CHAPTER VI

COMMERCIAL BANKING IN A DYNAMIC CONTEXT

The changing economic context of a country makes greater and more diversified demands upon the banking system. So all the world over, commercial banking practices and theories are undergoing fundamental changes now-a-days. In India too, the period of planned economic development has been a transitional one for commercial banking.

It is in the field of industrial finance that a reconstitution of ideas and institutions has been the most essential. Scarcity of capital for industrial investment is endemic in the situation in an underdeveloped economy and India is no exception. Economic development has largely been thwarted by the absence of suitable agencies for industrial finance. Joint stock banks in India, having been brought up in the British tradition, were mainly the financiers of trade in the past; whatever finance they provided to industry was mainly in the form of short term working capital. In recent times, however, they are taking a greater interest in industry. Their advances to commerce are gradually becoming of smaller relative importance. Financing of industry has taken a different character too. Banks are no longer interested in purely short term lending. They are taking greater interest in medium-term financing.

Some banks are also showing an interest in other formerly unthought of lines of credit such as hire purchase finance. The development is embryonic only, as yet, but the change of attitude itself is worth mentioning. These types of credit too are expected to help our growing industries.
The existing agencies of external finance for industries in India that deserve mention, apart from joint stock banks, are the following: The investing public, the managing agents, statutory Finance Corporations, Life Insurance Corporation and other insurance companies, a few investment trusts. Finance provided by all such agencies, however, is only a small part of the total industrial finance required, particularly in the context of a rapidly developing economy.

Commercial banks are, by far, the most important among institutional sources of finance. Yet they have refrained from medium or long-term lending to industry. Their unwillingness to invest heavily in the shares and debentures of joint stock companies reflects partly the underdeveloped nature of the capital market. It is also largely due to the fact that the results of commercial bank participation in industrial finance in India have been particularly unhappy in the past. Therefore so far as equity or long-term capital is concerned, except for a few leading companies, all classes of industries — whether big, small or medium — have to face difficulties. For the medium or small scale industries even the availability of working capital is a problem.

The issue of obtaining industrial finance in India is, therefore, of a more complex nature than in the advanced economies where short-term capital, at least, is abundantly available at cheap rates.

The provision of long-term or equity capital is of course not advisable from the point of view of safety and liquidity of a bank. The possibility of granting medium-term capital to industry should,
however, be explored. It has been the unfortunate experience that the larger banks, with their higher capital resources and greater financial strength, have not taken much interest in medium-term industrial financing or in financing the small and medium-sized industries. But the smaller and weaker banks, which should rather be dissuaded from taking part in such risky business, have shown too great an interest in them. Since the volume of investment envisaged in each successive Five Year Plan is becoming greater and greater, the claim placed upon the banking system by the industries is also becoming larger and larger. Under the circumstances all possible ways of extending bank finance to industry within reasonable limits of safety have to be explored.

**Banks and Industrial Finance**

In the early stages of industrialisation, connection between banks and industries was very close in countries like France, Germany, Italy, Austria, Hungary, Belgium and Netherlands etc. So also in U.S.A. and Japan. On the European continent, not only did the banks invest largely in the share capital of specialised institutions like the Credit Mobilier, but provision of industrial finance for more than working capital purposes was part of the normal functions of a bank. British banks were not required to contribute to industrial finance and they maintained a strictly aloof attitude to industries at first. By the years of the Depression, however, there was some departure from this position even on the part of the conservative British banks, although the quantitative impact of this change was negligible. In the U.S.A., speculative investments by commercial banks had played an important role in the laying up of public utilities like the railways in the nineteenth century.
During the thirties of this century banks in U.S.A. and on the continent took to greater industrial financing. Much speculative investment and bank failures were the result. So country after country passed legislation preventing investment—ear—commercial banking.

Despite of such unhappy incidents, industrial development in Europe and U.S.A. owed a major debt to bank finance. In Japan, the fiscal and monetary mechanism played a prominent role in the quick transformation of the country from a primarily agricultural, feudalistic to a highly industrialised capitalistic economy. Most important were, of course, the specialised official and semi-official banks which were not deposit banks proper. Yet in actual practice the distinction between the specialised and ordinary commercial banks was rather vague. The latter were traditionally engaged in the long-term financing of industry, agriculture and real estate.

Since the inter-war years, commercial banks in some major countries have deviated from strictly deposit banking business. One contributory factor was the financial crisis which threatened industries during the depression and the banks’ need to render help in the interest of the liquidity of their own assets. Another was the availability of alternative sources of finance to industry and the drying up of a profitable avenue of lending for banks as a result. Thirdly, joint stock banks are having excess liquidity in their hands since the late thirties. This led to the growth of term lending business in some major countries of the world.

In some underdeveloped economies too the connection between banks and industries is becoming closer. Thus in the Latin American countries, financial institutions were characterised traditionally by an unwillingness
to lend for more than short-term, inability to mobilise an adequate volume of savings, and a drifting of their loans and advances to speculative rather than productive channels. Even there, however, commercial banks are extending medium and long-term credit to industry either directly or indirectly through the medium of official institutions such as the "Fomento" corporations. The Banco de Brasil provides a prominent example of undertaking investment banking functions directly. It lends at favourable rates of interest through the Agricultural and Industrial Credit Departments. Such loans are increasing in volume.

In Chile, commercial banks have performed investment banking functions against adequate guarantees. Although such loans are not legally made for more than one year. Yet actually, the practice of rolling over of advances rendered them medium-term in character.

In Mexico, under the Banking Law of 1940, banks were authorised to grant installation and repair loans up to a maximum period of two and five years respectively, subject to certain safeguards.

In Colombia also commercial banks are playing an increasingly important role in industrial finance. A decree of 1950 allowed commercial banks to grant loans with maturities up to five years for the construction or enlargement of works exclusively for economically useful purposes. These loans were also renewable at the Central Bank. They were not, however, to exceed 10% of a bank's deposits or its total capital and reserves. In 1952, the Banco Popular in Colombia was authorised to issue industrial bonds as well as to extend medium-term industrial credits guaranteed by factory mortgage or by industrial chattel mortgage.

In Argentina, the Banking Reform of 1946 gave the nationalised Central Bank complete control over the loans and deposits of all commercial
The commercial banks, acting as agents of the Central Bank, play a very important part in industrial financing. All these instances point out the importance of bank finance for industry in a developing economy. Liquidity and risk are the main considerations obstructing extension of bank finance to industry. Such loans are mainly of a long-term nature. So they are more risky and less liquid. There are, however, many things to be said on the other side too. Prof. Sayers considers it fallacious to insist that banks should invest only in liquid assets since their funds are mainly short-term, for no bank could make a living that way. A successful combination of banking functions has been achieved in some countries e.g. Germany, Denmark and Switzerland. Mixed banking is not necessarily unsound banking. For, apart from demand deposits there are the time deposits, paid-up capital and reserves of banks. Also, the depositors usually call back only a small proportion of their demand deposits. Much, however, depends upon the development of banking and the spread of the banking habit. A fortunate post-war trend in most countries is the preponderance of time over demand deposits and of bank deposits over currency.

(1) a) Institutes for Industrial Finance and Development (with special reference to India) Lok Sabha Secretariat, July 1955

b) B.K.Nadan - Financing of Industries by Banks and other credit institutions in Latin America, Reserve Bank of India Bulletin, December 1932.

c) "Bank Credit and Industrialisation", Statist-Economic Survey of South America, March, 1960, p.33.

Diamond has shown that the "Restriction of commercial Banks to self-liquidating, short-term commitments does not serve to keep them from engaging in some kinds of speculative investment when they are so inclined". (1) Medium-term investments in well established companies are safer and more desirable investments. The experience of World Bank missions in Latin American countries like Cuba and Colombia shows that legal efforts to prevent combination of investment and commercial banking business has not prevented banks from investing in short-term, speculative lendings, as they have proved very profitable.

Since bank liquidity has come to mean shiftability to the Central Bank, and Central Banks have legally been entrusted with greater powers of control over commercial banks; the monetary authorities should try to bring about a change in the investment policy of commercial banks. This will restrict the flow of credit to profitable but speculative channels and lead to more productive types of investment. This is all the more necessary since an underdeveloped economy lacks an organised capital market with well-established alternative financial institutions.

This is not to deny the risks that are connected with large scale investments in long-term assets by banks. Examples are provided by the cases of France, America and Japan in the inter-war years and the extensive bank failures in India in the post-Second War years. In broad and active capital markets risks are minimised for banks, because they can choose first-class, safe bonds or diversify their risks. In an under-developed capital market, readily saleable first-class bonds and securities are difficult to obtain. Due to the shortage of properly qualified

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(1) Diamond - "Development Banks" (P.43)

Published under the auspices of the International Development Institute, I.B.R.D.
technical staff, credit information and credit appraisal arrangements too are quite inadequate.

In some continental countries commercial banks float medium-term debentures to cover their long-term investments. Flotation of such papers would be successful only if they are taken up by the public. Of that, the possibility is very meagre in India.

Because of the difficulties involved in bank industrial financing, specialised financial institutions are being set up now-a-days. Yet, there are strong arguments in favour of the fullest utilisation of existing financial institutions in a country where managerial and technical abilities are habitually short in supply.

Various safeguards have often been suggested for protecting banks engaged in industrial financing. The United Nations' Report on "Domestic Financing of Economic Development" recommends three such measures:

(1) Government guarantee of the repayment of medium and long-term loans granted by banks; (2) Provision of special rediscount facilities; (3) Setting up of a maximum limit for the proportion of long-term commitments to the assets of a bank.(1)

The last one is a purely negative measure. While it may afford some protection to depositors, it does not fill up the shortage of industrial finance. As regards the provision of special rediscount facilities, the Refinance Corporation serves the same purpose for medium-scale industries. Recently the Industrial Development Bank of India is doing the same for

large-scale industries also. The Reserve Bank and the Shroff Committee were both opposed to the idea of direct grant of rediscount facilities by the Reserve Bank. Government guarantee of repayment can never be a substitute for the banker's judgement and initiative. More important requisites would be specialised technical personnel to handle this type of business and better methods of collecting credit information. In India, borrowers are unwilling to provide and often resent any attempt to seek such information. Greater initiative on the part of bank management and closer personal contact with their customers would solve some of these difficulties. The Government may provide the services of technical personnel through the Director of Industries; it may also set up credit information bureau for exchange of information among financial institutions.

It has also been the general opinion that bank finance to industry has been limited in volume because of the onerous nature of the terms and conditions under which industries obtain such finance. Thus the Imperial Bank of India and other scheduled banks have always insisted upon two signatures, one being that of a managing agent, even when the bank is in physical possession of the liquid assets.

The Indian bank's practice of keeping stocks under their own lock and key when these are hypothecated to the bank has further added to their difficulty. For this the remedy suggested is the opening of warehouses so that banks may grant loans against warehouse receipts and the borrowing parties may make arrangements for the sale of the goods in stock.

It has also been pointed out that industry should meet not only its fixed capital requirements, but also a part of its working capital needs.

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(1) (a) S.K.Basu - Industrial Finance in India (Calcutta University) Fourth Edition, P.135-142
(b) Report of the Committee on Finance for the Private Sector Ch.VI, P.54-57
from its own resources. It should rather cut down dividends and try to build up its capital and reserve fund than loan too much on external financing. It is not possible for banks to finance a concern unless it is well established.\(^{(1)}\)

**Term Lending By Banks**

While joint stock banks should not do long-term financing the possibility of medium-term financing within reasonable limits of safety is commonly conceded now-a-days. The evolution of term-lending business in some major countries is one of the most important banking developments of recent times.

Term-lending business, as it evolved in U.S.A., involved a radical departure from the traditional canons of bank liquidity, viz., self liquidating character and shiftability of an asset. Even before the grant of formal term-loans in U.S.A., banks in many countries had been given loans which were medium-term in effect since many loans were not recalled on maturity. Term-lending proper differs from such lending in the formal agreement drawn up for the purpose.

An exhaustive definition of term loans is given by Jacoby and Saulnier in their study entitled "Term Lending to Business".\(^{(1)}\) According to this definition, the basic elements of term loan are the following:


\(^{(1)}\) Jacoby and Saulnier - "Term Lending to Business Financial Research Program, National Bureau of Economic Research, Ch. I, P.9
(1) Term loans are business loans as distinct from personal loans. The concern to the lender is the possibility of financial success of the enterprise. It is the earning power of the business rather than the collateral involved, the moral integrity or the financial worth of the enterprise which is the major consideration to the lender.

(2) As distinct from corporate bonds and debentures, term loans involve a direct relation between the borrower and the lender.

(3) Term loans are loans granted for more than one year.

All business loans, therefore, having an original maturity of more than 12 months are term loans whether or not they are secured or unsecured and irrespective of the borrower's purpose in obtaining the loan. Term loan arrangements differ considerably as between borrowers because the loan plan is adapted to financing the diversified needs of borrowers. Maturity periods of 3 - 5 years are quite common.

An important attraction of term-lending business is the adoption of specific credit standards along with methods of appraising and limiting term loan risks. Specially trained personnel are appointed for this purpose. Because of the large size of the loan and the longer period of maturity the risk of term loans is greater than that of ordinary loans. The general feeling is that the really effective protection to the lender does not come from the collateral security involved, but from the agreement that lays down the financial and other conditions to be maintained by the borrower. Each loan application is thoroughly scrutinised with reference to the financial circumstances of the firm, its prospective earning power, character or moral competence of the borrower. The borrower is required to maintain certain minimum standards of financial condition or else the lender has certain protective safeguards. In case the borrower's financial condition...
deteriorates or the loan agreement is violated, the period of maturity is automatically accelerated. Thus term loans are safer assets than short-term loans repayable at maturity or corporate bonds or debentures.

The remarkable fact is that term loans are being granted even by the orthodox British commercial banks recently. The volume of such business is growing. The Eccleffee Committee recommended the granting of such credit facilities within limits as an alternative to a running overdraft. Such loans are given to businessmen for meeting small credit requirements. A significant extension of term lending business has been in the provision of medium-term loans against export credit guarantees. British banks have not as yet undertaken such business on a large scale. Nor do they believe that its prospective volume will be large. Nevertheless their very willingness to enter this line of activity is an important departure from their past tradition.

Bank Finance and Industry in India

More than thirty years ago, the Central Banking Enquiry Committee made an assessment of the contribution made by different agencies towards industrial finance. According to them, the amount lent by banks formed only 9% and 4% respectively of the total industrial finance in Bombay and Ahmedabad. To this must be added the investment in debentures. These, however, were of a very small magnitude. So bank finance, on the whole, formed the smallest part of total industrial finance.

There have been different periods in the twentieth century when Indian banks have taken to larger industrial financing. First, during the Swadeshi movement between 1906 and 1913; secondly, during the post World War I days; thirdly, during the years following the Second War. All these
experiments with bank participation in industrial finance had unhappy consequences. A large number of bank failures occurred immediately after. Most of these banks had neither the knowledge, nor the resources necessary for such business. Except for these occasional variations, bank financing of industry was not usually of any importance.

Recently, however, the position of banks as the suppliers of industrial finance has been changing significantly. Some estimates of the sources and uses of funds for industry have been made by the Research and statistics Division, Ministry of Commerce and Industry. These estimates threw considerable light into the relative importance of various sources of industrial finance. The estimates are based on two studies made, one covering the period 1951 - 55 and including 750 public limited companies, the other covering the period 1956 - 1957 including 1001 public limited companies. These were medium and big sized companies, each having a paid-up capital of Rs 5 lakhs or more. In terms of paid-up capital, percentage coverage of the industries selected exceeded 76% for most of the industrial groups.

(1) "Trends in Company Finances with particular Reference to the First and Second Plan Periods" by Nigam and Joshi, Research and Statistics Division, Department of Company Law Administration, Ministry of Commerce and Industry, New Delhi, C.D. 66.1.
Pattern of sources of Funds

<table>
<thead>
<tr>
<th>Source of Funds</th>
<th>Total</th>
<th>750 public limited companies (1951-55)</th>
<th>1001 public limited companies (1956-57)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heads</td>
<td>100</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>A. Internal Sources</td>
<td>60</td>
<td>60%</td>
<td>32%</td>
</tr>
<tr>
<td>B. External Sources</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Paid-up Capital</td>
<td>7</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>II. Borrowings</td>
<td>17</td>
<td>17%</td>
<td>40%</td>
</tr>
<tr>
<td>a) From banks</td>
<td>6</td>
<td>6%</td>
<td>23%</td>
</tr>
<tr>
<td>b) Mortgages</td>
<td>3</td>
<td>3%</td>
<td>14%</td>
</tr>
<tr>
<td>c) Debentures</td>
<td>2</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>d) I.F.C.</td>
<td>N.A.</td>
<td></td>
<td>1%</td>
</tr>
<tr>
<td>e) Others</td>
<td>4</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>III. Trade dues and miscellaneous liabilities</td>
<td>16</td>
<td>16%</td>
<td>18%</td>
</tr>
</tbody>
</table>

(N.A. - Not available)

* Trends in Company Finances - Nigan and Joshi

Both these estimates show that bank credit was the most important among borrowed sources of finance. Years of larger investment and of more rapid economic activity were also years of greater reliance upon bank credit e.g. the year 1956-57.

A later study made by the Reserve Bank of India on Finances of joint stock companies for the period 1955-57 shows that borrowings from banks

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were much smaller during the years 1939 and 1939 than during the years 1936, 1937. During 1939, there was actually a net repayment of borrowings from banks. But these were years of a slackening of economic activity compared to the two previous years. Secondly, during these later years there was an increase in the importance of internal sources and decline in the importance of external sources in general. Thirdly, the decline in importance of bank finance was more particularly marked in two industries than in others, viz., cotton textiles and iron steel. This had an effect upon total borrowings from banks, these being the major industries. Yet, total borrowings from banks continued to increase, except for the year 1939. Bank finance still formed the most important part among sources of borrowed finance as is shown by the following table:

**CAPITAL AND LIABILITIES OF 1001 PUBLIC LIMITED COMPANIES**

<table>
<thead>
<tr>
<th>Capital and Liabilities</th>
<th>1935</th>
<th>1936</th>
<th>1937</th>
<th>1938</th>
<th>1939</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up Capital</td>
<td>469.37</td>
<td>499.13</td>
<td>532.10</td>
<td>560.77</td>
<td>593.37</td>
</tr>
<tr>
<td>Borrowings</td>
<td>313.53</td>
<td>409.33</td>
<td>514.23</td>
<td>557.73</td>
<td>563.43</td>
</tr>
<tr>
<td>a) From banks</td>
<td>183.50</td>
<td>205.35</td>
<td>253.84</td>
<td>264.45</td>
<td>250.36</td>
</tr>
<tr>
<td></td>
<td>(44.4)</td>
<td>(50.11)</td>
<td>(49.3)</td>
<td>(47.4)</td>
<td>(45.2)</td>
</tr>
<tr>
<td>b) Industrial Finance</td>
<td>3.90</td>
<td>12.16</td>
<td>16.06</td>
<td>17.00</td>
<td>17.96</td>
</tr>
<tr>
<td>Corporations</td>
<td>(2.3)</td>
<td>(2.9)</td>
<td>(3.1)</td>
<td>(3.0)</td>
<td>(3.1)</td>
</tr>
<tr>
<td>c) Other mortgage</td>
<td>34.70</td>
<td>57.31</td>
<td>102.40</td>
<td>125.51</td>
<td>133.07</td>
</tr>
<tr>
<td></td>
<td>(11.0)</td>
<td>(13.9)</td>
<td>(19.9)</td>
<td>(22.5)</td>
<td>(23.6)</td>
</tr>
<tr>
<td>d) Debentures</td>
<td>53.34</td>
<td>32.12</td>
<td>51.04</td>
<td>55.22</td>
<td>57.96</td>
</tr>
<tr>
<td></td>
<td>(17.0)</td>
<td>(12.7)</td>
<td>(9.9)</td>
<td>(9.9)</td>
<td>(10.2)</td>
</tr>
<tr>
<td>e) Others</td>
<td>76.99</td>
<td>82.91</td>
<td>90.99</td>
<td>95.47</td>
<td>93.50</td>
</tr>
<tr>
<td></td>
<td>(24.3)</td>
<td>(20.2)</td>
<td>(17.6)</td>
<td>(17.1)</td>
<td>(16.6)</td>
</tr>
</tbody>
</table>

(*Finances of Joint Stock Companies, Reserve Bank of India Bulletin, September 1961, P.1436, Table 17*)

Figures in brackets indicate percentage to total borrowings.)
A later survey provides data about 1333 selected public limited non-financial non-government companies with a paid-up capital of more than 5 lakhs each.\(^{(1)}\) In terms of paid-up capital these constitute 89% of the total paid-up capital of all such companies. Information available from these data bear out the importance of banks as a source of finance.

### CAPITAL AND LIABILITIES OF 1333 SELECTED PUBLIC LIMITED COMPANIES

<table>
<thead>
<tr>
<th></th>
<th>1960-61</th>
<th>1962-63</th>
<th>1963-64</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital</td>
<td>721.42</td>
<td>762.07</td>
<td>800.16</td>
</tr>
<tr>
<td>Borrowings</td>
<td>731.66</td>
<td>797.87</td>
<td>893.92</td>
</tr>
<tr>
<td>(a) From banks</td>
<td>374.77</td>
<td>425.36</td>
<td>492.31</td>
</tr>
<tr>
<td></td>
<td>(51.2)</td>
<td>(55.3)</td>
<td>(55.0)</td>
</tr>
<tr>
<td>(b) From Statutory</td>
<td>26.58</td>
<td>27.02</td>
<td>29.62</td>
</tr>
<tr>
<td>Finance Corporations</td>
<td>(3.6)</td>
<td>(3.4)</td>
<td>(3.3)</td>
</tr>
<tr>
<td>(c) Other debentures</td>
<td>66.17</td>
<td>69.13</td>
<td>72.03</td>
</tr>
<tr>
<td></td>
<td>(9.0)</td>
<td>(9.7)</td>
<td>(9.6)</td>
</tr>
<tr>
<td>(d) Other mortgages</td>
<td>133.66</td>
<td>133.21</td>
<td>136.17</td>
</tr>
<tr>
<td></td>
<td>(13.2)</td>
<td>(15.6)</td>
<td>(15.3)</td>
</tr>
<tr>
<td>(e) Others</td>
<td>130.43</td>
<td>143.15</td>
<td>163.59</td>
</tr>
<tr>
<td></td>
<td>(17.9)</td>
<td>(17.9)</td>
<td>(18.7)</td>
</tr>
</tbody>
</table>

(Figures in brackets indicate percentage to total borrowings)

\(^{(1)}\) Reserve Bank of India Bulletin, July 1964
P.861, Table 12
That bank credit is becoming an increasingly important source of industrial finance is clear from other evidences. According to the report on Trend and Progress of Banking for the year 1960, during the period 1951-55, scheduled bank credit rose by 169 crores. Of this, industrial credit amounted to 69 crores or 41 per cent. During the Second Plan period the volume of investment was larger and bank credit to industry also constituted a larger proportion of total bank credit. Total increase in scheduled bank credit amounted to 455 crores. Of this, industrial credit accounted for 75 per cent. Over the decade 1951-60, industrial credit accounted for two-thirds of the increase in bank credit. Correspondingly, the share of advances to commerce began to decline and that of advances to industry began to increase.

**SCHEDULED BANK ADVANCES TO COMMERCE & INDUSTRY 1951-60**

<table>
<thead>
<tr>
<th>Year</th>
<th>Advances to Industry</th>
<th>Advances to Commerce</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>33.5</td>
<td>52.9</td>
</tr>
<tr>
<td>1952</td>
<td>35.1</td>
<td>46.7</td>
</tr>
<tr>
<td>1953</td>
<td>34.5</td>
<td>49.2</td>
</tr>
<tr>
<td>1954</td>
<td>34.3</td>
<td>49.9</td>
</tr>
<tr>
<td>1955</td>
<td>34.3</td>
<td>50.1</td>
</tr>
<tr>
<td>1956</td>
<td>39.5</td>
<td>47.5</td>
</tr>
<tr>
<td>1957</td>
<td>43.6</td>
<td>42.7</td>
</tr>
<tr>
<td>1958</td>
<td>47.9</td>
<td>37.6</td>
</tr>
<tr>
<td>1959</td>
<td>44.7</td>
<td>31.6</td>
</tr>
<tr>
<td>1960</td>
<td>51.2</td>
<td>29.6</td>
</tr>
</tbody>
</table>

Figures from Trend and Progress of Banking.

*(1) Trend and Progress of Banking, Reserve Bank of India, 1960, pp.13-14*
The relative importance of advances to industry and commerce thus became exactly reverse during the decade of the fifties. The rise and fall in the share of advances to industry and commerce respectively continued during the sixties. Thus the proportion of advances to industry rose to 57% at the end of March 1963 compared to 53% at the end of April 1961. The proportion of advances to commerce, in contrast, declined from 36% at the end of April 1961 to 33% at the end of March 1963. (1)

Besides lending, bank financing of industry may take other direct and indirect forms. One form of direct financing is investment in the shares and debentures of joint stock companies. Apart from bank advances against the shares and debentures of joint stock companies, indirect financing may be done in the shape of buying the shares and debentures of various specialised finance corporations. Secondly, Indian banks are also entering into some underwriting business recently. The volume of such business is not large, yet it is increasing. If these contributions are taken into account, the share of bank finance in the total industrial finance would be much larger than that indicated by the volume of borrowings. These latter types of lending are also comparatively long-term in nature while borrowings may be for both short-term and medium-term. Some idea of the importance of bank finance in total industrial finance can be formed from the following table.

(1) Trend and Progress of Banking for the year 1963, Para-20.
Bank Finance in the Capital and Liabilities of Public Limited Companies 1956-57

<table>
<thead>
<tr>
<th></th>
<th>1955</th>
<th>1956</th>
<th>1957</th>
<th>1958</th>
<th>1959</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
</tr>
<tr>
<td>1) Paid-up capital</td>
<td>493.13</td>
<td>646.92</td>
<td>332.10</td>
<td>691.04</td>
<td>560.77</td>
</tr>
<tr>
<td>2) Borrowings</td>
<td>499.05</td>
<td>532.27</td>
<td>514.23</td>
<td>667.83</td>
<td>557.73</td>
</tr>
<tr>
<td>3) Total of (1) &amp; (2)</td>
<td>992.18</td>
<td>1179.19</td>
<td>1046.33</td>
<td>1358.87</td>
<td>1118.50</td>
</tr>
<tr>
<td>4) Bank investment in shares</td>
<td>7.34</td>
<td>7.13</td>
<td>9.29</td>
<td>13.09</td>
<td></td>
</tr>
<tr>
<td>5) Bank investment in debentures</td>
<td>3.89</td>
<td>4.04</td>
<td>6.15</td>
<td>8.63</td>
<td></td>
</tr>
<tr>
<td>6) Borrowings from banks</td>
<td>205.35</td>
<td>253.34</td>
<td>264.45</td>
<td>260.36</td>
<td></td>
</tr>
<tr>
<td>7) Total of (4) &amp; (6)</td>
<td>216.53</td>
<td>265.63</td>
<td>279.89</td>
<td>264.62</td>
<td></td>
</tr>
<tr>
<td>8) (7) as percentage of (3)</td>
<td>18.36</td>
<td>19.5</td>
<td>19.26</td>
<td>19.02</td>
<td></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India Bulletin, September, 1961 - Finances of Joint Stock Companies; Report on Trend and Progress of Banking. Blown up totals obtained from the coverage of the survey.
The volume of medium or long-term lending of scheduled banks, however, would not be as impressive as that of total bank lending to industry. Joint stock banks are traditionally and quite naturally unwilling to provide more than short-term finance. They do not want to purchase shares of companies to be newly established. Neither are they interested in the purchase of debentures of established companies as there is no ready market for them. Bank finance has, however, been deficient in the past with regard to working capital too. Among the big banks which have played a part of any importance in the provision of working capital, mention may be made of the Imperial Bank of India, the Central Bank of India, the United Commercial Bank etc. Credit is given in the form of bills discounted, advances and cash credits. The terms of giving such loans have proved too onerous for the industries concerned.

That bank credit has mostly taken the form of short-term commercial loans is evident from the small size of bank investment in shares and debentures of joint stock companies or their advances against such assets.
Investments of Scheduled Banks in the Shares and Debentures of Joint Stock Companies

<table>
<thead>
<tr>
<th>Period</th>
<th>Scheduled bank investment in shares of Joint-Stock Companies</th>
<th>Scheduled bank investment in debentures of Joint Stock Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31, 1956</td>
<td>7,34 (1.7)</td>
<td>3,09 (0.9)</td>
</tr>
<tr>
<td>Dec. 31, 1957</td>
<td>7,15 (1.4)</td>
<td>4,04 (0.8)</td>
</tr>
<tr>
<td>Dec. 31, 1958</td>
<td>9,29 (1.2)</td>
<td>6,15 (0.8)</td>
</tr>
<tr>
<td>Dec. 31, 1959</td>
<td>15,08 (1.7)</td>
<td>8,68 (1.0)</td>
</tr>
</tbody>
</table>

Investment in shares and debentures of joint stock companies

March 1961       13.10 (2.7)  
March 1962       13.98 (2.6)  
March 1963       21.81 (2.9)  

(Figures in brackets indicate percentage of total investments)

Advances of Scheduled Banks Against Principal Types of Securities (Amount in lakhs of rupees)

<table>
<thead>
<tr>
<th>Last Friday of</th>
<th>Advances against shares and debentures of Joint Stock Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1957</td>
<td>73,25 (10.5)</td>
</tr>
<tr>
<td>Dec. 1958</td>
<td>81,12 (11.5)</td>
</tr>
<tr>
<td>Dec. 1959</td>
<td>91,19 (11.6)</td>
</tr>
<tr>
<td>Dec. 1960</td>
<td>99,46 (9.8)</td>
</tr>
<tr>
<td>Last week of Nov. 1961</td>
<td>10549 (3.5)</td>
</tr>
<tr>
<td>Nov. 1962</td>
<td>11390 (3.3)</td>
</tr>
<tr>
<td>Nov. 1963</td>
<td>11394 (7.6)</td>
</tr>
</tbody>
</table>

(Figures in brackets indicate percentage to total advances)

Yet, in recent years, the attitude of banks towards industries is changing and banks are playing a greater role in providing medium-term capital than the above analysis would suggest. First, much of what appears to be a short-term loan is actually a medium-term loan. Secondly, banks are quantitatively the most important among external sources of medium or long-term capital. Thirdly, if indirect contributions of banks are taken into account, their share in long-term industrial finance would be much greater than it appears from the direct contributions.

It was the opinion of the Shroff Committee (Committee on Finance for the Private Sector, 1954) as also of the Reserve Bank of India's Working Group on Term Lending (1961) that because of the practice of rolling over their loans, a part of the advances of commercial banks to industries, though ostensibly for short-term, was actually for long-term. The Shroff Committee felt that even when it was for working capital purposes, it released the borrower's own funds for long-term expenditure. So it did serve the needs of long-term finance to a certain extent.

Scheduled banks are the most important among institutional sources of industrial finance. In India there are no developed investment trusts or issue houses. The few investment trusts there are play a very minor role. The relative importance of banks and various other institutional investors will be evident from the following table:

---

### Scheduled Bank

<table>
<thead>
<tr>
<th>Bank Investments in shares and debentures of Joint-Stock Companies</th>
<th>Shares Debentures</th>
<th>L.I.C.</th>
<th>I.F.C.</th>
<th>I.C.</th>
<th>I.C.</th>
<th>General</th>
</tr>
</thead>
<tbody>
<tr>
<td>a (1)</td>
<td>b (2)</td>
<td>c (3)</td>
<td>d (4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
</tr>
<tr>
<td>Dec.31, 1959</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15,03</td>
<td>9,63</td>
<td>77,90</td>
<td>13,29</td>
<td>31,53</td>
<td>33,36</td>
<td>66</td>
</tr>
<tr>
<td>Total (a) &amp; (b)</td>
<td>Total (a) &amp; (b)</td>
<td>(32,1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23,76</td>
<td>91,19</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total of (1) &amp; (2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec.31, 1960</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11,43</td>
<td>667</td>
<td>76,45</td>
<td>20,01</td>
<td>92,05</td>
<td>39,33</td>
<td>-</td>
</tr>
<tr>
<td>Total (a) &amp; (b)</td>
<td>Total (a) &amp; (b)</td>
<td>(32,5)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18,10</td>
<td>9848</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (1) &amp; (2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Figures in brackets indicate percentage to col.7)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Figures for March, 1961
Cols. (1) & (2) from Reports on Trend and Progress of Banking.
Col. (3) from Annual Reports of the L.I.C.
Col. (4) from Annual Reports of the I.F.C.
Col. (5) from Annual Reports of the I.C.I.C.
Col. (6) from India, 1961, 1962, Govt. of India Publications Division.*
### Capital Formation and Bank Financing of Industries, 1956-52

<table>
<thead>
<tr>
<th>Gross Fixed Assets formation 1001 selected Public limited companies</th>
<th>Blown up totals for all companies</th>
<th>Estimated long-term finance from external sources</th>
<th>Total (3 to 6)</th>
<th>Blown up totals for all companies</th>
<th>Investments of Scheduled banks in shares and debentures of joint stock companies</th>
<th>(9) as (9) as percentage of tags</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>1956</td>
<td>136.97</td>
<td>177.75</td>
<td>23.02</td>
<td>22.61</td>
<td>-1.42</td>
<td>3.26</td>
</tr>
<tr>
<td>1957</td>
<td>177.19</td>
<td>230.10</td>
<td>23.61</td>
<td>45.09</td>
<td>-1.03</td>
<td>3.70</td>
</tr>
<tr>
<td>1958</td>
<td>147.69</td>
<td>191.30</td>
<td>20.41</td>
<td>23.11</td>
<td>4.10</td>
<td>1.02</td>
</tr>
<tr>
<td>1959</td>
<td>107.09</td>
<td>139.06</td>
<td>27.09</td>
<td>7.56</td>
<td>2.74</td>
<td>03</td>
</tr>
</tbody>
</table>

Cols. 1, 3, 4, 5, 6 from "Finances of Joint-Stock Companies" - Study prepared by Reserve Bank of India for 1001 selected public limited companies, Reserve Bank of India Bulletin, Sept. 1961.

Cols. 2, 8 - Blown up totals obtained by multiplying the figures for 1001 selected public limited companies by 100 according to the coverage of the Surveys.

Col. 9 from Annual Reports on Trend and Progress of Banking, related to Dec. 31.
These tables do not take into account indirect financing of industry by banks in the form of purchase of shares of, the specialised finance corporations and underwriting or other activities. Even then and considering the fact that long-term financing is not the normal or expected part of a bank’s business, the role of bank finance has been quite important during the years taken into account.

In recent years commercial banks are making an increasing indirect contribution to long-term industrial financing by underwriting the shares and debentures of industrial concerns. Some of the more important scheduled banks have taken an initiative in this respect.

Mr. S.L.N. Saha of the Reserve Bank of India has made some estimates of the underwriting business done by various institutional agencies. From this, we can form a rough idea of the share borne by scheduled banks. In his "Capital Market in India" he has made a study of the volume of underwriting done by various institutional agencies during the years 1956-60. This study shows that underwriting done by commercial banks either independently or jointly with other financial agencies formed 33.6%, 20.3%, 17.61% and 33.6% (1) respectively of the total amount offered to the public during the years 1956, 1958, 1959 and 1960.

A recent survey made by the Reserve Bank of India shows that between January 1956 and June 1962, shares and debentures underwritten by banks amounted to Rs 21.3 crores and formed 30% of the issues in respect of which banks entered into underwriting commitments. The amount underwritten rose from Rs 41 lakhs in 1957 to Rs 7.20 crores in 1960, but dropped to Rs 2.60 crores in 1961; however, the amount underwritten during the first half of 1962 was higher than in any of the years 1956 to 1958. Of the total amount underwritten between 1956 and 1962 ordinary shares formed the largest proportion, next in importance being debentures and preference shares.

(1) Percentages derived from figures available in S.L.N. Saha’s "Capital Market in India".
As regards the amount banks had to take up on account of a shortfall in subscription, this rose to ₹ 5.4 crores or about 25% of the total amount underwritten. Of this, the shares and debentures sold off subsequently amounted to ₹ 1.5 crores. Another study made of the role of various underwriting agencies during the period January 1935 to June 1939 shows that banks as a whole formed the most important underwriting agency their share being 39% of the total amount underwritten during this period.

The amounts involved in underwriting business done by commercial banks is not very large as yet, still the progress is encouraging. The fact that the rate of earnings in such business is high, should have an encouraging result. Yet another form of indirect bank financing of industry is the guarantee for fulfilment of obligations undertaken by a bank's constituents.

Total guarantees extended by scheduled banks amounted to ₹ 296 crores in September, 1962. Guarantees to the industrial sector amounted to 63 per cent of the total. 62 per cent of the total guarantees represented guarantees to the public sector. The guarantee business also assumed a special importance since guarantees were extended to foreign suppliers in respect of imports by constituents on deferred payment basis. Thus such guarantees were extended to foreign suppliers for imports on behalf of the iron, steel and engineering industries. In view of the difficult foreign exchange situation, however, banks are discouraged from granting this type of guarantee.

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Increase in bank financing of industry can be accounted for by various factors, the chief one being a change in the sources of demand for bank finance. As the economy becomes more and more industrialised the relative importance of the primary and tertiary sectors is declining and that of the secondary sector is increasing. Naturally, advances to commerce are yielding their position of primary importance to advances to industry. In absolute volume bank lending to commerce is much higher than before, but bank lending to industry has risen even higher. The Reserve Bank, on its part has expressed the desire from time to time that commercial banks should take up to term lending to industry on a larger scale. Joint-stocks banks, however, being profit making concerns, cannot take to industrial financing unless it is more profitable than its existing business. The fact that this new line of credit bears larger profit possibilities, has also induced commercial banks’ shift to such business. Industrial financing offers various channels of investment, some of which are highly profitable. Such are underwriting business, term-lending etc. Another possible reason of the increasing bank financing of industry is the fact that a large part of the finance which should otherwise have gone to trade is now going to industry on account of changed methods of doing business on the part of industry. Thus, there is a likelihood that industry’s holding of inventories is increasing so that inventory accumulation which is usually done by trade with the help of bank credit, is being done by industry itself. It will be difficult to produce exact quantitative data in support of this statement but in conditions of inflation and scarcity it is very much likely for industry to stock raw materials or semi-finished goods. Moreover in some cases the trader is eliminated.
direct contact being established between the manufacturer and the buyer. This is true of some heavy manufacturing industries. In these ways trade is to some extent supplanted by industry and finance which would otherwise have gone to trade is going to industry itself. This is a tendency which has its parallel in other countries also. Thus in U.S.A., U.S.A., etc. industry is getting more direct finance from banks, without the intervention of trade.

**Banks and Term Lending in India**

Although Indian joint-stock banks do grant loans for more than short-term, term lending on a formal basis, as is done in U.S.A., is not of a large magnitude in India. As early as 1930-31 the Central Banking Enquiry Committee advocated the need for longer-term lending by Indian joint-stock banks.

The Shroff Committee (Committee on Finance for the Private Sector, 1954) mentioned instances of indirect medium-term lending by commercial banks through the practice of rolling over their loans, purchases of shares and debentures of industrial concerns, advances against them and investments in the shares and debentures of various Finance Corporations. The Committee analysed the evidence submitted to it on the question of long-term bank financing of industry. Even among a section of the representatives of bankers there was a feeling that banks could provide long-term finance against fixed assets provided such advances could be made eligible for borrowing from the Reserve Bank of India. The memorandum of the Indian Banks Association stated that the financial facilities granted to cooperative banks with respect to intermediate
term finance should be extended to commercial banks. (1) The shares and debentures in industrial concerns held by banks might be used as security against loans by the Reserve Bank.

The Shroff Committee held that within its limits, bank credit had been sufficiently helpful to industry. Individual banks could provide medium or long-term loans provided they were satisfied in their own judgment that such advances were for moderate amounts in consonance with ordinary banking prudence and were also consistent with the maintenance of liquidity. (2) They should not, however, lean on the Reserve Bank for providing liquidity against such loans. The establishment of the Refinance Corporation for Industry took away much of the strength of the demand for such rediscounting facilities with regard to medium scale industries.

The Shroff Committee advocated the grant of medium-term finance to industry by: (a) subscribing to easily marketable shares and debentures of first-class industrial concerns; (b) making larger advances to approved parties against such assets; (c) making larger subscriptions to the shares and debentures of specialised Finance Corporations.

However, the essence of term-lending is a direct agreement between the banker and the borrower. The idea is that the banker, with his intimate knowledge of the firm, will be able to assess the creditworthiness of his customer independently of the marketability of the company’s shares, and debentures. This ensures greater flexibility.

(1) Report of the Committee on Finance for the Private Sector (1954) P.41
(2) Report of the Committee on Finance for the Private Sector, Reserve Bank of India, 1954, P.47
In order to facilitate indirect long-term lending by banks, the Shroff committee suggested the setting up of a consortium or syndicate of leading commercial banks and insurance companies to invest in new issues of shares and debentures of industrial concerns. The Reserve Bank gave some attention to the question of setting up a consortium at the time, but the idea was ultimately dropped. The issue has lost much of its importance as the leading financial institutions are actually participating jointly in underwriting new issues. It seems that some of the major commercial banks are doing this business on an extensive scale. The co-participants are L.I.C., I.C.I., C.I., I.F.C., some investment trusts and important sharebrokers.

In 1960, the Reserve Bank of India appointed a Working Group for working out certain guiding principles for the appraisal of applications for term-loans. The Working Group recommended the adoption of formal term-lending by major commercial banks. It felt that the traditional ideas regarding liquidity should be modified, especially in view of the changing requirements of the times. Liquidity was more a matter of stable functioning of the economy and smooth maintenance of the consumption process than of the time period of the loan. The lending procedures of the state sponsored financial institutions were rigid and were bound to remain so. As a result, the total amount of loans granted by such institutions since their inception, had amounted to less than 3 100 crores upto 1961. At the same time, the Third Plan expected a greater supply of funds from financial institutions. Banks with their large resources, close contacts with industrial units and large network of branches all over the country were specially suited to supplementing the existing facilities for term lending.

The grant of formal term loans is a frank recognition of the fact that many apparently short-term loans satisfy the fixed capital requirements of
industry because of the practice of rolling over the loan at maturity. This is what happened in U.S.A. and is at present happening in India. The practice of rolling over short-term loans has been continuing since quite a long time in this country. Other loans which do not satisfy the traditional canons of liquidity are being granted to some extent by Indian banks, e.g. personal loans to individuals not in business, loans against stocks and shares, insurance policies and real estate. Formal term-loan agreements would provide banks with higher rates of interest and a greater degree of security. In the case of short-term loans the borrower has the option of not renewing a loan at maturity. This advantage, according to the Working Group was no substitute for a scientific appraisal prior to the grant of a term loan. Two favourable factors affecting the climate for investment in India were the establishment of the Deposit Insurance Corporation, which increased depositors’ faith in banks and the growth of time deposits of banks in recent years.

Except for the State Bank of India, medium-term lending had mainly taken an indirect form in the case of bankers until recently. Yet there was an increasing awareness on the part of the bigger banks, at least, of the need for extension of medium-term loans.

In his speech as the Chairman at the Annual General Meeting of the United Commercial Bank, in April 1961, Mr. G.D. Birla said, "Everyone realises the vital need to provide not only working capital, but also industry’s reasonable medium-term requirements of credit". The only obstacle was the inadequacy of resources of the banking system. So, "it will be necessary to take steps to mobilise resources and to channel them into the banking system".

Circumstances have been changing since then. Within the last four or five years Indian banks are becoming increasingly engaged in medium-
terms lending for periods upto 7 or 10 years, with formal arrangements for periodic repayment of the loan.

In April 1962, the Reserve Bank of India made a survey of medium-term lending by banks to industry. This survey was intended to include data not only about formal term loans but also short-term loans which were ostensibly for short term but were sure to be renewed and continued actually beyond one year. Preliminary data relating to 43 banks (including all Indian banks with deposits of Rs 2.5 crores or over) indicated that outstanding medium-term credit to industry amounted to Rs 78.6 crores as on April 27, 1962, which formed about 14 per cent of their total outstanding credit to industry. Of this amount, formal term loans amounted to about Rs 45.6 crores.

The slow progress of term-lending may indicate a conservative attitude but under the circumstances such conservatism is quite rational. Short-term commercial loans are usually quite smoothly liquidated, but the liquidity of medium-term loans depends upon the profitability of the business. While in the U.S., there are specialised agencies like Dun and Bradstreet providing necessary information, the loans are also given to going concerns whose profitability can be assessed from past records. But in India demands for loans often come from new ventures so that assessment of profitability becomes quite a difficult problem. Businessmen in India again often resent attempts on the part of banks to acquire detailed information. Neither are there sufficient institutional arrangements for collection and exchange of credit information.

Ultimately, commercial banks are dealers in short-term funds and they can engage in medium-term lending only within reasonable limits of safety. Conditions in India, so far as term-lending business is concerned, are completely different from that in U.S.A. Joint stock banks in India are
already handpressed for funds in meeting the normal demands of trade and working capital requirements of industry. In U.S.A., in contrast, term-lending business owed its origin, among other reasons, to large-scale accumulation of funds in the hands of banks.

Because the profitability in term-lending business is high, it is quite possible for banks to outstrip the bounds of prudence and engage in competition with specialised finance corporations for a type of business which is rightly theirs. Thus there have been instances of long-term lending by commercial banks against the security of industrial assets like plant and factory buildings - a type of business which is neither normal nor quite safe for commercial banks. (1)

In the opinion of a prominent banker, commercial banks' long-term assistance should be treated more as a reservoir to which resort could be made, rather than seeking it at the commencement of the project as a substitute for loans from the specialised institutions. If commercial banks make too much long-term loans at the beginning, this would restrict the possibility of obtaining working capital at a later date. (2)

Thus, while term lending by Indian banks has an important bearing on our industrial development, the scope for extension of such business is limited under the present circumstances. That the limit is already reached has been acknowledged by the Reserve Bank of India by the middle of 1964. The Reserve Bank of India's opinion is that "on the current magnitude and composition of their resources, Indian banks have already extended as much

(1) S.K. Basu - Survey of Contemporary Banking Trends, P.299

medium-term credit as they may reasonably be expected to do". (1)

The State Bank of India's Scheme for Medium Term Lending to Industry

An important development in the field of medium-term lending is the State Bank of India's scheme for providing medium-term loans to industrial undertakings.

The features of the scheme are as follows: First, the loan will be extended to any industrial undertaking irrespective of the size and scope of its activities. Secondly, the loan will be given for purposes which require comparatively longer-term finance. These loans will be available for obtaining durable assets like land, buildings, plant and machinery, for setting up new units or expansion of production in existing ones, for modernisation, renovation and improvements.

The rate of interest payable will be connected with the Money Market rates. It was at the beginning, 2 per cent above the State Bank of India advance rate, subject to a maximum of 6½ per cent.

As regards payable security, it should take the form of a first charge on fixed assets like land, buildings, plant and machinery. The value of the security offered should not be less than double the amount of the loan applied for.

The loan will be repayable in agreed instalments over a maximum period of seven years from the date of receipt of the loan. Repayment of the first instalment may, however, be deferred until the borrower

(1) Reserve Bank of India Bulletin, April 1965, P.523.
secures the benefit of increased production. The repayment should be in equal agreed instalments although in exceptional cases a variation can be made by repaying smaller amounts in the earlier years and larger amounts later. In 1964 the State Bank of India Act was amended to permit the Bank to enter into term-loan agreements for a maximum period of 10 years instead of 7.

Prospective borrowers are to apply for the loan in prescribed application forms which will contain details about the distribution of the proposed expenditure over various items, the arrangements made for raw materials, power and water supply, technical staff etc and the estimate of future earnings.

Arrangements are made for the follow-up of loans. An official of the bank will inspect the borrowers' factories and book to have information of the progress made by the borrowers in implementing the scheme for which the loan has been obtained. (1)

By the end of 1963, the Bank's assistance by way of medium-term loans/guarantees covered automobile, electrical equipment, brake equipment, cement, chemicals, cotton and jute textiles, fertilizers, iron ore mining, paper, road transport, shipbuilding, shipping, steel rolling and wire nails, steel wire rope, sugar and synthetic rubber industries.

By 1964 medium-term loans amounted to about 10 per cent of the Bank's total credit portfolio. Refinance facilities were obtained from the Refinance Corporation and, later, from the Industrial Development Bank of India, whenever necessary.

The Bank has also been providing deferred payment guarantees either singly or jointly with other financial institutions.

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(1) "Medium-Term Lending to Industry" - Brochure published by the State Bank of India and obtained by the courtesy of the Bank.
Commercial Banks vis-a-vis Development Banks

A growing economy requires a diversified credit structure. Direct long-term lending by commercial banks is not prudent. The medium-term lending that can be done by them is also limited in scope. Therefore, specialised financial institutions for meeting the long-term capital requirements of the private sector are being opened up at a rapid rate in underdeveloped and, even developed economies. The development banks score over commercial banks in that they provide not only finance, but often entrepreneurship and technical knowledge too. In some cases, e.g., with the Industrial Credit and Investment Corporation of India, they can act as important instruments for attracting foreign capital.

The problem of development is that of mobilisation of savings and its transfer from one sector to another. Underdeveloped economies lack both appropriate financial institutions and entrepreneurship of the right type. The need for State-sponsored specialised institutions for financing economic activity is therefore very great in an underdeveloped economy where the risk and uncertainty attached to pioneering productive activity are very high.

Not only do the development banks act to fill up the void left by commercial banks, but the proper working of commercial banks itself depends to a large extent upon the development of the capital market with its diverse credit institutions. It is sometimes suggested that in an underdeveloped economy the first efforts should be directed towards building up the "Infra-structure" of credit rather than at the growth of joint stock banking as such. In underdeveloped money and capital markets where there is a shortage of funds of any type, joint
stock banks and development banks would serve as complements to each other. There are various different ways in which development banks can help commercial banks. These are: (1) by trying to build up a capital market; (2) by providing the necessary technical information and economic appraisal of enterprises; (3) by providing opportunities of indirect financing of business.

It has been possible for commercial banks in the past as well as in the present, to maintain close connections with development banks to the benefit of all concerned. Thus, the Credit Mobilier of France and all the other development banks which were set up on its model in nineteenth century Europe obtained the largest share of their funds from the joint stock banks. The directors of the banks also served as members of the board of directors of these specialised institutions. In the present century the commercial banks have again served as important shareholders of the development banks, being next in importance only to the Government. These institutions have thus provided profitable opportunities of investing bank funds in those lines of business which would not otherwise be prudent for commercial banks.

That a connection between commercial banks and development banks would be of great benefit to both, is typically proved by the instance of the Industrial Development Bank of Turkey. The commercial banks, although afraid at first of losing their business, took up three-quarters of the initial share capital of the IDB under Central Bank and Government pressure. With the expansion of existing
enterprises and creation of new ones, there has been a large expansion in business for commercial banks. Joint stock banks and development banks may also be of great use if they can form a consortium or syndicate for making joint loans.

**Development Banks in India**

Apart from the State Financial Corporations, there are six specialised institutions for industrial finance in India. These are, the Industrial Finance Corporation of India, the Industrial Credit and Investment Corporation, National Industrial Development Corporation, the National Small Industries Corporation, the Refinance Corporation of India and the Industrial Development Bank of India. Of these the NIDC is expected to play a promotional role more than that of a financing agency. The NSIC is intended to meet the requirements of small scale industries. The other four institutions differ in their structure and objectives, but all of them have close connections with joint stock banks.

All the above mentioned institutions were set up to fulfil the vacuum left by commercial banks in the field of medium and long-term financing. Still, however, joint-stock banks are of preponderant importance among all institutional agencies in providing industrial finance supplying about 40-50% of the total. Finance provided by the specialised institutions is as yet a very small part of total institutional finance.

The three specialised institutions, viz. IFCI, ICICI and Refinance Corporation of India, all have close links with the scheduled banks. Apart from Government and Reserve Bank, share capital of these institutions is contributed by institutional investors. Among
institutional investors, scheduled banks occupy an important position.

Acquiring a portion of the share capital of development banks is the most usual form of interlinking of business between these and joint stock banks. Thus commercial banks and insurance companies subscribed to the initial share capital of the Development Finance Corporation of Ceylon, the Pakistan Industrial Credit and Investment Corporation, the I.C.I.C. and F.C.I. in U.K., the Industrial Finance Corporation, Industrial Credit and Investment Corporation and Saffinance Corporation of India. The extent of commercial banks' share in the share capital of the IFCI will be evident from the following:

**Distribution of shares of the IFCI (30th June 1964)**

<table>
<thead>
<tr>
<th>Central Government of India</th>
<th>Reserve Bank of India</th>
<th>Scheduled Insurance Companies</th>
<th>Cooperative Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>20.0%</td>
<td>20.7%</td>
<td>24.3%</td>
<td>25.3%</td>
</tr>
</tbody>
</table>


The IFCI was set up in a period of general lack of confidence and depressed condition in the money and stock markets. Its business consists of granting loans and advances to and purchasing shares and debentures of industrial concerns, guaranteeing long-term loans raised by such concerns and underwriting the issue of stocks, shares, bonds and debentures.

The IFCI made it clear from the beginning that it had no intention of competing with the commercial banks, but its functions would be complementary to those of the latter. The assistance rendered by it would strengthen the fixed capital structure of joint stock companies and thus render the commercial banks better able to provide working capital. The IFCI was set up with the avowed purpose of

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(1) IFCI - First Annual General Meeting of the shareholders, August 1949.
providing long-term financial assistance to industrial concerns where recourse to normal banking channels or capital issue methods was not possible. The industries mostly benefitted were processing industries like food and sugar manufacturers, paper and paper products, textiles, industrial chemicals etc. From a survey of the industries obtaining assistance from the IFCI, it seems that the need of long-term industrial development has been accorded a position of secondary importance compared to that of present consumption requirements. Processing industries, particularly food manufacturers including sugar have been the greatest beneficiaries. In view of this emphasis in IFC investments, it may be questioned whether the Corporation is acting as an adequate supplement to bank finance from the point of view of long run economic growth.

In one respect, however, the Corporation provides an important alternative agency to bank finance, viz. in acting as an agency for foreign loans. It has proved able to secure considerable amounts of foreign currency loans in recent years, including 30 million U.S. dollars, 40 million E.C. and 50 million Francs during 1963-64.

The Industrial Credit and Investment Corporation of India differs from all other similar institutions in that it is intended to act as an agency for attracting private capital, both domestic and foreign. Naturally, the importance of banking sources will be all the greater in providing the share capital of this institution. Of its initial share capital of Rs. 5 crores, Rs 2 crores was taken up by several Indian banks and insurance companies and certain of the directors of the Corporation and their friends, Rs 1 crore by British Foreign Exchange banks and certain U.K. and Commonwealth insurance companies. There are two ways in which the ICICI supplements banks' operations. First, it provides
loans in foreign currency ever end above those in domestic currency. Secondly, an important part of the working of the ICICI is appraisal (technical and financial) and follow-up of loans. Joint stock banks in India do not usually have trained technical staff to carry on a thorough appraisal and supervision of loan applications. The ICICI, apart from giving loans, also provides technical, managerial and financial advice.

The Shroff Committee (Committee on Finance for the Private Sector) recommended investments in the shares and debentures of specialised finance Corporations as a means of indirect long-term industrial financing by commercial banks. In order to encourage this type of activity, the Committee recommended that such trustee securities that were guaranteed by central and state Governments should be regarded as eligible as security for advances on par with Government securities as under section 17(4)(a) of the Reserve Bank of India Act.

The Refinance Corporation of India and Term Lending

Among specialised institutions, that which is most closely connected with banks and which facilitates the provision of bank finance to the largest extent, is the Refinance Corporation of Industry.

The Refinance Corporation was set up in 1938 for the purpose of extending medium-term financial facilities through established banking channels to medium-sized industrial units in the private sector. This it does by refinancing term loans granted by scheduled banks. By medium-sized units were meant those having resources upto Rs 2.5 crores. Its issued capital of Rs 12.50 crores was contributed to by the Reserve Bank of India, the Life Insurance Corporation, the State Bank of India.
and 14 other scheduled banks at first. The share capital was allocated to the 14 banks broadly in relation to the size of their deposits in India.

Out of its total funds, the Corporation was to allocate quotas to banks grouped into four categories with reference to the size of their deposits. Within these quotas, the banks might obtain refinance against certain types of loans. Loans to be eligible for this purpose should have been made for periods between 3 and 7 years, to a medium-sized industry, and for a medium-sized amount. It was expected that selected scheduled banks would thus get the opportunity of extending formal term-lending facilities to industries and secure liquidity against eligible paper up to the quota allotted to them.

The scope of operations of the Refinance Corporation was gradually expanded and its methods of working made more flexible. Thus the period for which refinancing facilities would be granted was raised from 7 to 10 years. Refinance facilities were extended to 56 banks, 14 State Financial Corporations and 3 State Co-operative Banks without requiring them to be members. The quotas allotted to the 15 member banks were discontinued. The limits of refinance available were also raised from Rs 50 lakhs to Rs 100 lakhs. Refinance facilities were to be granted originally with regard to industrial units having paid-up capital and reserves up to 2.5 crores, but later on, institutions which had larger paid-up capital and reserves were made eligible. Loans made to small scale industries also became eligible for refinance if they were guaranteed under the Credit Guarantee Scheme.

Upto 1962, the services rendered by the Corporation were rather limited in extent, partly due to the limited nature of its operations till 1960, but mainly due to reluctance on the part of banks to avail of the
facilities granted. Since 1963 there has been a marked increase in the demand for the Corporation's funds and in its activity. The Corporation also began a new type of business, viz, refinancing medium-term credit for export, in order to help the relatively small exporter to obtain credit from banks. Upto June 1963, total refinance facilities sanctioned amounted to Rs 51.21 crores and total refinance disbursed to Rs 20.17 crores. During the year 1964 refinance facilities sanctioned and disbursed to eligible commercial banks were of the extent of Rs 17.03 crores and Rs 18.02 crores respectively.

In September 1964, the Refinance Corporation for Industry was merged with the newly established Industrial Development Bank of India.

The Industrial Development Bank of India

The Industrial Development Bank of India which was set up in 1964 is the biggest of all institutions for industrial finance and has the widest range of functions. It is to perform the functions which are performed by all the other finance corporations. It has no connection with commercial banks so far as ownership is concerned, since it is to be owned fully by the Reserve Bank of India. But its existence will be of great use to commercial banks in a number of ways, direct and indirect. It will help in building up a capital market and in setting up new industries through financial and promotional assistance. Both these functions would be of great use to the commercial banks in their business. But it will also directly help commercial banks in industrial financing by taking over the refinancing...

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(1) Annual report of the Refinance Corporation for Industry, 1968
(2) Reserve Bank of India Bulletin, April 1965, P.540
activities of the Refinance Corporation for Industry and guaranteeing loans raised by industrial concerns from scheduled banks and some other institutions or the underwriting obligations of such institutions.

The Scope of and Need for Participation Loans

A very effective way of combining the services of different financial institutions is participation loans. The recent practice of American banks of acting as financiers to industries in combination with other financing agencies has rendered them important instruments of industrial finance. The advantage of participation loans lies in the sharing, and hence, in the scope for lessening of risks. The co-participants may be banks, banks and other financial institutions such as life insurance companies, banks and governmental or semi-governmental financing agencies.

Participation loans among banks themselves have become very common in U.S.A. The factors favouring such joint ventures have been, first, the unit banking system under which many unit banks could not satisfy the credit requirements of one single borrower; secondly the legal restriction prohibiting banks from lending more than 10 per cent of their capital and reserves to one borrower; thirdly, the fact that banks making loans of long maturities in non-residential real estate found it convenient to enter into participation loans with savings banks so that the commercial bank financed the loan for the initial period of 3-5 years, then it was taken up by the savings bank.

Participation loans would be of great use to Indian banks too. It may be mentioned in this connection that under the amendment of the Banking Companies Act in 1963 the Reserve Bank has been given the power to give directions to banks regarding the maximum amount of advances that may be granted to any one company, firm, association of persons or individual.
Such restrictions prevent the freezing up of too large a share of bank's advances in one direction and encourages participation loans.

The Indian banks' practice of not sharing information among themselves acts against any co-operative action. The secretive attitude on the part of bankers reflects jealousy and a lack of vision. This is unwise because in a growing economy the prospects of good business will be very wide. Exchange of information will be advantageous for both the parties concerned. In its absence it becomes possible for a bank's constituent to get accommodation from a number of banks to an extent not justified by his financial condition or repaying capacity. This has often been responsible for the losses of Indian banks.

One other way out is the building up of a suitable credit investigation organisation like Dun and Bradstreet of U.S.A. This is a private agency working on a profit making basis. If the banks do not want to exchange information among themselves, they can do so to a common agency which will then pass on the necessary information to the enquiring bank. But such an institution has not yet grown up in India.

With a view to pooling of credit information, the Reserve Bank of India Act was amended in 1962. Under this amendment all scheduled banks and non-scheduled banks are required to submit quarterly statements relating to credit information for secured advances of Rs 5 lakhs and above and unsecured advances of Rs 1 lakh and above. Such information is to be supplied to banks and notified financial institutions in a consolidated manner on application. The extent to which such facilities are being utilised may be appreciated from the fact that the requests for information entertained during 1963 and 1964 were 1,542 and 2,710 respectively.\(^{(1)}\)

Participation loans among banks in U.S.A. are akin to term loans in

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\(^{(1)}\) Reserve Bank of India Bulletin, April 1965, P.540
that the ability of management and the future earning potential are more important considerations than the security offered. There must be perfect knowledge between the banker and the borrowers. The extent of participation depends upon the reserves and commitments of the banks. A single document is drawn between the borrowing units and the banks. One bank is appointed as the agent; it handles all the financial documents and receives financial statements. Mutual confidence is the basis of such business. The agent bank receives the instalments and interest which are subsequently distributed prorata among the participating banks. The agent bank thus acts as a trustee for all the other banks.

Participation loans in U.S.A. have helped to meet the vast and varied financial requirements of industries in the post-war years. Participation between a bank and a savings bank, and/or an insurance company and/or private financial houses and/or governmental agencies have been quite helpful. Banks make participation arrangements with insurance companies or savings banks. Since the latter two are better fitted to handle long-term loans, the bank handles the loan for an initial three to five years, then they are handed over to the participating agency.

Bank participation has been useful in regional financial development exemplified by the financial support given to the Massachusetts Development Credit Corporation and the Greater Wilkes Barre Industrial Fund in the Wyoming Valley. (1) These funds were set up by the local people when a decline in the local industry threatened the prosperity of Massachusetts and Wyoming Valley in Pennsylvania. Local banks became members of the funds, not purchasing shares thereof, but by an undertaking to provide funds on a loan basis for an initial period.

(1) Ram Bahadur "Bank Participation in Promotion of Projects for Regional Industrial Development" - in Banking and Investment Seminar Report 1959, held under the auspices of the ICB.
Banks have also granted loans in participation with governmental agencies like the Small Business Administration and the Export-Import Bank.

The usefulness of such participation ventures on the part of Indian banks cannot be overstated. While mutual jealousy among banks restricted interbank participation agreements in the past, there has been a large degree of cooperation in joint underwriting agreements among banks, finance corporations and insurance companies in recent years. The Shroff Committee had recommended that banks should enter into underwriting agreements with insurance companies and that leading banks should form a consortium or syndicate along with insurance companies to do underwriting business. The Reserve Bank of India encouraged the idea of forming a syndicate among those financial institutions and proposed taking up legislative measures. In view of the increasing degree of collaboration between banks and other financial institutions in practice, the idea of setting up a formal syndicate has been dropped.

Participation agreements are being entered into in a variety of ways by the State Bank of India. Thus the State Bank has been guaranteeing deferred payments to industrial concerns jointly with other financial institutions. In the Reserve Bank of India's "Pilot" scheme for small-scale industrial finance, the State Bank of India, cooperative banks, the Director of Industries and State Industrial Finance Corporations work in collaboration. Recently, the State Bank entered into a joint participation scheme with the southern Gujarat Industrial Cooperative Bank Ltd. for the provision of credit to small scale industries and small scale industrial cooperatives.

A sharing of risks is also secured by the "Credit Guarantee Scheme" of the Reserve Bank of India under which the Reserve Bank, the State Bank of India, other scheduled banks and cooperative banks share risks for advances made to small scale industries.
Finance for Small Scale Industries

The problem of finance for small scale industrial units deserves special mention due to two reasons. First, their predominating importance in the economy from the point of view of their contribution to national income and the employment opportunities they provide. Secondly, due to the peculiar nature of their operations they find it difficult to obtain any type of finance, whether short term or long-term. Their credit worthiness, in general, is low because of the regional nature of their operations, the fact that questions of personal efficiency count for too much in a small concern, that information about their past working or future earning potential is lacking and that their low equity-sales ratio provides lenders with inadequate security against loans.

In industrially advanced countries, small industries obtain working capital from commercial bankers or specialised institutions. The need for working capital is proportionately much higher in their case than in the case of large scale industries. But in our country with the exception of the State Bank of India, a few commercial banks and some cooperative banks, the rest do not advance funds to small units. According to the Seminar on Financing Small Scale Industries (1959) there are factors both on the demand side and on the supply side impeding extension of bank credit to small industries. (1) On the demand side there was a borrower-resistance caused by various factors such as a rigidity of approach on the part of financial institutions, an unwillingness of commercial banks to lend for medium or long-term to small scale industries, the detailed or complicated nature of

information required from borrowers by commercial banks, rigid requirements of security and insistence upon too large a margin, delayed method of processing loan applications or sanctioning loans etc.

On the supply side the considerations of liquidity and risk obstructed commercial bank lending, particularly of the medium and long-term types. Commercial banks also expressed the view that possible disapproval by the Reserve Bank of loans to small scale units deferred them from making such loans. According to the Reserve Bank it was the usual experience that advances to small-scale industries were likely to be more sticky and difficult of realisation than other advances.

In order to assess the magnitude of bank credit extended to the small scale sector, the Reserve Bank of India conducted an ad hoc survey of advances extended by a selected (sample) number of offices of scheduled and non-scheduled banks to medium and small scale business units. (1)

From this sample survey, as well as the discussions of the Seminar on Finance for Small Scale Industries, we came to several conclusions about the role of bank finance in small units. First, commercial banks have largely provided short term loans for working capital on the security of readily realisable assets. Secondly, while 30% of the total scheduled bank credit went to small and medium sized business units, most of the finance went to trading establishments; small and medium sized industrial units received a very small share of the industrial advances or total advances of the banking system. Thirdly, it was the financially weaker non-scheduled banks which took the greater interest in medium and small scale business units the ratio in their case being 51% of total credit. Fourthly, nearly 30% of the credit available to the sector of the small and medium-sized units was secured.

(1) Reserve Bank of India Bulletin, June, 1959, sp. 709-715.
The greater interest shown by the non-scheduled banks might explained by their having closer local contacts and ability to assess the creditworthiness of the units concerned. It might also be due to the absence of other suitable investment opportunities for the non-scheduled banks. The situation is not totally desirable because the non-scheduled banks, being financially weaker, are less able to bear the risks. Secondly, advances made by non-scheduled banks can never reach substantial proportions.

Of the total advances made to small scale business units by the banking system, advances to trade formed 75% of the total; advances to industry accounts for not more than 10% of bank advances to small industries, i.e. not more than 3% of the advances of banks.

Some particular industries are more favourably situated from the point of view of obtaining capital. These are, iron and steel, light engineering and oil crushing industries. By contract, in the case of cotton textiles the major proportion of bank finance went to bigger concerns. An explanation may be found in the larger investments in fixed capital and greater creditworthiness of the former.

In contrast to the position in our country, in Japan and U.S.A., commercial banks provide substantial amounts of finance to small scale industries. This does not mean that commercial banks adopt different standards of creditworthiness with regard to bigger and smaller industrial units. Commercial banks cannot relax their eligibility requirements according to the size of industries. But the fact is that the small scale units themselves are more creditworthy. Small scale industries in those countries have reached better standards of technical efficiency, management and financial soundness. In our country, managerial and technical ability, knowledge of accounts and financial soundness are often lacking in the case
of small industries. In U.S.A. and Japan, financial institutions, government 
and the business community take an active part in improving the methods of 
business of their borrowers, apart from providing credit. Commercial banks 
in the U.S.A. and their associations have taken the initiative in trying to 
educate small businessmen in modern business methods. Better standards of 
technical efficiency and management have enabled commercial banks in that 
country to offer such widely extended facilities as term loans, instalment 
loans, loans secured by real estate and accounts receivables. But in India 
identical steps have not been taken to improve the working of small business 
units. The Government of India has set up for this purpose Small Industries 
Service Institutes, but their role is very limited.

Banks in the two countries mentioned above enjoy several other 
advantages, such as, a higher sense of integrity among businessmen, their 
greater willingness to supply information about themselves, existence of 
old established private bureaux for credit information and a developed 
practice of exchange of information among banks. The system of participation 
loans enables banks with limited resources but local knowledge to share 
risks with larger banks. Finally, the credit guarantee and insurance schemes 
provide further safeguards to banks. Until recently, only a very limited 
guarantee used to be provided by the National Small Industries Corporation 
by guaranteeing partly advances against raw materials granted by the State 
Bank of India to individuals executing government contracts secured on the 
Corporation's recommendation. No doubt, banks in India have been naturally 
conservative in their attitude.

Suggestions made by the Seminar on Financing Small 
Scale Industries

Four suggestions were made by the Seminar on Financing Small Scale
Industries for facilitating Commercial bank lending to small industries.

The first proposal was for some relaxation of the limits for individual bills and the minimum amount of borrowing under the Bill Market Scheme. The minimum limits have been considerably lowered by stages. But in view of its effect upon credit expansion, access to the Bill Market Scheme has its limitations.

Secondly, because of the unwillingness of commercial banks to make term loans, the suggestion was that the facilities provided by the Refinance Corporation should be extended to a larger number of banks and equipment loans given to small scale industries. Since 1961 a larger number of banks are being afforded the refinance facilities. Since 1962 loans made to small scale industries were made eligible for refinance. Recently, the State Bank of India has been granting instalment credit for purchase of equipment by small scale industries.

The third suggestion was that the rediscounting facilities provided under section 17(2)(bb) of the Reserve Bank of India Act for financing approved small scale industries should be made available to commercial banks also (such facilities being confined only to co-operative banks at present); the condition regarding the State Government guarantee in this context should not be insisted upon. Since 1963 credit facilities in the form of purchase or discount of bills were made eligible for guarantee under the Credit Guarantee Scheme.

All the suggestions mentioned above might have only limited scope since commercial bank lending to small scale industries could never assume a substantial size as long as the risk attached to such financing remained high.

The most important part of their suggestions was the scheme for guarantee of loans to small industries. Since the major deterrent to bank finance in this sector was the element of risk, such risk might be eliminated
through credit guarantee. So the Seminar proposed a scheme combining some features of the Japanese and American Schemes. Its essence was a sharing of risks by the State Bank, other commercial banks and the co-operative banks.

The only system of guarantee then existing was that in the form of an agreement between the State Bank of India and the National Small Industries Corporation. However, since the NSIC was primarily an institution for fulfilling other objectives, it was thought that the financial business of a guarantee of loans should better not be entrusted to it.

The Credit Guarantee Scheme

Following the suggestions made at the Seminar, the Government of India, in consultation with the Reserve Bank of India, introduced a guarantee scheme for advances to small scale industries on July 1, 1960. The scheme was introduced on an experimental basis at first, but permanently since January 1963. The lending institutions were to be given some protection against possible losses on advances to small scale industries. The Reserve Bank of India was to function as "Guarantee Organisation". Losses on account of advances were to be shared between the lending institutions and the Guarantee Organisation. The maximum amount recoverable in respect of any one advance was not to exceed Rs. 1 lakh.

Initially the scheme was applicable to 22 approved districts. Institutions that would take advantage of the guarantee facilities were the State Bank of India and its subsidiaries, 49 other scheduled banks, the State Co-operative banks, the State Financial Corporations, the Madras Industrial Investment Corporation. Non-specified institutions might avail of the guarantee provided a specified credit institution participated in the advances to the extent of not less than 25% of the amount involved.
The provisions of the scheme were further relaxed in June 1962.
The scheme was extended to 32 districts, covering many of the more important
centres of small scale industry in the country. Initially, the period of
guarantee was not allowed to exceed seven years. Now the guarantee could
extend beyond a period of seven years.
Formerly, borrowing units had to furnish affidavits showing that
they were small scale units with capital investment of not more than
Rs 5 lakhs. Because of the delay and inconvenience in obtaining affidavits,
it was decided that certificates from credit institutions would be
sufficient evidence of the size of the units.
An essential condition of the guarantee was also that the advance
should not be utilised for a purpose other than that for which it was
granted.
Since the introduction of the scheme in July 1960 to the end of
1964, 13,477 applications were received and guarantees were issued in
respect of 12,468 applications for a total sum of Rs 49.53 crores. (1)
Although the State Bank of India availed of the major share of the
opportunities offered by the scheme, other financial institutions have been
taking increased recourse to it.
Among other methods suggested for encouraging the extension of
commercial bank finance to small scale industries, the Shroff Committee
recommended an expedition of making payments against Government bills.
Banks were usually prevented from making advances against such bills
because of the delay involved in getting payment. Other suggested

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methods of easing the problem of small scale industrial finance have been
the formation of credit pools among banks; lending to borrowers on the
security of an assignment of accounts receivables on the lines done by
commercial banks in U.S.A.; the practice of lending against warehouse
receipts, which has proved to be of great help to small scale industries
in U.S.A. etc. (1)

Each of these devices will, no doubt, remove some of the obstacles
to obtaining finance for small scale industries. However, the illiteracy
of many small scale producers, their informal methods of business,
importance of the personal element in their lending relations, absence
of licensed warehouses etc. create difficulties in lending against
formal documents.

NEED FOR AN INTEGRATED AND COMPREHENSIVE APPROACH
TO THE PROBLEM OF SMALL INDUSTRIES

The difficulties of financing small scale industries are, as in
the case of agriculture, inherent in the very nature of the occupation
itself. Here the problem is how to institutionalise the credit
structure. The chief barrier lies in the small size of the unit which
is, on its part, responsible for the low capital structure, financial
unsoundness, managerial inefficiency and technical handicaps of such
business. Unless the standard of working of a firm can be raised, mere
provision of credit is not enough. Secondly, the problem of credit is
closely connected with that of marketing. In the absence of proper
marketing facilities, the financial weakness and inadequate creditworthiness

(1) S.K. Basu - Place and Problems of Small Industries Chapter I.
of the producer perpetuate for ever. An improved system of finance for small industries must, therefore, be multifarious in purpose trying to improve the working of the small unit as a whole rather than merely providing credit. Secondly, it must be an integrated system with coordination among the activities of all credit agencies and joint participation, if necessary.

The greater development of institutional credit in U.S.A. and Japan has been possible because of better standard of creditworthiness attained by the borrowing units. The financial institutions themselves have largely helped them in obtaining this position. A similar attitude should be adopted by financial institutions in our country.

Secondly, activities of all types of financial institutions might be coordinated. A Working Group set up by the Reserve Bank of India felt that the State Bank's Pilot Scheme of coordinated credit might be extended to cover all agencies, bank and non-bank providing credit to small industries. Each institution could provide the type of credit for which it was best suited. It would also mean economising the use of expert technical staff needed for credit appraisal.

Apart from the suggestions discussed above, one possible method whereby commercial banks could provide more effective financial assistance was the delegation of greater authority to branch agents who with their closer knowledge of local conditions and closer personal contact with their customers might be of great use. In Japan, commercial banks possess extensive authority of acting as agents of the Small and Medium Enterprise Finance Corporation. A large part of the funds of the Corporation is distributed through them. The Director of Industries or the State Financial
Corporations might make similar use of local offices of banks. Commercial banks may also lend indirectly through the specialised financial institutions.

The Reserve Bank had been trying to encourage lending to small-scale industries through the grant of more liberal credit facilities to banks since January 1962. Thus additional borrowing quotas were granted to different scheduled banks in so far as they lent to small scale industries. There was a large increase in scheduled bank advances to small scale industries. Between June 1960 and June 1963 such advances doubled from Rs 20.7 crores to Rs 42.5 crores. The bulk of it was, however, made by the State Bank and its subsidiaries. Such additional quotas became unnecessary since September 1964 when restrictions on total lendings to scheduled banks were removed.

However, commercial banks can help small scale industries only as supplements to other institutions and not as substitutes for them. They can also do so only under adequate insurance or guarantee.

State Bank of India and Finance for Small Scale Industries

The major portion of scheduled bank advances to small scale industries consists of advances made by the State Bank of India and its subsidiaries. So the role of the State Bank deserves special mention. The decision taken by the State Bank of India in 1956 to meet the special needs for finance of small scale industries was a very important one. The Bank, in consultation with the Reserve Bank of India and in collaboration with other institutional agencies, decided to work a 'Pilot' scheme at three centres in each of the three circles of the Bank - Bombay, Bengal and Madras. Under the scheme, ...

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a simple application form is issued in all the 9 centres and a borrower is required to apply to an Agent of the State Bank or the co-operative bank, for all his credit requirements. The provisional arrangement was that applications for smaller amounts should normally be entertained by the Director of Industries; applications for other loans should be taken up by the State Bank or the co-operative bank if they were for working capital and by the State Industrial Finance Corporations if they were for medium and long-term capital. The State Bank and co-operative banks supplied the necessary information about the creditworthiness of parties. Technical advice was given by the Department of Industries and/or the Small Industries Service Institutes. The Agents of the Bank had been asked to adopt an attitude of positive help and guidance in favour of the small industrialist. The administrative procedures and the rigidity of standard would be relaxed in the case of the small industrialist, although within the traditional safeguard of the Bank.

Some of the branches of the Bank were known as "intensive centres" where the Bank made special efforts to co-ordinate its activities with that of other small financial agencies. These centres showed encouraging progress, not only by the number of accounts but also by the fact that most of the finance was made available to the relatively small units. For, the limits granted were less than 250,000 in the case of 90% of the borrowers. By the end of 1960 there were 60 intensive centres.

The introduction by the Government of the Credit Guarantee Scheme for small industries since July, 1960, was of particular advantage to the State Bank of India in the provision of credit to small scale industries. The National Small Industries Corporation entered into an agreement with the Bank to provide guarantee to that portion of the Bank's advances against
raw materials which was in excess of advances normally granted by the Bank. The progress of the scheme was not encouraging as the agreement covered only advances for the procurement of raw materials. So it was decided to revise the scheme in order that the guarantee would be available for advances for other purposes as well.

The Bank also entered into agreements with seven State Financial Corporations by 1961, (including those of West Bengal, Bombay, Andhra Pradesh, Punjab, U.P., Orissa and Rajasthan) to act as agent of the Corporations in their dealings with small scale industrialists. This arrangement would enable the Corporations to extend their spheres of activity although they have not more than one or two offices in the State. The Corporations, however, made little use of the resources of the Bank.

In 1960 steps were taken for making an evaluation of the "Pilot" scheme. Certain recommendations based on the Evaluation Report were made by the Central Co-ordination Committee, which have since been accepted by the Bank. Some important decisions taken were:

(i) To extend the scheme to all branches of the Bank. The scheme was to be worked on an intensive basis in some centres;

(ii) The rate of interest on advances granted to small scale industries was fixed at an all inclusive rate, not exceeding 6%.

The Bank has also been paying special attention to the provision of medium-term finance to small scale industries, including new units. The Bank's Local Head Offices and certain other branches were authorised to entertain applications for medium-term loans from new units. On December 31, 1964, 79 small units had been sanctioned medium-term loans of Rs 63.3 lakhs.

The Bank has also been liberalising loan procedures, such as granting advances against hypothecation of stocks in process. It has been performing
other services too for small units, such as collection of bills, establishment of letters of credit at concessional rates etc. Total assistance under the liberalised scheme amounted to \( \text{Rs} \ 34.1 \) crores in December 1964.

By 1964 the number of units and credit limits sanctioned for working capital purposes rose to 5,834 and \( \text{Rs} \ 30.6 \) crores respectively. Units having capital investments up to \( \text{Rs} \ 2.5 \) lakhs constituted about 95 per cent of the total number of units assisted and about 73 per cent of the total limits sanctioned. About half of those loans were guaranteed by the Credit Guarantee Scheme.

The Bank had introduced an Instalment Credit Scheme in 1962 for purchase of equipment and machinery by small industrialists. Loans under this scheme rose from \( \text{Rs} \ 5.1 \) lakhs at the end of 1963 to \( \text{Rs} \ 53.3 \) lakhs at the end of 1964, the number of units utilising the facility rising from 11 to 135.

The bank also grants loans to Small Industries Corporations and Small Industries Development Corporations.

It entered into a joint participation scheme with the Southern Gujarat Industrial Co-operative Bank Ltd. for the provision of credit to small scale industries and small scale industrial co-operatives.

**HIRE PURCHASE FINANCE AND PERSONAL LOANS**

An important development in commercial banking business during the present century has been the evolution of instalment lending in the form of hire purchase finance and personal loans or consumer instalment credit. The tremendous growth in material prosperity in Western countries, with their higher standards of living and large consumption requirements have called for newer types of finance. So banks are taking an increasing
interest in the "Form of loan which is essentially short term by nature, which is regularly and systematically reduced and which, over a fairly long period now, has shown only a fractional ratio of losses". (1)

Hire Purchase Finance

Hire purchase is a form of instalment buying. Under a hire purchase agreement the hirer is given possession of the article sold with the payment of the first instalment. He becomes the owner of the article only after all the instalments are paid. Hire-purchase finance feeds both consumption and production requirements. It may be used to finance instalment purchase of durable consumer goods. Secondly, where there is a shortage of fund in one particular sector, such as the small scale productive unit, banks may finance purchase of machinery and equipment on a hire purchase basis. While American banks had been doing instalment lending business for sometime past, a very significant event has been the entry of the orthodox British joint stock banks into hire-purchase finance and personal loan business since 1958. British banks have been encouraged to enter this type of business due to a fall in the demand for bank advances along with their excess liquidity position.

There are specialised financial institutions known as Hire Purchase Finance Companies. They pay off the dues to traders selling on hire purchase basis and the trader hands over an invoice or sale note to the finance company so that dealings are now only between the finance company and the customer. Hire purchase finance companies obtain most of their finance from commercial banks. Commercial bank financing of hire purchase may be direct or may take an indirect form through the intermediary of the finance houses. In the case of British banks this has taken the form of acquiring

(1) Mr. W. A. Bellantyne, General Manager, Royal Bank of Scotland, speech delivered at the Annual General Meeting of the Bankers in Scotland, June 1958 - Bankers' Magazine, June 1958, p. 22.
the whole or a part of the spare capital of established hire purchase finance companies. In U.S.A., on the other hand, bank participation in hire purchase finance has been direct.

Here the security is of primary consideration, the character and financial standing of the borrower are secondary in importance. The delinquency ratio in the advanced countries is very low and the loan agreement implies that the loan will be automatically repaid on maturity.

**Personal Loans or Consumer Instalment Credit**

Very closely akin to hire purchase finance and of equal significance are personal and/or consumer loans or consumer instalment credit. These are mainly loans given for personal consumption purposes, such as the purchase of household equipment, electrical appliances, automobiles, televisions or radio sets, purchase of repairing of houses, paying of doctor's bills, insurance premia or for the higher education of children etc. Consumer financing may be direct, taking the form of granting personal loans repayable in a series of monthly instalments and of the purchase of retail instalment paper from dealers and from individual customers. Commercial banks have also participated indirectly in the extension of this type of credit by making loans to sales finance companies, personal finance companies, industrial banking companies, credit unions etc.

An important difference between hire-purchase finance and personal loans is that banks do not lay any claim to the goods brought with the money advanced in the latter cases. Unlike hire purchase finance, consumer credits or personal loans are mostly unsecured, reliance being placed upon
the borrower's character and ability to pay rather than upon any tangible security.

Both hire-purchase finance and personal loans are different from traditional commercial banking in so far they are loans for consumption and not for trade; secondly, reliance is placed not upon the shiftability or self-liquidating character of the asset in question, but upon the anticipated future income of the borrower.

The Case for Hire Purchase Finance and Personal Loans in India

In the context of our rapidly growing economy, the possibilities of hire purchase finance and consumer loan business have been considered by some. Not only do hire purchase finance and consumer instalment credit help to increase consumption and standards of living, but they have proved to be of immense help elsewhere to productive activities, particularly in the sector of small scale industries. According to the Consumer's Credit Department of the American Banker's Association, 6% in number and 10% in amount of commercial bank instalment loans are small business loans. In Britain, also, a purpose-wise analysis of personal loans shows that a large number of loans have been to small business and for the purchase of professional equipment, so these loans are equally important for purposes of production and consumption. (1)

In the context of the importance of small scale industries in our economy and the difficulty that has to be faced by them in obtaining finance, hire purchase finance and instalment credit can be of immense

benefit to them in purchasing their machinery and equipment. Besides the case of small scale industries, instalment lending can play a very important part in the development of the motor transport industry too. It may be noted that the growth of hire purchase finance and personal loans in U.K. and U.S.A. respectively were connected with the growth of the automobile industry. This will create one of the basic utilities and thus smooth the process of economic growth.

In spite of their advantages, these types of instalment lending have only limited possibilities in a country like India, at present. First, in U.K. or U.S.A. because of the low delinquency ratio and higher rate of earnings, these loans prove very safe and profitable forms of investment for banks. The assessment of earning capacity and integrity of borrowers has reached a high degree of perfection through a system of specially trained executive and supervisory staff so that the normal risks of this type of business have been almost eliminated. In England hire purchase finance is provided by specialised financial institutions who have their own expertise and specially trained staff. But such perfect systems of credit assessment cannot be expected in India. Neither can we expect as low a ratio of losses as in U.K. or U.S.A.

Secondly, surplus of income over consumption is very low in India so that any growth in standards of production and consumption must take place at a very slow rate. Banking habit is also underdeveloped. So we cannot expect that people will take recourse to such borrowings on a large scale immediately.

A great difficulty in taking up hire purchase finance or personal loans business is that the problems of credit assessment are completely
different from those of ordinary bank loans and calls for the services of specialised technical staff. Hire purchase financing, if it is done indirectly through specialised institutions doing this type of business, as in U.K., does not raise problems of credit appraisal in the same manner. Indirect hire purchase financing would be more desirable under Indian conditions. Personal loans, too, require a highly perfected system of credit information. Banks will be required to maintain a specialised personal loan department. A thorough investigation has to be made into the nature of the borrower's occupation, stability of job and income, age, sex, marital status, number of dependents and stability of residence; his assets and liabilities, handling of past debt and experience of other creditors etc. are to be considered. The amount of loan and the circumstances that induced him to take the loan are also pertinent factors. In evaluating business loans too, personal information like age, health, training, education, temperament, family status and stability are very important. Other important considerations are, whether the borrower is a good moral risk, his business management ability, past record and future prospects, the borrower's equity in business, and the nature of assets and liquidation values etc.

The inflationary risks connected with instalment purchase of consumer goods when they are in short supply cannot be denied. Instalment lending was resorted to in U.S.A. as an antidepression device in the thirties; both in U.K. and U.S.A. such lending was introduced as a means of investing the surplus funds of commercial banks. In both these respects, the situation in India is exactly the reverse. The inevitable inflationary consequence of instalment purchase of consumers' goods when most consumers' goods are in short supply is too great a risk to be ignored. It seems that under Indian conditions instalment lending should be encouraged more
for the purchase of machinery and equipment by producers and for purchase
of motors, trucks, lorries to facilitate motor transport, than for the
purchase of purely consumers' goods in the immediate future.

Hire Purchase Financing and Personal Loans by Indian Banks

Indian banks have made an entry into hire purchase finance and
personal loan business in recent years. The State Bank of India has laid
down a hire-purchase finance scheme of its own. Other commercial banks are
also showing an interest in this field, although the volume of such business
is not as yet large. The factors inhibiting such business have been a
consideration of the risk involved and the attitude of the Reserve Bank
towards unsecured loans. Since the risks are apprehended to be quite large
and the Indian banks are not enjoying a plethora of funds at present, it
seems that the decision to enter into such business was prompted more by the
desire to attract new customers than by the advantages offered by them.

Recently, an economic survey of hire purchase finance in greater
Calcutta was conducted by the Department of Economics Calcutta University. (1)
This survey threw important lights into the role of various financial
institutions in the provision of such finance. The head offices of the 19
scheduled banks in Calcutta were approached. Of these, 11 denied having any
relation with hire purchase finance. Yet they provided overdraft facilities
to dealers who sold durable consumption goods both on cash and hire purchase
basis. So this provided indirect help to hire purchase business.

Besides two banks which had their own personal Loan Department, 6
others reported to advancing loans for hire purchase transactions. This they

(1) Economic survey of Hire Purchase Finance in Greater Calcutta
Dept, of Economics, Calcutta University (unpublished).
did through their general advance department. The hire purchase agreements are taken in bunches as collateral security and collection of instalments is technically the responsibility of the seller.

These types of financing have mostly been done indirectly through specialised financing agencies or credit corporations. The hire purchase agreement forms and relative promissory notes representing instalment payments are handed over by the financing agencies to the banks. Often intimate relations grew up between particular banks and particular financing agencies. This largely simplified the problem of assessing the creditworthiness of the financial institutions.

One desirable feature about the hire purchase financing and personal loan business done is that they mainly cover the purchase of trucks, lorries and automobiles which are important producers' goods.

The Indian Overseas Bank is the first one to introduce a personal loan service. The Dena Bank also has been extending such loans since 1939. The explicit object of the Personal Loans Department of both the banks is to provide direct personal credit to purchasers rather than through other agencies. The intention is to increase the number of the bank's customers. Loans are granted both for the purchase of durable consumer goods, such as motor cars, sewing machines, electric fans, household appliances, cycles, scooters etc. and also for the purchase of professional equipment like agricultural implements, X-ray and other equipments, electric motors etc. The personal integrity of the borrower, rather than any material security offered is of major consideration to the banks. The liability of the borrower ceases in case of his death.


Also Dena Bank's folder on Personal Loan Scheme, obtained by the courtesy of Mr. P.C.V.Gandhi, Managing Director, Dena Bank.
In the case of personal loans, banks do not usually insist upon security. The only security acceptable, where necessary, has been the life insurance policy of the borrower. The major consideration for the bank is the borrower's stability of income. The other more important consideration is the age of the borrower. The younger the borrower, the greater is his credit-worthiness.

There are various sources of credit information. Thus the borrower may be a client, customer or broker of the bank, or he may be the customer of some other bank which provides the necessary information. Information is also obtained from the borrower's employer or the firm in which he works and parties known both to the bank and the applicant. Other factors upon which a great emphasis is laid, are, the business standing and integrity of the intending borrowers, their total properties, liquid assets and general reputation in the market.

The amounts of the loan vary between Rs 120 and Rs 5,000 and the period varies between 6 and 30 months. For hire purchase finance, the usual period is between 12-20 months. If a loan is repaid before maturity, a rebate is allowed on interest payments, on the other hand, a penal rate is charged for not making the repayment in time.

In the case of the one bank which did personal loan business and which supplied information to the survey conducted by the University of Calcutta, it was found that it did not have any specially trained staff to manage such business except the training imparted through conferences, circulars etc. Such people also attended to other types of work of the bank.

In the case of all banks doing hire purchase and personal loan business the delinquency ratio has been very low.

Thus, while most banks do not enter the sphere of hire purchase finance and personal loan business from a fear of the risk involved, those
that have entered this business do not find the risks to be very great. The risks may largely be eliminated and the attractions increased for such business by adopting better systems of collection and dissemination of credit. The Life Insurance Corporation could help by providing insurance at a cheap rate. Besides the Indian Overseas Bank and Dena Bank, however, Indian banks in general are not enthusiastic about personal or consumer loans and banks, other than the two mentioned, have not taken up this business.

Mention must be made, in this connection, of the hire purchase finance business of the State Bank of India. Under the new sub-section 33(i)(ff) of the State Bank of India Act, the State Bank has been granting advances for the financing of hire purchase transactions covering the sale of commercial vehicles with a view to assisting road transport. Since 1962 the State Bank has also introduced an Installment Credit Scheme for financing purchase of equipment by small or medium sized business, particularly those which would be connected with defence requirements. The total amount of the loan, which would be normally limited to Rs 5 lakhs, would be repayable in regular monthly, quarterly or half-yearly instalments spread over a period of five years. The equipment or machinery to be purchased would be hypothecated to the bank.