important indirect authority to enforce sound principles of banking. Even with regard to cancellation of registration for insurance the Deposit Insurance Corporation in India can take steps only when a bank has ceased to function normally e.g. when its license has been cancelled, or it has been ordered to be wound up etc. and independently, e.g. when it has entered into schemes of compromise or amalgamation with any bank. In U.S.A. on the other hand when examination of a bank reveals the continuance of unsafe or unsound banking practices, violation of law or regulation, the DIC can start proceedings for the termination of the insured status of the bank.
Besides the share capital of ₹ 1 crore which is to be subscribed fully by the Reserve Bank, the Act makes provision for two funds—an Insurance Fund and a General Fund. But the Act makes no mention of the size of these Funds.

Regarding insurance premium, the Act lays down that the Corporation will fix the rate of premium with the prior approval of the Central Government, provided the premium payable shall not exceed 15 paise per annum for every hundred rupees of total deposits, which amounts to 3/20th of 1 per cent. The rate has been fixed by the Corporation at 5 paise per hundred rupees, i.e., at 1/20th of 1 per cent. The insurable limit for each depositor in the same right and in the same capacity at each bank is fixed at ₹ 1,500.

Several figures will show that the size of the initial capital, the insurable limit per depositor and the rate of premium payable have been fixed too low. The size of the initial capital and the Deposit Insurance Fund should be related to the total and average annual loss of deposits over a number of years. Taking the years 1953-60, the total loss of deposits over all these years amounted to about ₹ 930.9 lakh (calculated on the basis of the figures of total deposits of banks which ceased to function during this period and subtracting the deposits of banks which were merged with others). On this basis, the average annual loss of deposits for these 9 years would amount to ₹ 117.35 lakhs. The size of the initial capital of ₹ 1 crore is thus even lower than the average annual size of deposits of banks that have gone into liquidation over the eight years taken into account. These were more or less normal years for Indian banking. If we take an abnormal period, e.g., the years 1947-52, the size of the initial capital is even more inadequate. Thus the average
loss of deposits per year between 1947 and 1952 amounted to Rs. 18.54 crores.\(^{(1)}\)

It may be mentioned in this connection that the Shroff Committee recommended an initial capital of Rs. 5 crores.

It may be argued that the insurable limit being low, the liability of the Corporation is also limited. But the larger the coverage afforded by insurance, the greater is its utility in maintaining confidence in the banking system and restoring the circulating medium once a bank has failed. The adequacy of the coverage also has to be considered in relation to the average size of deposits in every bank. In the year 1959 the average size of deposits in banks with deposits of Rs. 100 crores and above was Rs. 4,785.6. For all scheduled banks the size was Rs. 3,400. It was only with banks with deposits of less than Rs. 5 crores that the average deposit amounted to Rs. 1,539.6. So the protection offered under the Act would be just sufficient to cover the average size of deposits of the scheduled banks with deposits of less than Rs. 5 crores. For all scheduled banks the protection afforded will amount to about half the average size of deposits and for the biggest scheduled banks it is less than one-third. This restricted coverage was subjected to considerable criticism during the Lok Sabha debate. The Shroff Committee had recommended an insurable limit of Rs. 5,000 per depositor. The Deputy Finance Minister Dr. Bhagat said that 75% of the total accounts and 20% of all deposits were likely to be covered. This might be true of scheduled and non-scheduled banks taken together. But for the scheduled banks alone a much smaller percentage of total deposits would be covered. It may be argued that it is the smaller banks which require greater protection, but the bigger banks may suffer from a sense of injustice because they have to

\(^{(1)}\) B.K. Dutta - Necessity of a Banking Plan, P.25, Appendix VIII.
make the major contribution to the Insurance Fund - insurance premium has to be paid on all deposits, not just insured deposits - but the protection offered will be negligible in comparison. The possibility of splitting up of accounts by depositors with the increased administrative complications and operating expenses it may cause has also to be taken into account. It may be argued that the need for protection is greater for smaller depositors as the bigger depositors are better able to protect themselves by exercising a greater influence on a bank's policies and because they are better able to judge the credit worthiness of a bank. But actually the Act denies full protection even to the average depositor with a deposit of Rs 3,400.

Because of the narrow insurable limit, the insurance premium also has been kept quite low. In the U.S.A. the original assessment rate was fixed at 1/12th of 1 per cent, the small number of bank failures and small losses of the FDIC since 1950, banks came to be granted a credit on their insurance premium. As a result the actual rate came down to 1/27th of 1 per cent in the year 1960 although the official rate remained the same as before. The Shroff Committee recommended a premium rate of 1/16th of 1 per cent. The maximum rate under the Deposit Insurance Corporation Act in India has been fixed at 3/20th of 1 per cent and initially the rate has been placed at 1/20th of 1 per cent. One good feature of the Indian Act is that it provides the Corporation with considerable discretionary authority to vary the premium rate on the coverage. But the rate of 1/20th of 1 per cent is too low, even lower than the minimum expected by banks. This is also too low compared to the total resources or earnings of banks. Taking the aggregate deposit of all banks at Rs 1854.6 crores in the year 1960, 3/20th of 1 per cent would amount to an aggregate sum of about Rs 276 lakhs and a rate of 1/20th of 1 per cent would mean about Rs 93 lakhs. Taking the gross earnings and net profits of the bigger banks (Banks with total deposits of more than Rs 5 crores) at
Moreover insurance premium receipts at Rs 93 lakhs per year would be actually smaller than the average annual loss of deposits at Rs 117.35 lakhs between the years 1953 and 1960. Instead of trying to keep the cost of insurance and coverage at too low a level, it would be more reasonable to raise the coverage and, if necessary, the rate of premium.

An insurance premium of Rs 93 lakhs would be less than 10 per cent of the average net profits of banks over the years 1956-60 and would be about 1.1% of the total average incomes of banks during the same period. A higher rate of premium would not, therefore, be too great a burden. The incursion that it might make into net profits might be compensated by a lowering of the rate of interest paid on deposits. Even a diminution in interest payments by the small figure of say .02% would largely solve the problem paying insurance premium for banks.

Our conclusion is, therefore, that in order to ensure success of the deposit insurance scheme, the insurable limit should be raised above Rs 1,500/- and there is scope for increasing the insurance premium too.

The consensus of opinion, in this respect, is in favour of larger and, if possible, full coverage. One principal objection to an extension of deposit insurance coverage is based on the belief that the watchfulness of large depositors helps to promote sound banking practices. This argument does not apply to conditions in our country at least. For here depositors, whether they are big or small, seldom exercise that degree of watchfulness over the working of banks. There are a number of other arguments in favour of a higher coverage. Thus, higher coverage helps in achieving more fully both of the major objectives of deposit insurance - protection of the individual depositor and promotion of stability in the economy as a whole, through protection of the money supply and maintenance of public confidence.

in banks. Higher coverage would also be of use to smaller banks in getting and retaining larger deposit accounts and thus would correct to some extent the unevenness of the insurance burden among big and small banks.

Moreover, Jones points out that because a certain percentage of the total deposits are insured it does not mean that deposit insurance is effective to even that extent because the big depositors in their respective banks have a greater propensity to withdraw their deposits in time of crisis than have the small depositors. Deposit insurance, therefore, would be more useful socially if 100 per cent coverage were introduced. He also feels that since most of the deposits in excess of $5000 for any person have been withdrawn by the time a bank fails, the insurer has the costs of practically 100 per cent insurance, but the social disadvantage of the deposit withdrawals from the banks remains. Finally, it is usually unlikely for the monetary authorities to permit failure of the very large banks - the banks which hold bulk of the uninsured deposits. In that case, depositors in those banks have, in effect 100% insurance. But in the absence of official recognition of the fact the Government bears the risk of cost without the maximum social benefit.(1) From all these considerations it appears that a higher, and if possible, full coverage in our country seems the most reasonable thing.

One of the great merits claimed for the insurance mechanism in U.S.A. is that it is a self-sustaining one. It is true that bank deposit as an asset is placed on a separate footing from all other assets. Still, the question may be asked whether it is justifiable to single out the risk attached to this particular sector of the economy as the one eligible for insurance at a cost to the Treasury or the Reserve Bank, unless the system is self-sustaining. Otherwise it would mean a heavy burden for the monetary authorities. In U.S.A. it was originally believed that deposit insurance

cannot succeed except with the implicit support of Government credit.
Actually, however, this anticipation has not been fulfilled. In a crisis, the
own funds of the Corporation may not be enough and it must have, behind
it, the backing of the Treasury and the Central Bank. But under ordinary
circumstances, the Deposit Insurance Corporation should depend upon its own
income and resources rather than impose a burden upon the Government finances.

It is doubtful whether it will be possible for the Deposit Insurance
Corporation in India to achieve that degree of self-sufficiency on the basis
of the assessment incomes. A higher rate of assessment need not be a permanent
burden on banks as is proved by the experience in U.S.A. Larger coverage and
higher assessments for insurance would increase the cost of premium to the
banks in the first instant. But, the greater protection offered would add to
the psychological effects of deposit insurance and thus reduce the insurance
losses ultimately. If this results in a sufficient accretion to the Insurance
Fund, it may be possible to refund a part of the premium to the commercial
banks.

Finally, the scheme of deposit insurance in India, as compared to that
in the U.S.A, is deficient in one very important respect. Apart from paying
off the depositors in case of bank failures, the FDIC helps banks in
difficulty with a very effective alternative procedure. The Corporation has
been granted the power to permit loans on the purchase of assets for the
purpose of amalgamating distressed with stronger banks. The alternative
method has resulted in much smaller losses of deposits than would have occurred
in case of outright liquidation proceedings. As a result, recourse to the
FDIC has actually been much less than it would otherwise have been. Law
provides no such powers to the Deposit Insurance Corporation in India. Thus
the burden of deposit insurance will be imposed on banks without other
associated benefits. It is true that the Reserve Bank of India has legal powers
of arranging for the amalgamation of weaker banks or their merger with a stronger one. The Reserve Bank has also played an active part in the amalgamation of many banks. The Deposit Insurance Corporation would be more likely to judge better the need for amalgamation in any particular case because it will be more directly affected by failure of a bank. As has been pointed out by the Staff study in the Federal Reserve Bulletin in February 1950 the FDIC has actually two functions: that of acting as agency for merger and secondly, the receivership function. The former function has been more extensively performed in recent years than the latter. It has been proved superior on several grounds. First, ordinary business has not been disrupted by a disruption of banking services; secondly, all depositors and not a certain proportion, have been protected, consequently losses of deposits to be met by the Corporation have been less severe; Finally, undesirable limitations on neighbouring banks and communities have been less severe. It would be more desirable if the former aspect of the business of the FDIC were incorporated in the Deposit Insurance Act in India.

The Report of the Deposit Insurance Corporation for the year 1963 showed that 78% of all deposit accounts and 24% of the amount of all deposits were covered by insurance at the end of September 1963. Between December 1961 and September, 1963, the total number of accounts with insured banks increased from 70.39 lakhs to 85.97 lakhs.

Banking Legislation and Reform

Post War banking legislation has proved to be of great consequence in improving the structure and working of Indian banking. The period of banking reform started in India even before that of economic planning, with the passage of the Indian Banking Companies Act, 1949.
Banking legislation has a special significance in an underdeveloped economy. First, it helps to prevent unsound banking practices to generate healthy banking trends and thus, to increase people's confidence in banking; secondly, it increases the Central Bank's control over the money market (which is otherwise extremely inadequate). Thirdly, it helps in spreading banking services evenly to various sectors of the economy. Banking legislation in underdeveloped countries of Asia and South America today is being framed with a view to fulfilment of such an expanding objective.

Before 1936 there was no banking legislation as such apart from what was embodied about companies, in general, in the Indian Companies Act. An amendment to that Act in 1936 led to the inclusion of a separate chapter (Part XA) relating to banking companies. Such legislation was, however, extremely narrow in scope. The definition of a banking company was vague, thus giving rise to difficulties of administration and interpretation. The legal powers of the Reserve Bank too, were insufficient to help a bank in distress. The Indian Banking Companies Act, 1949, was the first comprehensive banking legislation which sought to fill up many of the lacunae in the existing legal framework. Since then a number of banking laws have been passed. Progress achieved in banking reform through legislation has been enormous. We can analyse the contribution of legislation to development of Indian banking from several aspects:

(a) Checking the undesirable practices of commercial banks and establishing sound canons of business; (b) Strengthening the financial structure of banks; (c) Tightening the Reserve Bank's control over commercial banks and other financial agencies; (d) providing for better banking facilities for the various sectors of the economy.
(a) Banking Legislation and Commercial Banking Business

Laying down of the proper scope of working of commercial banks is a common feature of banking legislation in underdeveloped countries of today. This is borne out by banking legislation in countries like Paraguay, Guatemala, the Dominican Republic and Korea. (1) The post war banking crisis in India brought out the dangers that are associated with unsound and indiscriminate banking practices. Such defects were sought to be remedied by the Banking Companies Act, 1949.

Nature of Banking Business

This Act, for the first time, clearly defined "banking" and a "banking company", removing all the previous vagueness on this account. "Banking" is strictly defined as "accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise". (Cl.5). Under previous legislation, acceptance of deposits had been defined to be the principal business of a bank. Banking business in India is more rigidly defined under the Indian law than under legislation in other countries where acceptance of obligations other than deposits are regarded as part of banking business.

Secondly, the Act specifically lays down the forms of business in which banking companies may or may not engage. Thus while some clauses of the Act mention the type of business that banking companies may transact, clause 8 imposes a prohibition on trading in goods except in connection with the realisation of security given to or held by it. Clause 9 prohibits investment in real estate for more than a temporary period. Many of the

banking failures of the nineteen twenties were due to such investment. However, lending against such assets is not forbidden. Opening up by banks of subsidiary companies in which the directors themselves were interested had acted to the detriment of banking companies in the past. Formation of subsidiary companies except for the undertaking and execution of trusts and for other purposes incidental to the business of banking is, therefore, prohibited by clause 19 of the Act. This clause also prohibits the holding of shares in any company, whether as pledgee, mortgagee or absolute owner to an amount exceeding 30% of the paid up share capital of that company or 30% of the bank's own paid up capital and reserve whichever is less. Another abuse is sought to be remedied by clause 20 which states that no banking company shall make any loans or advances on the security of its own shares or grant unsecured loans or advances to any of its directors or to firms or companies in which the directors themselves are interested.

Removal of Managerial Irregularities

Managerial abuses are sought to be prevented in other ways as well. Thus no banking company is to be managed by a managing agent or by a director of any other company. Persons in management are also not to be allowed to take away a disproportionate share of the profits or resources of a banking company (clause 10). Voting rights of any one shareholder is not to exceed 5 per cent of the total (clause 12). Clause 16 prohibits interlocking of directorates.

Subsequent legislation put further checks on managerial irregularities. The Banking Companies (Amendment) Act, 1956 and Banking Companies (Miscellaneous Provisions) Act 1963 sought more and more to restrict the misuse of voting rights by concentration of shares in a few hands. By the Banking Companies (Miscellaneous Provisions) Act the term of office of a person managing the
affairs of a bank was restricted to five years. The maximum voting right of individual shareholders was reduced from 5 per cent to 1 per cent. The Act of 1963 also prohibited the grant of unsecured loans by a bank to any company with which the chairman of the bank was connected as chairman or managing director, managing agent or director or partner of the managing agent of the company. Formerly this provision applied only to private companies.

Cash and Liquidity Ratios

One part of the effort to establish sound working principles for banks consisted of the laying down of minimum cash and liquidity ratios. The Banking Companies Act, 1949, introduced two different cash reserve ratios against time and demand liabilities - at 2 per cent and 5 per cent respectively. Moreover, banks were to maintain a total liquidity ratio of cash, gold or unencumbered approved securities at 20 per cent of total time and demand liabilities. In the absence of a developed market in short-term assets, Government securities were included among liquid assets. However, the Duitani hundi, the only genuine trade bill available in the country and handled by the bigger banks was excluded from the liquid assets. The exclusion of agricultural bills drawn for financing seasonal agricultural operations, (which were also rediscountable with the Reserve Bank) imposed a hardship both upon the commercial banks acquiring such assets and upon the agricultural sector in obtaining credit.

Minimum liquidity requirements were raised by an amendment of the Banking Companies Act in 1962. The liquidity ratio was fixed rather low in 1949 in the prevailing context of raising the standard of working of sub-standard banks. But now that the banking system was more securely
established than before and the range of its operations had increased, the minimum liquidity ratios also had to be raised. In place of two different cash reserve ratios against time and demand liabilities a uniform ratio was established, which could vary between 3 and 15 per cent. In addition, a minimum liquid assets ratio of 25 per cent was fixed so that the total minimum liquidity ratio became 28 per cent, the cash reserve ratio and the minimum liquidity ratio requiring to be maintained separately. These changes served two purposes. First, they raised total liquidity requirements. In the context of a rapidly growing demand for bank advances, the proportion of liquid assets of banks was steadily falling and the liquidity position at times was dangerously overstretched. Secondly, it helped to prevent the monetisation of public debt in the face of a continuous pressure upon total liquidity position.

In India, the cash reserve ratio in the past had been much higher than the usual ratio in most countries. But total liquidity ratio has always been rather low, even after the passage of the Banking Companies Act of 1949. In recent years again the cash reserve ratio and the total liquidity ratio had both been sharply declining. The liquidity ratio of scheduled banks other than the State Bank of India had declined from about 43 per cent in 1950 to about 38 per cent in 1960. (1) The newly fixed liquid assets ratio of 20 per cent is lower than the minimum liquid assets ratio of 30 per cent in U.K. Under the circumstances, and taking into account the growing credit requirements of the economy, the higher liquid assets ratio is quite justified.

In 1963, in India's neighbouring country, Pakistan, two different ratios of 2 per cent and 5 per cent respectively against time and demand liabilities were changed for a uniform 5% per cent. Among other underdeveloped

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countries, legal reserve requirements were raised in Brazil in 1962.

(b) Strengthening of the Financial Structure of Banks

Legislation in India seeks to make provision for an adequate structure of capital and reserves. Insufficient capital and reserves have often been responsible for bank failures in the past. The importance of increasing the capital and reserves structure of banks lies in that these constitute a bank’s own funds in contrast to deposits which constitute other people’s funds. Ultimately the strength of a bank depends upon its own resources and not upon borrowed resources.

The Act of 1949 tries to prevent the maintenance of an inflated structure of authorised capital to hoodwink the depositors while paid-up capital was very low. Banks were required to maintain subscribed capital at not less than one half of authorised capital and paid-up capital at not less than one half of subscribed capital. Banking companies were to maintain a minimum volume of paid-up capital and reserves. The bare provision of a fixed minimum capital, as laid down in the Companies Act, 1936, discriminated against the depositors of big banks. Under the Act of 1949, in fixing minimum reserves, distinctions were made among banks according to the territorial range of their operations and according to whether they had a place of business in Bombay or Calcutta. These cities, being very thickly populated and the biggest centres of business in India, were expected to cause larger capital requirements. In fixing the ratio of capital and reserves with reference to population the Indian law followed the American practice (Clause II). The Act also provided for the building up of a reserve fund out of the profits. Not less than 20 per cent of the profits were to be transferred to the reserve fund until the fund became equal to paid-up capital (Clause 17). The size of the capital and reserves was not, however, related to total deposits or total assets. The Act also placed a premium on branch expansion
since larger the number of offices, the larger was the capital and reserves that had to be maintained. This was a precaution against indiscriminate branch expansion. But it also acted against expansion of banking facilities by sound banks. One suggestion was, therefore, that introduction of a licensing system before every new branch was opened, would have given the monetary authorities greater regulatory power and would have been more desirable. This did not preclude the importance of fixing an adequate capital structure. What was necessary was some measure of flexibility instead of a rigid insistence upon a fixed capital limit.

In the context of swift changes in the economy under the five year plans, the need for further increases in capital and reserves was felt later on. The Banking Companies Act was, therefore, amended in 1962. The legal provisions for strengthening the capital base of banks were the following:

(1) The minimum paid-up capital and reserves of banking companies incorporated in India should be 5 lakhs instead of 50,000 as before. Foreign banks operating in India would now be required to increase the amounts which they had to keep as deposits (in lieu of capital and reserves) with the Reserve Bank of India by transfer of 20% of their future annual profits from Indian branches.

(2) The transfer of 20 per cent of the profit to the reserve fund in respect of all banks was to continue even after the Reserve Fund became equal to capital, until paid-up capital and reserves together became equal to 6 per cent of the deposit liabilities.

The Reserve Bank's arguments in favour of the proposals were the following. Under the stimulus of development expenditure, bank deposits and...
credit had been increasing rapidly in spite of a notable increase in the profits of banks during the decade of the fifties, the growth of capital and reserves had been slow, especially, in relation to the growth of deposits. Secondly, there had been changes in the nature of business undertaken by commercial banks. Many banks were venturing into new lines of activity, such as term-lending and under-writing of shares, which involved greater risk. The existing provisions of the Banking Companies Act were felt to be unsound because under them the reserves bore no relation to the growth of deposits and assets.

The need for maintaining an adequate capital and reserves structure cannot be questioned. Banks with a insufficient capital and reserves structure are the most vulnerable. Banking business, like any other, is subject to unforeseen hazards from time to time. A part of its advances may prove unjudicious or there may be a fall in the value of its assets. The risk is all the greater in the context of a restrictive monetary policy. A high bank rate will mean a fall in the value of Government securities. Banks will be better able to bear these losses if they have sufficient funds of their own. The need for maintaining an adequate capital structure also enforces the necessary degree of caution upon a bank's business. There has been a striking decline in the ratio of paid up capital and reserves of India scheduled banks to total deposits in recent times.
### TABLE

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Source: Trend and Progress of Banking

With fundamental changes in the nature of bank lending, need for increasing a bank's funds are being recognised everywhere. Banks in the U.S.A. and some other countries have been increasing their capital funds in recent years. Thus the ratios in 1959 and 1960 in India were much lower than the ratios of 9%, 7.7%, respectively in the U.S.A., Germany and Canada, in 1959. In underdeveloped countries like the Philippines, Indonesia and Brazil, too, the ratios were much higher at 13.6%, 18.1% and 14.3% respectively. The only exception was the U.K. where the ratio was only 3.6%. But the proportion of secret reserves is much higher in that country.

Moreover, in no other country is the banking system so well-established as in U.K. Even there, attempts are being made to increase the ratio of paid-up...
capital and reserves to deposits in recent years.

There is no uniform rule about the appropriate ratio of capital and reserves to total deposits. A ratio somewhere between 7 and 8% has usually been regarded as something proper. The average ratio of Indian Scheduled Banks at 4% is much lower. It is even lower in the case of some banks, including quite big ones.

There is, however, little sense in placing all the faith in the published reserves in promoting sound banking. It is the secret reserves which form the real basis of strength for a bank. Published reserves can be used to protect depositors against unforeseen emergencies only in the ultimate event of a bank failure. Normally any decline in the proportion of such reserves will mean a decline in faith in the bank. The adequate degree of protection in a crisis can, therefore, only be offered by a bank’s secret reserves. The legislation did not contain any reference to secret reserves. The need for protecting the secrecy of the inner reserves of banks from the point of view of maintaining a cushion of safety for them was recognised under the Banking Companies (Amendment) Act, 1960. Too great an emphasis upon the target of equalizing published reserves to paid up capital and both to a certain percentage of deposits will mean that a greater proportion of profits must be shifted to build up such reserves. The smaller must, therefore, be undisclosed reserves and the cushion of safety for banks.

Neither is there any sanctity about a particular ratio of capital and reserves to total deposits because banks have to fall back upon their reserves only in an emergency. It is difficult to predict what particular ratio will be adequate in such an emergency.

Banks, in general, would prefer the fixation of the reserve ratio on the basis of a voluntary agreement. A statutory ratio would place them
under the necessity of constantly adjusting their capital and reserves to a fluctuating volume of deposits. Moreover, because of the incursions it would make upon profits, it would place state owned banks at an advantage compared with privately owned banks. The Governor of the Reserve Bank also agreed that there was a great deal to be said in favour of a pattern of conventions which all banks would be expected to follow. It was in concurrence with the bank's wishes that the ratio of capital and reserves to total deposits was fixed at 6 per cent instead of at 7½ per cent as proposed originally.

Fixation of the ratio of reserves with reference to the total volume of deposits has been the accepted practice in India since 1949. While there is no question about the need for maintaining an adequate capital and reserves structure, there are various ways of maintaining capital and reserves. Apart from maintaining capital and reserves as a percentage of total deposits the other commonly accepted method is fixing the volume of capital and reserves with reference to the total assets. While the former is the more frequently accepted practice, there is much to be said in favour of the latter. First, acquisition of deposits does not automatically lead to a growth of profits. So banks with low profits but larger deposit resources may be discriminated against. Secondly, the security or otherwise of a bank depends more upon the composition and nature of its risk assets than upon the size of its deposits. Banks operating in different areas may require different capital deposit ratios according to the various degrees of risk attached to their assets. So the ratio of capital and resources should be fixed with reference to the total commitments of a bank. Moreover, fixation of the ratio of reserves with regard to total advances would put a curb upon indiscriminate lending. At the same time the volume of reserves should be linked with the total
volume of deposits so that the rate of growth of own funds does not fall behind
the rate of growth of a bank's liabilities. Linking of the ratio of reserves
to total assets involves some administrative complexities, however, not-
withstanding its advantages. Different ratios of reserves have to be fixed
against different assets according to the varying degree of risk attached
to them. The device of fixing the ratio of reserves with reference to a
bank's assets has been accepted in underdeveloped countries like Guatemala,
Korea, Paraguay and the Dominican Republic. (1)

For some banks the existing ratio of resources to deposits was as
low as 3%. In their case, building up an adequate capital and reserve only by
the method of transferring profits to the reserve fund would take up a
considerable time. As many of them had not entered the market for fresh
capital for 10 or 15 years and as, again, a substantial part of the subscribed
capital of many was uncalled, the Reserve Bank was in favour of the issue
of new shares and calls on unpaid capital. This, some bankers argued, might have
harmful effects on the value of bank shares and would raise the problem of
paying dividends. The Reserve Bank gave the assurance that it would bear
the prevalent conditions in the stock market and other relevant considerations
in mind.

Even before the legislative enactments were made the banking system
had started serious efforts to expand its capital and reserve base both by
approaches to the new issue market and by transfers to the capital funds
from their profits.

Realisation of the accepted ratio, however, will be a lengthy and difficult
process because the scope for large transfers of funds from profits is narrow;
On the other hand, owing to lower ratio of dividend, tax laws etc., bank shares

are not a very attractive form of investment at present.

(c) Increasing the Powers and Responsibilities of the Reserve Bank of India

The most striking aspect of banking legislation in India has been the vast addition to the powers and responsibilities of the Reserve Bank of India. As the Central Bank becomes more closely associated with Government policy, the need for control over the banking system becomes greater. This is even more true of an underdeveloped economy than of a developed economy. There are two implications of an increase in the Reserve Bank's powers. First, in the context of a developing economy the Reserve Bank is required to maintain just the proper volume of credit which will cause neither inflation nor a stringency of funds. Secondly, the Reserve Bank is entrusted with greater authority so as to ensure the maintenance of sound working principles by joint stock banks.

The Reserve Bank obtained a wide array of powers and responsibilities from clauses 21, 22, 23, 27, 33, 34, 35, 44, 45, 55 of the Banking Companies Act, 1949. Later amendments of the Reserve Bank of India Act and Banking Companies Act added extensively to it.

Licensing of Banks

Under clause 22 every banking company carrying on banking business in India must hold a licence granted by the Reserve Bank. Thus the existence of a bank becomes dependent on its obtaining a licence from the Reserve Bank. Since licensing would be conditional, the Bank has the discretion of granting or not granting a licence. Before granting a licence, the Reserve Bank may require to be satisfied that the company is in a position to pay off the claims of its depositors in full, that its affairs are not conducted to the detriment of the interest of the depositors and, in the case of a banking company incorporated elsewhere than in a province of India, the Government of the
country in which it is incorporated, shall not discriminate in any way against banking companies registered in a province of India. Licence may be cancelled for non-fulfilment of any of these conditions.

Branch banking

Many of the banking disasters in the past had been due to the indiscriminate expansion of branches without reference to the financial stability and soundness of a bank. As a precaution against uneconomic branch expansion opening of new branches or new banks within India was made subject to the approval of the Reserve Bank of India under the Act of 1949. The Banking Companies (Amendment) Act, 1950, made prior permission of the Reserve Bank of India necessary for opening branches outside India too.

Lending Policy of Commercial Banks

The Reserve Bank has been given wide powers of determining the lending policy of commercial banks. Under Clause 21 of the Banking Companies Act, if the Reserve Bank feels it expedient or necessary in the national interest to do so, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular and all banking companies or the banking company in particular is bound to follow the policy so determined. The Reserve Bank is further empowered to give directives as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances, the rates of interest to be charged on advances and each of the banking companies is bound to comply with any of these directives.

The above clause has been amended by the Banking Companies (Miscellaneous Provisions) Act 1963 to give the Reserve Bank the power to determine the maximum amount of advances that may be granted and the maximum amount up to which guarantees may be given on behalf of any one party.
The Banking Companies Act was, thus, the source of the Reserve Bank’s powers of selective credit control. This was a significant step since the quantitative methods of control were never very effective in India.

**Inspection and Supervision**

Whereas in some other countries the inspection and supervision of banks has been the responsibility of a separate authority such as a superintendent of banks (e.g., in the Dominican Republic, Paraguay) or of the Comptroller of Currency (as in U.S.A.) the Reserve Bank of India has been entrusted with sweeping powers in this respect. In South Africa and New Zealand also such legal powers vest in the Central Bank.

Most of these powers were obtained by the Reserve Bank of India under the Banking Companies Act, 1949, additions being made to them from time to time by subsequent legislation. Proper exercise of the Central Bank’s authority is dependent upon the receipt of accurate information. According to the Act of 1947, therefore, every banking company was required to submit to the Reserve Bank monthly returns of its assets and liabilities. It might also require any banking company to furnish the Bank with statements and information about its business (Cl.27).

Over and above receiving such information, the Bank was empowered to cause an inspection of a banking company, or of its books and accounts, either on its own initiative or at the direction of the Central Government. The Reserve Bank might report to the Central Government on any inspection made and if the Central Government then felt that the affairs of the banking company were being conducted to the detriment of the interest of the depositors, it might prohibit the banking company from receiving fresh deposits and direct the Reserve Bank to arrange for the winding up of the banking company (Cl.35). The Reserve Bank might further order the banking company to make such changes in the management that it might consider...
necessary following an inspection. (C1.36)

Moreover, the Reserve Bank might caution any banking company in particular, or banking companies in general, against entering into any particular transaction or class of transactions. (C1.36)

The Banking Companies (Amendment) Act of 1950 gave the Reserve Bank greater discretionary authority in choosing the types of assets that were to be maintained by banks.

By the Banking Companies (Amendment) Act, 1956, the Reserve Bank was empowered to issue directives to banks with regard to matters of policy or administration in the national interest or in the interest of the institutions themselves.

**Bank Management**

One of the most controversial parts of banking legislation has been that which has given the Reserve Bank almost unlimited authority over bank management. Such authority has been growing continuously since 1949. Thus under the Act of 1949 the Reserve Bank had received the power of ordering such changes in bank management to be made as it might consider necessary after an inspection. Under the Amendment Act of 1956 the Reserve Bank got the further authority to approve of the appointment or reappointment of managing directors or chief executive officers and also to regulate the terms of appointment of these officials. In 1959 the Reserve Bank obtained the further power of removing from office the Chairman or any director or manager or chief executive officer of a bank if they were found to have contravened the provisions of any law and the Reserve Bank was satisfied that the association of such a person with the banking company was undesirable. That which has given rise to the greatest controversy in the whole series of legislation in this respect has been the newly inserted

Formerly the Reserve Bank could remove any person in management only for contravention by him of any law directly and could not make appointments directly on its own initiative to the post of director or chief executive officer of a banking company. Under the present amendment, the Reserve Bank has been empowered to remove any person associated with the working of a banking company, whether or not that person has been found to have contravened the provisions of any law, if the Reserve Bank considers it necessary either in the public interest or in the interest of the depositors or for the better management of the company. The Reserve Bank may also appoint a suitable person in place of the person removed from office. The person involved will, however, be given a reasonable opportunity of making a representation to the Bank.

This section of the Act has been criticised on the ground that it gives dictatorial powers to the Reserve Bank. Indiscriminate use of such powers would be dangerous for the proper working of banks. Even sweeping legal powers with the Reserve Bank cannot ensure proper working of the banking system if such powers are not exercised in time and with alertness.

Helping Banks in Distress

One major criticism against the Reserve Bank in the past had been that the Bank did not come adequately to the succour of banks in distress. The Reserve Bank was, however, largely circumscribed by the insufficiency of its legal powers. The Indian Banking Companies Act, 1949 added enormously to the powers of the Reserve Bank to provide assistance to banks in times of distress (clause 55). Under the new dispensation the Bank might
make loans and advances against types of security other than those that were already permitted, provided they were considered sufficient by the bank.

Winding up, Amalgamation and Reconstruction Proceedings

Under the Act of 1949, winding up and amalgamation proceedings were made subject to the authority of the Reserve Bank. Such proceedings might be started only if the Reserve Bank certified that they were not to the detriment of the interest of the depositors (37, 38, 44, 45).

After the bank failures of 1960 it was felt that the Reserve Bank should have greater authority to deal with banks in difficulty. So the Banking Companies (Second Amendment) Act was passed in 1960 providing the Reserve Bank with additional powers to rehabilitate banks in difficulty. It was authorised to grant moratorium. During the period of moratorium the Reserve Bank might prepare a scheme for the reconstruction of the banking company or its amalgamation with another. The grant of moratorium has advantages over outright liquidation proceedings. It secures continuity of business. The object of the grant of moratorium is to secure reconstruction of a bank and its merger with a bigger institution. It means that the assets of the company will be kept in reserve in the interest of the depositors. There are greater possibilities of realising the assets of a company than under liquidation since it does not necessitate the realisation by a bank of all its assets at the same time.

The Reserve Bank and Non-Banking Financial Institutions

The amendment of the Reserve Bank of India Act in 1963 (Banking Companies Miscellaneous Provisions Act) extended the authority of the Reserve Bank over the non-banking financial companies too. Trading,
manufacturing and hire-purchase companies have recently been offering increasing competition to joint stock banks in attracting deposits. Non-banking companies are better placed than commercial banks in that they can offer higher rates of interest. Competition between banking and non-banking companies would mean either a shift of deposits from the former to the latter or the offering of rates of interest on deposits which might prove too uneconomic for banking companies. At the same time such institutions were free from the Reserve Bank’s control. The new Act increases the Reserve Bank’s control over non-banking companies in a number of ways. Thus the Reserve Bank is empowered to regulate or prohibit the issue of any prospectus or advertisement by a non-banking company calling for deposits from the public, and to call for returns and information on deposits received by them. The Reserve Bank can also issue directions to such institutions regarding the receipt of deposits, including the rate of interest payable on them and the period for which such deposits may be received. The Reserve Bank may prohibit the acceptance of deposits by such companies for non-compliance with its directives. The Bank may also require a non-banking institution to send a copy of its annual balance sheet and profit and loss account to its depositors.

Apart from such power over all non-banking companies in general, the Reserve Bank has some further powers over non-banking financial institutions. Thus the Reserve Bank can call for information from them about their paid-up capital and reserves, investments made and advances granted by them and give directions to them relating to the conduct of their business. Moreover, the Bank can inspect any non-banking institution, look into its books and accounts and provide penalties for failure to comply with the directives of the Reserve Bank or for wilful submission of incorrect information.
The accession of the Reserve Bank's authority of inspection and supervision over non-banking companies is a welcome move since in India the unorganised banking sector which is beyond the control of the Reserve Bank still forms a large segment of the financial system. The growth of the non-banking financial institutions mentioned above adds to the problems of credit control. Even in developed economies, the problem today is how to extend the Central Bank's control over these institutions.

Nowadays most underdeveloped economies are trying to build up a stronger and more varied credit structure through legislation. In many countries, this has meant increased state ownership of financial institutions. Instances are provided by Burma, Ceylon, Iraq, the United Arab Republic etc. In this respect, banking legislation in India seeks to combine the advantages of centralised control with private ownership.

Control of Foreign Banks

Banking business in many underdeveloped countries has, until recently, been a monopoly of foreign bankers. Branches of banks incorporated abroad—banks owned and managed by foreigners—had a predominant sway over the entire banking system. Thus, in Burma and Ceylon, foreign banks commanded more than 90 per cent of the banking business. Recent banking legislation in such countries has led to nationalisation of foreign banks. In India, too, foreign banks play a very important part. They have also been largely independent of the Reserve Bank's control in the past. Banking legislation in India, more particularly the Act of 1949, seeks to increase the Reserve Bank's control over them in various ways. Such legislation also seeks to remove discrimination between Indian and foreign banks. Thus Clause 11 of the Act of 1949 imposed some minimum requirements of paid-up capital and reserves. It is mentioned in Clause 22 that a banking company incorporation elsewhere
than in India, get a licence only if the Government or the law, the country in which it is incorporated, does not in any way discriminate against banks incorporated in India. All this is in addition to the usual regulations about lending policy, branch banking, submission of information etc., to which all banks are subject. Due to these legislative measures added to changes in money market conditions, the Reserve Bank's control over foreign banks has become much stricter than before.

(d) Extension of Banking Facilities to the Rural Areas

Banking legislation has been playing an important part in the economic development of India by helping to extend banking facilities to unbanked regions of the economy. It seeks to extend banking facilities throughout the country, more particularly to the rural areas, through a state-partnered, state-sponsored, integrated commercial banking structure. The basis of such a structure was laid down by the State Bank of India Act 1953. By this Act, the Imperial Bank of India was nationalised and transformed into the State Bank of India which was expected to cater to the rural needs through a countrywide network of branches. Other laws such as, the State Bank of Hyderabad Act, 1936 and the State Bank of India (Subsidiary Banks) Act, 1939 arranged for the merger of other state associated banks with the State Bank of India.

The new and enlarged state-owned commercial banking machinery set up under these laws has been quite prompt in its branch extension activities and, through them in helping agriculture and small scale industries. This machinery is also expected to be of indirect help in encouraging other commercial banks to expand their business to the rural and semi-urban areas.

Thus banking legislation in India has had a wide and varied scope, suiting the requirements of an underdeveloped economy. The banking system has been largely reformed of its structural and organisational defects.
during the last decade and a half. The whole system has been coming more and more under centralised control, thus making for greater uniformity and sounder operation. It is nowadays true that most of the undesirable features of banking that were responsible for the periodic crises in the past have now been remedied for ever. So much power and responsibility have, however, been entrusted to the Reserve Bank of India that much will depend upon the manner in which the Bank fulfills its responsibilities.

**Rationalisation of the Banking Structure - Rehabilitation of Weaker Banks**

There are, some small banks which have special problems of their own and which, therefore, need special treatment. The poor performance of a few weak units may undermine confidence in banks in general and thus act as a drag upon the entire system. The weaker, uneconomic units must either be set on a sounder footing, or give up their separate entity.

During the banking debacle of 1947-50, much of the undesirable banking growth of the War years and wiped out. The problem of reconstituting weaker and inefficient units is not now of the same magnitude that it was in the post-War years. Yet some weak banks need a reconstruction of their affairs. Among these there are a number which may ultimately stand on their own as economically viable units provided they get the necessary assistance and are subject to a stricter discipline. There are some others which are not economically viable as independent entities. These should enter into schemes of merger and amalgamation as their independent existence is risky to the security of the depositors and of the entire banking system.

**Need for Preserving Small Banks**

A country like India with its complex economic set-up and varied credit
needs, must be served by a diversified banking structure in which big and small units work side by side. Large scale amalgamations and mergers have their disadvantages as well as advantages. A movement towards amalgamations and mergers may mean monopolistic growth. Elimination of smaller banks, therefore, should be taken up only when the smaller banks cannot maintain their independent existence but not simply as a matter of policy. Smaller banks have a special importance, too, because of their closer connection with the rural and semi-urban areas.

Until recently, the main emphasis of the Reserve Bank's policy was upon amalgamations and mergers. But recently there has been a change of attitude and the Reserve Bank is feeling that a well managed small-sized bank with potentiality for growth is not a problem. So in 1963 the Reserve Bank of India took the initiative in organising a series of seminars for the small bankers. The chief executive officers of banks with deposits of up to 1 crore in the Southern region met at the Seminar to discuss their problems and to exchange ideas.

In his inaugural address at the first Seminar, Mr. P.C. Bhattacharya, Governor of the Reserve Bank of India, declared that although the relative share of small banks in the total banking business of the country was small still they had an effective and useful role to play in furthering economic development. These banks were already playing a useful part in reducing the size of operations of money lenders. They were playing a particularly important role in the development of small scale industries and business. Amalgamation was only one solution to the problems of small banks. Given adequate opportunities even small banks could stand on a sound footing. Thus some small banks had already qualified for a licence under the Banking

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Companies Act. The introduction of deposit insurance will be an important factor in assisting small banks in mobilisation of deposits in the rural areas.

These seminars brought to the fore the problems and experiences of small bankers. The position of small banks was found to have remained static for a long time. There was very little increase in their resources. Their advances had actually declined to a sizeable extent. One causal factor behind this loss of business was competition from bigger, stronger banks. The smaller banks were at a greater disadvantage than bigger banks for lack of trained staff and experience. There was also little opportunity of lending against the usual commercial banking securities in the areas in which they worked.

The small banks definitely possessed the advantages of more flexible and less formal methods of business, closer personal touch with their clients and knowledge of the areas in which they worked. But they should also take up a more progressive outlook. Thus a large portion of the advances of such banks consisted of personal loans against the security of gold ornaments until recently. The emphasis in their lending policies should be changed now. An important point emphasised at the seminars was the need for standardisation of forms and procedures of working among small banks. Introduction of standard forms and procedures among small banks would remove much confusion both for the Reserve Bank and for the depositors.

With increased monetisation the smaller towns and semi-urban areas will gradually need greater banking facilities. Existing small banks in these areas have to be rehabilitated or new units set up. The small banks may enter into correspondent arrangements with bigger banks. New banks may be set up as subsidiaries of bigger banks in the first instance, paying back their capital and becoming self-sufficient ultimately. Provision of
this type of assistance will be of advantage not only to the small banks, but also to the bigger banks because extension of banking business in the country will ultimately help in attracting more business for the bigger banks too. In these ways the advantages of stronger financial position and greater local contacts may be combined. If necessary, the Government should provide financial assistance in the initial years to both the big and small banks entering into these arrangements with each other.

**Schemes of Amalgamation and Merger**

Efforts to set up small banks on their own can be justified only where there is a possibility that the small banks can ultimately stand on their own as viable units. They cannot be allowed to subsist permanently as a burden upon the resources of the banking system or of the Government. Yet outright liquidation of such banks may mean an immobilisation of a certain volume of deposits when, in the context of a developing economy, mobilisation of deposits is an urgent necessity.

Schemes of amalgamation and merger offer many advantages to Indian banks in the present context. Amalgamation means lessening of risks through spreading them. It also means substantial cost reduction through economies in managerial expenses, the centralisation of cash reserves and economy in the transfers of cash, agency costs etc. It is usually argued that amalgamation means an end to competition and results in a monopolistic growth. But keen competition among numerous small units for a limited volume of banking business, as is prevalent in India, brings about many undesirable consequences. Among these we may mention offering of uneconomic rates of interest on deposits, frittering away of funds into questionable types of advances, etc. In fact it is the smaller banks which usually offer the higher and consequently, the more uneconomic rates of interest for them and
make advances of the more risky and unrealisable nature. Establishment of stronger units through amalgamation or merger will tone up the quality and direction of banking and bring about competition of a healthy type. Smaller banks also cannot afford to have sufficiently trained technical personnel. The establishment of large banks with widespread branches will thus lead to an improvement in banking services and facilities. In fact, it has been found in India that the bigger banks have initiated schemes of merger and amalgamation in the interest of reaping the benefits of widespread branch banking. Since the Reserve Bank's policy is to encourage the expansion of branches to unbanked areas, in areas where small banks already exist, bigger banks from outside have absorbed them and thus gained the advantages of branch banking.

Ever since the banking crisis of the late forties, the Reserve Bank has been taking an active interest in bank amalgamations. The Banking Companies Act, 1949, gave the Reserve Bank of India an important authority over bank amalgamations. Section 45 of the Act required the Reserve Bank's previous sanction for any scheme of amalgamation. However, the actual legal process of amalgamation was a time killing one. A new section - section 44A, was inserted in 1950 which made the process of amalgamation much simpler.

The Reserve Bank has, all along, encouraged schemes of voluntary amalgamation and merger among banks. It has offered help and guidance to the banks concerned. In spite of all this encouragement, however, there has been little initiative on the part of banks in this respect. Two schemes of amalgamation were of major consequence since the passing of the Banking Companies Act, 1949. One was the amalgamation of 4 Bengaloe banks in 1950 to form the United Bank of India. Since then, it has become one...
of the 8 major Indian banks. The other was that of the Hind Bank with the Bank of Baroda in 1935. This represents an attempt on the part of relatively big banks to form larger and stronger units. This decade also saw the integration of certain major state associated banks with the State Bank of India as recommended by the All India Rural Credit Survey Committee.

Between 1950 and 1958, the pace of amalgamations and mergers was extremely slow. The only progress consisted of an amalgamation between a scheduled and a non-scheduled bank in 1951 in West Bengal and two more schemes sanctioned in 1957. In 1958, the Reserve Bank of India approved two other mergers in the South. A number of proposals for amalgamation had actually been rejected because they were not to the interest of the depositors. Where the Reserve Bank of India thinks that amalgamation is not desirable or feasible, it has encouraged a number of schemes involving the transfer of certain assets and liabilities of banking companies. Both scheduled and non-scheduled banks have been parties to such schemes.

The pace of voluntary amalgamations and mergers has necessarily been slow because while amalgamation economises costs by rationalisation of branches and staff, merger and amalgamation are always synonymous with retrenchment in the minds of the employees. The attitude of the staff associations, therefore, makes it difficult to obtain the economies of rationalisation. Again, if two banks move on to a higher class through amalgamation, their costs will increase because the Bank Awards made a classification of banks into different categories with different standards. Heavy compensation too has to be made to staff which is rendered surplus. In the case of merger of one small bank with a big bank, there is the difficulty of absorbing various categories of staff with their differing levels of training and experience. It is also difficult to persuade any large or
medium-sized bank to take over small, poorly managed banks because of the threat to its financial strength that it involves.

The Reserve Bank was subjected to considerable criticism for the slow progress of voluntary mergers and amalgamations. The formulation of a programme of planned compulsory mergers and amalgamations was felt necessary. Accordingly, the Banking Companies Act was amended in 1960. The Amendment Act enabled the Reserve Bank to apply to the Central Government for the grant of moratorium in respect of a banking company for six months and within this period the Bank would prepare a scheme for reconstruction of the banking company or its amalgamation with another. The scheme of moratorium was, according to the Reserve Bank, of special significance because, in the event of liquidation, the assets had to be realised to pay off the depositor. Moratorium did not require immediate sale of the assets but it gave time to reconstruct a bank and merge it with another. The recovery of assets became the responsibility of the banking company which, with its specialised knowledge and experience would be able to secure a better value of the assets over a period of time than would be possible if the assets were sold all at a time. The essence of moratorium was, thus, reconstruction rather than liquidation.

Another important legislative measure adopted this year was the introduction of a new section 48 in the Banking Companies Act. This section empowered the Reserve Bank to formulate, with the approval of the Government, schemes of reconstruction and compulsory amalgamation among banks. The grant of a moratorium was a necessary preliminary.

Another amendment to the Banking Companies Act in 1961, conferred powers to the Reserve Bank to prepare a scheme for the compulsory amalgamation of any banking company with the State Bank of India or its subsidiaries.
This Act also permitted the amalgamation of more than two banking companies under a single scheme.

The pace of both compulsory and voluntary amalgamations has been accelerated since 1960. Between 1960 and 1964 altogether 65 mergers and amalgamations took place. Of this 15 were voluntary amalgamations and 41 compulsory mergers. There were, in addition 90 cases of transfer of assets and liabilities in order to secure consolidation. Altogether 50 banks were granted moratorium between 1960 and 1964. Of the 41 banks amalgamated with others, the depositors of 23 banks were given credit for the full amount of their deposits in the books of the transferee banks.

As yet, however, the Reserve Bank lacks any clear-cut policy with regard to mergers and amalgamations. Thus, moratorium was granted to the Metropolitan Bank Ltd., in 1963 with a scheme of merging it with four or five smaller non-scheduled banks. But the declared principle behind mergers is to reconstruct a bank by merging it with a sounder, bigger institution, not by merging it with still weaker units. The scheme came under considerable criticism. So it was decided later on to amalgamate it with one bank in the first instance.

Nationalisation of Commercial Banking

Banking reform, in some underdeveloped countries, has taken the form of State ownership and control over commercial banking. Thus in Burma all commercial banks were nationalised in 1963. All commercial banks in Iraq and five in the U.A.R. were nationalised in 1964. So were all foreign banks by 1965 in Indonesia. In Ceylon State control is gradually
becoming closer so that it amounts virtually to nationalisation. In India also the possibilities of nationalisation as a means of banking reform are being discussed in recent years. Even since India adopted the goal of a socialistic pattern of society, this question has come up from time to time. Moreover, as a developing economy requires a high degree of coordination between State policy and banking operations, this issue has received further attention in Parliamentary discussions. A resolution to this effect was introduced in September 1963. The impressive score of achievements of the Imperial Bank of India since nationalisation has influenced the demand for nationalisation. The fact that is often overlooked is that the Imperial Bank of India stands on a different footing since it was always a semi-Government institution and its close connection with various Government and semi-Government agencies has contributed in large-measure to its successful working as a nationalised institution.

The demand for nationalisation stems, on the one hand, from practical considerations of economic advantage, on the other, ideological consideration of achieving a socialistic pattern of society. It is the economic arguments that require greater scrutiny.

The main arguments put forth in favour of bank nationalisation are the following. First, it will prevent the malpractices of bank management. Such malpractices mainly take the form of granting loans and advances without adequate security to directors of a bank or to firms and persons in whom the directors are interested. Such loans often prove insecure and, therefore, harmful to the interest of the depositors. Secondly, it is believed that nationalisation will break up the concentration of power and secure better distribution of wealth. It is argued that bank shares are mostly concentrated in a few hands and these, through their control over financial resources, dominate the sphere of industry too. Public ownership of banks will put an
end to this growth, leading to better mobilisation and channelling of resources from the point of view of economic growth. Thirdly, banks under private initiative lack vigour and initiative. They are narrow, orthodox and selfish in their outlook.

The charge of malpractices brought against bank management is a serious one. This was one of the arguments put forth in favour of nationalisation of insurance. Undesirable practices on the part of bank management, no doubt, have had disastrous effects for the banking system in the past. But the extent of such malpractices is not now as great as before. It was admitted by Mr. Krishnamachari in the course of discussions in Parliament that loans to directors or to firms and companies in which the directors were interested did not form more than 13 per cent of total deposits in the case of the four major scheduled banks, whereas it was much larger in the case of the State Bank of India. Secondly, the vast addition to the supervisory and regulatory powers of the Reserve Bank of India in recent years reduces the risk from such malpractices to a very great extent. In many cases undesirable management has been detected and prompt action taken. In 1963 law gave sweeping powers to the Reserve Bank to take penal action against bank management. Thus the Reserve Bank is given the power to remove managerial and other persons from office if it feels it necessary in the public interest or in the interest of the depositors. As regards speculation in the stock exchanges or other undesirable types of lending which had been so common in the past these are no longer as serious a problem today as it was in the immediate post-war years, in the absence of protective legislation. The Reserve Bank has also been given adequate powers of selective credit control.
to put a check on particular types of lending.

There is no reason to believe that nationalisation will immediately boost the standard of efficiency and integrity of bank management. Nor is it possible for the central monetary authorities to look into the working of bank offices all over the country. On the occasion of the failure of the Peal Central Bank it was pointed out by the Governor of the Reserve Bank of India that it was not to be expected that the Reserve Bank would keep watch over 4000 odd banking offices all over the country. A countrywide nationalised banking structure will, therefore, be subject to many difficulties. Since banking services are largely personal in character, there is much to be said in favour of decentralisation. A governmental machinery will lack that personal touch which counts for so much in contributing to the efficiency of banking services.

It is believed that nationalisation will break up the concentration of economic power. A large degree of concentration of economic power, is undoubtedly noticed in a capitalistic economy but it is not necessarily confined to banking. If better distribution of wealth is to be achieved, then nationalisation of banking and industry should proceed simultaneously. Moreover, concentration of economic power is due to other factors - mainly the lack of entrepreneurship and managerial ability - and not so much due to the concentration of financial resources. Actually, majority of bank shares are distributed in the hands of many and voting rights are strictly circumscribed by law. Nationalisation will mean even greater concentration of economic power without the fear of competition to secure prompt and efficient service, imagination and creative energy.

It is contended that taking over of banks by the State will help in mobilising and securing greater resources for economic development. The
argument seems to have two ramifications. First, bank nationalisation will mean accretion of large deposit resources. State owned banks may secure greater funds either because they command greater confidence or because of their greater vigour. Secondly it will lead to the channelling of funds from less to more desirable uses. Officialdom does not necessarily have greater vigour than a privately owned institution. Rather it is the other way round. The large growth in deposit resources of the State Bank of India - an occurrence often cited as an example - is to a great extent, due to its association with Government business. Moreover, the State Bank inherited an unusually efficient administrative set-up from its predecessor, the Imperial Bank of India. In fact, it is suggested that the very efficiency of the State Bank of India is due to the fact that it has to face competition from other commercial banks. The real difference between a nationalised and private institution lies in the greater confidence that can be commanded by the former. Recently, various steps have been taken, such as deposit insurance, strengthening the capital and reserves structure of banks, increasing their liquidity ratios - all of which should go a long way in increasing confidence in banks. The rapid growth in bank deposits during the last 3-4 years is adequate proof of the private banks' success in mobilising deposits. As regards the contention that bank nationalisation will mean a better utilisation of resources, this objective may be realised only if the nationalised bank can secure larger resources. Otherwise it will simply mean a diversion of funds from the private to the public sector. A mixed economy cannot neglect the private sector. That can be allowed only when the state takes over the complete responsibility of industrialisation. Planning in India places a major reliance on the private sector. That sector must be provided with finance by the privately owned commercial banks.

In India, in the absence of a developed capital market, private banks already invest a sizeable share of their resources in Government paper. Nationalisation will lead to a shift of funds from the private to the public sector, but unless deposit resources of banks increase very fast (which is unlikely), the net gain to the public sector will not be very large, considering the large sums that will have to be paid out in the form of compensation. There are other ways of securing a greater Government control over deposits, such as maintaining secondary reserve ratios or calling for special deposits, apart from outright nationalisation.

On balance, the disadvantages of nationalisation will largely outweigh its advantages. The belief that nationalisation will substitute the profit motive for some motive of social justice is ill-founded. The limits of administrative efficiency of bureaucracy are often overlooked in our country. Nationalisation may substitute apathy, red-tapism and conservative outlook for vigour, prompt action and adaptability to changing circumstances. Neither can a nationalised institution completely ignore the commercial aspect for some vague ideal of social justice. The almost dictational powers that have been accruing to the Reserve Bank in recent years render many of the arguments in favour of nationalisation invalid. The fact that the evils of the banking system still persist shows that the working of the Reserve Bank's machinery is not perfect. Under the circumstances nationalisation cannot promise a panacea of all banking diseases.

It is claimed by some that a nationalised banking system will be better able to feed the requirements of some essential sectors of the economy, such as agriculture, small scale industries etc. There are, however, several arguments against such a claim. It is true that private bankers have to keep considerations of liquidity foremost in their mind, so they must work within certain limits. Even then, the concept of liquidity is changing in recent
years and they are entering fields from which they kept apart in the past, e.g. industrial financing. Secondly, the shortage of finance for the sectors mentioned above may be accounted for more by factors connected with the borrower’s side than with the lender’s. Loans to this sector by the Government too have proved to be bad debts due to the dishonesty or lack of creditworthiness of the borrower concerned. Commercial banks quite naturally, cannot be expected to venture into such risky business.

Discussions during the parliamentary debate revealed that the demand for nationalisation sprang more from ideological than from practical considerations. Ultimately the Finance Minister gave the assurance that banks were not to be nationalised in the present context.

Branch Expansion

Expansion of banking services and economic development are closely linked with each other, creation of new banking facilities in hitherto unserved areas leads first, to better mobilisation of savings. Secondly it leads to expansion of the organised sector of banking.

Extension of banking facilities geographically may take two forms. It may be in the form of creation of new banks, or of the creation of new offices of existing banks. Since the disastrous days of the late forties and early fifties bank legislation has, in many ways, placed restriction on the extension of branch banking. Yet, the Reserve Bank’s policy of merger and amalgamation shows that the trend is towards bigger banks and, therefore, larger number of branches. This emphasis is also evident from the stress laid upon the branch expansion programme of the State Bank of India. The major advantages that may be claimed for branch banking are the spreading of risks and facilities of remittance of funds.

The distinct trend in India is, therefore, towards consolidation. There has been a decline in the number of banks and increase in the number
of bank offices. The total number of banks had declined from 595 at the end of 1949 to 343 at the end of 1960. A large part of the decline was no doubt, due to the corrective action taken against the unhealthy banking development of the forties. In spite of the sharp decline in the number of banks, the number of bank offices increased. Upto the year 1953, several banks were being closed down every year. The number of offices of all scheduled banks increased from 2670 in 1953 to 4383 in 1961.

On an average the number of bank offices has increased by 121 every year. The increase in the number of offices shows the growth net of the number of offices closed during the year. If we take into account only the new branches opened, the growth would be even more impressive. Thus between 1954 and 1962, banks opened 2000 branches, the average annual rate being 225. During 1963, 250 branches were opened during the first nine months only.

The growth in the number of branches is conditioned by various circumstances. Thus it may be slackened by many practical difficulties, e.g., lack of transport and communication facilities over different parts of the country. Moreover, indiscriminate branch expansion may be disastrous in its effects. The more important question would be how far banking growth serves the needs of different parts of the country.

It is a common complaint that bank branches have expanded mostly to big cities which already have some banking facilities. The smaller towns, as also the rural areas, tend to be starved of such facilities. A study prepared by the Reserve Bank shows that banking facilities tend to spread to bigger towns and cities. An unbanked town, according to the definition of the Reserve Bank, is one which does not have modern banking facilities of any kind.

(1) Statistical Tables Relating to Banks in India 1960.
(3) Economic Times, February 20-23, 1964
(4) Reserve Bank of India Bulletin, August, 1963 - Unbanked Towns in India.
type (including co-operative and commercial bank facilities). It appears that the larger the population per town, the smaller is the number of unbanked towns.

Percentage of Unbanked Towns in Different Population Groups on the Basis of the 1961 Census

<table>
<thead>
<tr>
<th>Group No.</th>
<th>Population</th>
<th>Percentage of unbanked to total number of towns</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10 lakhs and above</td>
<td>Nil</td>
</tr>
<tr>
<td>2</td>
<td>5 lakhs to 10 lakhs</td>
<td>Nil</td>
</tr>
<tr>
<td>3</td>
<td>1 lakh to 5 lakhs</td>
<td>2.1</td>
</tr>
<tr>
<td>4</td>
<td>50,000 to 1 lakh</td>
<td>5.7</td>
</tr>
<tr>
<td>5</td>
<td>30,000 to 50,000</td>
<td>10.9</td>
</tr>
<tr>
<td>6</td>
<td>20,000 to 30,000</td>
<td>11.5</td>
</tr>
<tr>
<td>7</td>
<td>10,000 to 20,000</td>
<td>34.1</td>
</tr>
<tr>
<td>8</td>
<td>5,000 to 10,000</td>
<td>57.7</td>
</tr>
<tr>
<td>9</td>
<td>Below 5,000</td>
<td>68.8</td>
</tr>
</tbody>
</table>

Total number of towns (1) | Number of unbanked towns (2) | Percentage of unbanked to total towns
2690                      | 1017                         | 37.9

One fact pointed out by this survey was that the number of unbanked towns at the end of March 1962 was 1017 out of 2690. At the same time modern banking facilities were available at 2390 centres. The conclusion is, therefore, that 717 centres which were not classified as towns had modern banking facilities. This may be explained by the extension of banking facilities to the rural and semi-urban areas partly by the State Bank of India and partly by the co-operative banks.
Another fact which comes out is that although many new branches are being opened every year, yet the extension of banking facilities has not kept pace with the requirements of the various parts of the economy. According to the 1931 census and Statistical Tables Relating to Banks, 1931, only 1184 out of 3018 towns had modern banking facilities. Between 1951 and 1961 modern banking facilities had been extended to only 619 of these 1,334 towns. If we take into account the rural and semi-urban areas also the need for banking expansion will be even greater.

A large part of the banking expansion is again, due to the achievements of the State Bank of India and its subsidiaries. Between July 1955 and June 1960 the State Bank opened 416 branches as against 400 stipulated by the State Bank of India Act. Between 1960 and 1964, 100 and 174 branches had been opened respectively under their schemes. That is between 1955 and 1964, 690 branches were opened by the State Bank of India and its subsidiaries.

With effect from January, 1964, the State Bank of India has taken up a programme of opening 319 branches within a period of five years at unbanked Treasury and Sub-Treasury centres.

As the Reserve Bank felt the need for accelerating the pace of branch expansion, in July 1962, it requested all Indian banks other than the State Bank of India and its subsidiaries to draw up their own branch expansion programme for a three year period from August 1962 to July 1965. They were to keep in mind the special needs of the underbanked areas. However, in order that the banks' earning capacity and financial position might not be adversely affected, banks were also to take into account the needs of

towns of commercial and industrial importance which, although they had banking facilities, offered scope for more. Fifty banks had submitted their branch expansion programmes in response, and by the end of 1964, licences were issued for opening 437 new offices of which a minimum of 184 were to be opened in unbanked areas. The bank also approved additional proposals to open 136 offices, 33 of which were to be in unbanked centres. The pace of branch expansion showed considerable acceleration since 1963 as the following table shows:

TABLE

Variations in the Number of Offices of Indian Banks

<table>
<thead>
<tr>
<th></th>
<th>1962</th>
<th>1963</th>
<th>1964</th>
</tr>
</thead>
<tbody>
<tr>
<td>New offices opened</td>
<td>203</td>
<td>355</td>
<td>368</td>
</tr>
<tr>
<td>Existing offices closed</td>
<td>51</td>
<td>39</td>
<td>53</td>
</tr>
<tr>
<td>Over-all variation in the number of offices</td>
<td>152</td>
<td>316</td>
<td>315</td>
</tr>
</tbody>
</table>

Source: Annual Reports on Trend and Progress of Banking.

Upto 1956, the Reserve Bank of India followed a rather cautious policy of licensing. Since 1956, because of the changed circumstances and the need for mobilising larger resources, the Bank's branch licensing policy has been considerably liberalised. The pace of branch expansion also has become faster.

The attempt at branch expansion has met with one formidable obstacle from the beginning and the faster the pace of expansion, the more keenly has this obstacle been felt. It is the scarcity of trained personnel and the lack of training facilities. This is a difficulty which is being
experienced even by the State Bank of India. Thus the Karve Sub-Committee on Branch Expansion Programme recommended a two year respite after 1960-61 so that effective steps might be taken to improve organisational methods and to recruit and train up technical personnel. The difficulty caused by absence of suitable trained personnel is being magnified as the range of the banks' business - both of the traditional and non-traditional variety is expanding.

Training facilities are provided, by some individual banks and by the Reserve Bank of India through the Banker's Training College since 1954. The College conducts senior and intermediate courses of training as well as courses in foreign exchange and industrial finance for the supervisory staff of commercial banks. The training facilities provided by the Reserve Bank are, however, not adequate for the needs of the country. This is proved by the fact that between 1954 and 1964 altogether only 1843 officials of banks received training. In addition the College has started a special course in "Staff Management in Banks" since 1964 for senior officials.

It is too expensive for individual banks to make their own arrangements for training, so they are recently doing so in collaboration with each other. The bigger banks, with the help and encouragement of the Reserve Bank of India have set up about 14 training institutions.

In addition, the Reserve Bank has been organising seminars of bank executives to discuss organisational and personnel problems. Thus a seminar of chief executives of the small and medium-sized banks was organised in 1963 and another such seminar of the top executives of medium sized and bigger banks was organised in January, 1965. Both these seminars threw considerable light into the problems of banks and suggested courses of future action.