CHAPTER - IV
ORGANISATIONAL ASPECT OF MONETARY POLICY —— ATTEMPT TO CONSOLIDATE
THE MONEY MARKET DURING FIRST AND SECOND PLAN (POLICY OF SOUND BANKING SYSTEM)

In a developed money market monetary policy concentrates its major energy to control and stabilise the currency and credit only. But in an underdeveloped money market the consolidation of money market is one of prime necessity. Indeed, a sound banking system is really the effective ground on which monetary policy operates. Again, in an underdeveloped money market the existence of a central bank is justified only if it assumes the genuine leadership not only in controlling but also in organising and developing the money market. Even in the organised part of the money market in India all banks did not behave equally. It cannot be denied that there were strong banks in existence even before the coming of the Reserve Bank. But these banks were outnumbered by weak banks. This had made even the organised part of the market as a defective corner. "While weak and sickly banks", as has been aptly remarked by Prof. G.P. Gupta, "are threats to public confidence in banking business, the failure of an unsound bank demoralises the whole money market— the action ground for the Central Bank's policy of monetary management. In the field of banking the weak can weaken the strong, the collapse of the weak itself weakens the other and better institutions and this can happen even when the central bank gives support to the strong."

The various weaknesses with which the whole banking system suffered were broadly categorised into two - defective advances and investments on the one hand and deficiencies of management and control on the other. A great majority of the directors of these banking companies lacked the knowledge and experience necessary for the exercise of adequate supervision over the activities of the chief executive officers. This naturally paved the way for those officers to exercise wide powers while making investment and advances.

In a few cases the system of internal audit and inspection was found to be defective. Some banking companies were in the habit of declaring dividends without making adequate provision for bad and doubtful debts, depreciation in investment or other unrealisable assets.

Secondly, the advances of some of the banks were entirely out of proportion to their resources and in a few cases clean advances preponderated, while the machinery for investigating the credit worthiness of the borrowers was defective. Some banking companies ignored the principle of diversification of risk. Besides, investment policy was not without errors. In the ease of some banking companies investment in government securities were low in proportion to their resources, while in a few cases frequent borrowing reduced the liquidity ratio. Some banks held shares of companies in which some of the directors of banks were interested and these shares were not readily marketable. In the midst of these unhealthy environs the Reserve Bank took its birth in 1935 and the main task lay before it was "to encourage the development of sound and integrated commercial banking system," as has been aptly remarked by
With a view to fostering sound banking in the country through the principle of amalgamation of small banks, the Reserve Bank, as a first step, granted a substantial credit to Travancore National Bank and Quilon Bank to effect an amalgamation scheme in 1936. But just after two years, the banking system was involved in a crisis in South India. On June 20, 1936 the amalgamated Travancore National and Quilon Bank had closed its door, creating a shock in the banking business. Quite naturally, it was a direct source of threat to public confidence in the banking system as a whole. The depositors doubted the strength of the local banks in South India.

It can not, however, be denied that the Reserve Bank with its limited power had tried its level best to institute an investigation to the affairs of that bank in order to avoid any crisis. But the Travancore National and Quilon Bank did not agree to such an investigation till the close of its life span when the circumstances went beyond any control. The Reserve Bank, of course, had played its efforts in every way to save the bank. But then it was too late to save the bank. Inspection as to its financial position should have been instituted much earlier and especially, at the time of granting the credit. Investigation just before the death is equivalent to that after the death. The Reserve Bank since its inception was expected to create a confidence in the banking system and to help in organising the money market as a whole. But instead, the consequences proved the tragic failure of the Reserve Bank at that hour.

Hereafter, the Reserve Bank had made an attempt to give effective
guidance to those scheduled banks coming for help through investigation
on the point of granting any financial help. This had made clear along
with others what should be the relation between the Reserve Bank and the
scheduled banks by issuing circular letters to all scheduled banks. The
banking crisis imprinted another defect, viz. the absence of a sufficient
quantity of rediscountable assets. For this purpose, and for establishing
a direct link in between the scheduled banks, on the one hand and non-
scheduled, on the other, the Reserve Bank made a series of sincere but
vain attempts up to 1947.

But all these were not in accordance with any statutory powers
conferred upon the Reserve Bank and naturally, therefore, the Reserve
Bank was doomed to failure. The sense of urgency at this hour called
for a bold effort to arm the Reserve Bank with sufficient statutory
powers to control the affairs of the Indian money market.

POLICY TO CONSOLIDATE THE MARKET SINCE 1949:

The organisational aspect of monetary policy had actually begun
in 1949 by the passing of the Banking Companies Act on the one hand
and by the creation of the Banking Operation Department in the same year
by the Reserve Bank for administering the provisions of the Banking Companies'
Act on the other. The Act conferred upon the Reserve Bank various statutory powers such as inspection and supervision of banking companies, granting licence to standard banks, approval or disapproval of schemes of amalgamation of the weak banks and so on. During the course of its operations the powers of the Reserve Bank were extended to a considerable extent by various amendments of the Banking Companies Act as well as of the Reserve Bank of India Act.

It should, however, be noted that the post war banking legislation in India had been directed towards remedying the defects of the workings of the banks and strengthening the banking structure. The old conservative monetary policy had proved to be too inadequate and called for a bold effort to arm the Reserve Bank with sufficient statutory powers to control the affairs of the money market. A series of interim measures along with the traditional instrument of monetary control were undertaken to that end. But the first systematic and comprehensive attempt was made by the passing of the Indian Banking Companies Act in 1949. The Act empowered the Reserve Bank not only to exercise its control over the credit structure of the country but also to organise the money market as a whole.

The Act, 1949 was based on the Indian Companies Act, 1913 and various adhoc measures that were undertaken during the post war period. New provisions were also incorporated by the Act for the organisation of

5. Vide Circulars.
6. (a) Banking Companies (Inspection) Ordinance, 1946.
   (b) The Banking Companies (Restriction of branches) Act, 1946.
   (c) The Banking Companies (Control) Ordinance, 1948.
the money market. It brought to a close the long period of doubt about
the wisdom and scope of regulation of commercial banking and had endowed
the country with one of the most comprehensive pieces of banking legisla-
tion to be found in any country. Under the Act, the Reserve Bank was
empowered to exercise control on a statutory basis over all the banks —
scheduled and non-scheduled, local and foreign. The Bank was in a
position to give directives to the banking companies on interest rates
and the purposes and margins of loans.

The Bank was further empowered to inspect and supervise the
banking companies. A policy of systematic bank supervision has been
an important instrument for raising the standard of individual bank,
removing the defects in management and toning up the banking system.
For the success of bank supervision the institution of periodical
inspection of the banking companies is one of utmost necessity. Although
specific powers to inspect banks were granted to the Reserve Bank under
the Banking Companies Act, 1949 there was no statutory obligation to
carry out inspection at regular intervals. Yet in considering the
responsibilities devolved upon it under the Act, the Reserve Bank had
decided in 1949 and later had reiterated in February, 1950 to institute
a systematic periodical inspection of all banking companies governed
by the Act irrespective of the size and standard.

The policy of licencing of banks was intended to prevent the indiscriminate growth of banks, to ensure the continuance and growth of only such banking companies as are run on sound lines, to weed out from amongst the existing units those working along unsound lines and finally, to discourage indiscriminate flotation of banking companies. The Reserve Bank was, however, always anxious to give as many banks as possible a fair chance to qualify for a licence. The policy of licencing had been used more precisely as an instrument for improving the workings of individual banks rather than as a mere restrictive one. Section 22 of the Banking Companies Act, 1949 made it obligatory for banking companies to obtain licence from the Reserve Bank to commence or carry on banking business in India while an existing banking company was allowed to carry on banking business until a licence was refused to it. These licences were being granted on the basis of good inspection report. Prior to the granting of a licence, the books and accounts of individual banks were to be inspected and any defects or irregularities in their workings were to be duly notified to the management for early eradication of these defects or irregularities. The banks were under an obligation to submit thereafter regular reports in relation to their progress made for the improvement of their standards. During the transitional phase licences were usually being withheld by the Reserve Bank if the Reserve Bank considered that the bank was in a position to improve its standard. On the contrary, licences had been refused by the Reserve Bank if it considered that the nature of operation of the bank did not carry with it any sign of improvement in its standard of operation in not too distant future.
The policy of licensing on question of branch offices had been directed to two points - extension of banking facilities to those areas where they were not available or were inadequate and sound banking system. The first one was associated with the recommendations of the Rural Banking Enquiry Committee which conferred upon the Reserve Bank special responsibilities for the development of banking in India. Licences for branch banking were considered on consideration of actual want in the rural and semi-urban areas. The second one, viz. the sound banking was also looked upon in view of the past experience and workings of the banks applied for branch expansion. Licences very often granted to open new branches even where there existed banking facilities if it was found that the opening of new offices would impart a healthy tone to banking business in the area. These facilities were being granted not only to the Imperial Bank of India, which had been charged with the extension of banking facilities but also to the other bigger scheduled banks. Besides, expansion of banking activities was favourably considered by the Reserve Bank, especially in cities like Calcutta and Bombay if it was found as a necessary prelude to the efficient conduct of the business of the bank.

Through the exercise of twin powers of inspection and licensing, conferred upon it by Statute, the Reserve Bank was expected to organise the money market in general and banking system in particular. But the existence of a number of weak units with numerous small depositors spread all over the country, placed the banking system in a vulnerable position and the refusal of licences to so many banks would have led to undesirable repercussions on the banking system. This called for a bold effort to eliminate the sub-standard and non-viable banking units through a process
of amalgamation and mergers.

It is, however, interesting to note that while under the Banking Companies Act, any scheme of amalgamation could not be effective without the sanction of the Reserve Bank, the Bank had no power to impose a scheme of amalgamation on the banking companies till 1960. It could only exercise its power to consider any proposal that was placed before it. The policy of the Reserve Bank with regard to amalgamation of banking companies had been to encourage them if they were considered to be in the interest of the depositors and likely to lead to the establishment of a sounder institution. With this end in view the Reserve Bank sponsored an amendment to the Banking Companies Act in 1960, which minimised the legal formalities involved in the process.

Along with these instruments, mentioned above, there were also other measures undertaken by the monetary authorities for the purpose of better organisation of the banking system. Among these the most important ones were (a) the policy to maintain minimum paid up capital and reserves, (b) the policy to maintain minimum liquid assets ratios and (c) the control over advance of the banks. Let us now discuss, in detail, the workings of these instruments one by one.
OPERATION OF THE POLICY

INSPECTION AND SUPERVISION OF BANKS

The Bank had instituted, as a first step for the supervision of the banking companies, inspection of all banks. In pursuance of the policy to detect and remove the defects in the working of banks before they assume serious proportion necessitating drastic action, regular inspections had been commenced on March, 1950. The first round of inspection of all scheduled banks was completed in 1953 and the inspection of non-scheduled banks was progressing bringing the total number of banks inspected so far to 374. Of the total banks inspected, 265 banks were inspected under section 22 of the Indian Banking Companies Act, 1949 for ascertaining their eligibility for the grant of licence to carry on banking business. The rest of the banks were inspected under section 35 of the Act for the assessment of the overall financial position and methods of operations of the banks. In the same year inspection of the non-scheduled banks was nearing completion. In case of scheduled banks seven banks were also reinspected under section 22 and eleven under section 35 of the Banking Companies Act.

8. The policy of Bank inspection could be traced back in an interim measure whereby the Reserve Bank of India could inspect the book and account of any banking company as and when necessary (Banking Companies (Inspection) Ordinance, Jan., 15, 1946). In the same year the Reserve Bank was granted another power of regulating the expansion of branch banking which had shown certain undesirable characteristic features during the war (Banking Companies (Restriction of branches) Act, 1946).

The institution of inspection had shown that although the banking system as a whole continued to be sound yet the methods of operation and the workings of a number of banks in the country were not free from defects. The defects were the inadequate reserves, meagre liquid assets, over-extended advances, relatively large unsecured advances against immovable property and a large proportion of bad and doubtful debts. 

These defects were, however, pointed out to the banks concerned for early eradication. The banks were required to submit periodical report so that the Reserve Bank might keep its watch over the steps taken by the banks and progress made by them in the rectification of these defects. At the end of June, 1954, in all 520 banks were inspected. Of these 113 banks (27 scheduled and 86 non-scheduled) were inspected more than once. During the year ending June 1953-54, 19 scheduled and 166 non-scheduled banks were inspected. Of these 94 banks were inspected under section 22 and the remaining under section 35 of the Banking Companies Act, 1949. Two of these remaining banks were inspected in connection with the application for the grants of their moratorium. One of these two banks was inspected with the permission of High Court to consider the feasibility or otherwise of the scheme of arrangement proposed by it. 5 state-owned or state controlled banks which were outside the orbit of the Banking Companies Act were also inspected with their consent for the purpose of examining their financial position.

10. Trend and Progress of Banking in India during the year 1954, p 19.
The institution of inspection and supervision at this stage had improved the workings of the banks to a considerable extent. Reserves were being built up; outstanding borrowings were reduced—the amount outstanding in case of ten banks at the time of inspection was almost a third of that observed at the time of the first inspection; and the banks had taken steps to increase their holdings of liquid assets. The over extension of advances had also recorded some improvements after the first inspection e.g. 16 banks had reduced their over-extended position from 185 lakhs to Rs. 162 lakhs. The progress reports submitted by the banks revealed some amount of improvement relating to some defects, like insufficiency of reserves against bad and doubtful debts and granting advances either against no security or against immovable properties.

After the completion of the first round inspection of all reporting banks greater attention was paid to reinpection for the assessment of the progress made by the banks. By the end of June 1955 the number of banks inspected more than once reached 199. Of these 51 were scheduled and 148 non-scheduled banks. The institution of inspection and pointing out of defects is not enough. In order to eradicate the defects completely from the banking system, for the purpose of consolidation of money market as a whole, periodical

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progress reports from the banks had been called for after the detection of any objectionable or undesirable features. To that end, 107 banks were required to submit monthly progress report while 313 banks that of quarterly report. In case of detection of a common defect even after the reinspection, specific steps had been taken by the Bank against the banking companies concerned. The practice of pointing out defects and calling for progress reports had proved to be useful in the rectification of any defects of a bank. Scrutiny of periodical returns had shown that defaults under section 24 and 25 were of a casual nature. Habitual defaults under section 24 were considered seriously and to that powers under section 46(3) were invoked as and when necessary.

Until June 1956 the number of banks inspected more than once was recorded as 455. Although in some cases progress had been relatively slow, the banks had generally taken effective and expeditious steps to rectify the defects in their operation. They had come to realise that the inspections had helped to promote their own stability and the interest of their depositors and had, therefore, offered increasing measure of cooperation.

In accordance with the practice of obtaining periodical progress reports, 213 banks were submitting or were asked to submit monthly reports and 334 banks quarterly reports as on 30th June, 1957. In cases where the findings of the inspection reports called for stricter control over the affairs of the banks concerned, suitable conditions

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were imposed by the Bank. The system of periodical inspection and of calling for progress reports had on the whole revealed certain defects. The defects were inadequacy of reserves and liquid assets, the high proportion of advances in relation to resources, the relatively large volume of unsecured advances and advances against immovable property, the concentration of advances in the hands of a few borrowers and the low level of investment in government securities. On the question of procedural and organisational defects, considerable progress had been made by banks within a short period of time. But on question of operational defects a very few of them had been able to show appreciable progress. Of course, defects like those relating to sticky advances, clean advances and advances against immovable property were, by their very nature, difficult for rectification within a very short period of time.

In 1958, 46 scheduled and 120 non-scheduled banks were inspected. Most of them were inspected more than twice and three of them had been inspected for the first time. All the banks were inspected under section 36 of the Banking Companies Act, 1949. In accordance with the policy of obtaining periodical progress reports from banks, in respect of rectification of defects, brought to light in inspection reports, 220 banks were submitting or were asked to submit monthly reports and 102 banks quarterly reports as on June 30, 1958. Suitable conditions, were imposed over the affairs of the banks which were required to be strictly controlled.

19. Trend and Progress of Banking in India during the year 1957.
21. Ibid.
by the inspection reports. Such conditions were imposed on 37 banks (25 scheduled and 12 non-scheduled) during the year. 22

During 1959, 66 scheduled and 251 non-scheduled banks were inspected. All the banks excepting two were inspected under section 35 of the Banking Companies Act. One was inspected under section 45 (q) of the Banking Companies Act and the other with its own consent. In the same year monthly progress reports in respect of the rectification of defects pointed out to them were called for from 171 banks while 144 banks were asked to submit quarterly report in this regard. 23

In accordance with the policy of stepping up the pace of inspection of commercial banks 71 scheduled and 238 non-scheduled banks had been inspected during the year 1960. Of these one was inspected under section 22 and one under section 45Q of the Banking Companies Act. All the remaining banks were inspected under section 35 of the Act. In addition, scrutinies of the affairs of 3 banks, 6 state associated banks were undertaken in connection with their merger with the State Bank of India. Scrutinies of the affairs of 3 banks were also taken up in terms of Section 44A of the Act, 1949, and that of two banks under Section 44(1) of the Act. Periodical progress reports regarding the action taken by inspected banks for rectifying the defects pointed out in the inspection reports were called for from 213 banks. By the end of June of the year, 225 banks were submitting such periodical progress reports on the basis of which further steps were taken to

A critical analysis of inspection and bank supervision revealed that the first round of inspection of all scheduled banks was completed by 1953 and that of reporting non-scheduled banks by 1955. The inspection highlighted that banking system as a whole continued to be sound, the methods of operation and working of a number of banks in the country judged by the accepted canons of banking left considerable scope for improvement. The undesirable features were categorised into two; defective advances and investment on the one hand and deficiencies of management and control on the other. Defective advances included those cases where credit was made available without due regard being paid to the safety or liquidity of proposition. In some cases advances had been granted against securities such as real estate and fixed assets which were not readily realisable; while in other a high proportion of advances had been granted on an unsecured basis without taking into account the borrowers' resources. Secondly, it was noticed that a number of banks were not in the habit of taking necessary precaution in respect of proper documents, maintenance of up-to-date credit report of their borrowers, insurance of goods, properties etc. against risk of fire and taking proper legal opinion on the title of the borrowers' property lodged as security while granting advances to the borrowers.

Defects concerning the management and control of the banking companies were the outcome of the lack of any sense of responsibility on the part

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**TABLE 4.1**

Particulars of defects noticed in certain Banks at the time of their first inspection and subsequent/or latest Re-inspection and their rectification. (Amount in lakhs of rupees)

<table>
<thead>
<tr>
<th>Nature of defects</th>
<th>Number of Banks</th>
<th>Amount outstanding as on the date of First Inspection</th>
<th>Subsequent or latest re-inspection</th>
<th>Increase (+) or Decrease (-) percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Inadequate and poor reserve</td>
<td>29</td>
<td>23.36</td>
<td>31.46</td>
<td>+34.7</td>
</tr>
<tr>
<td>2. Insufficient reserve against bad and doubtful debts</td>
<td>20</td>
<td>2.69</td>
<td>3.42</td>
<td>+18.3</td>
</tr>
<tr>
<td>3. Frequent borrowings</td>
<td>40</td>
<td>306.83</td>
<td>78.42</td>
<td>-74.4</td>
</tr>
<tr>
<td>4. (a) Large investments in shares and debentures of joint stock companies</td>
<td>2</td>
<td>15.01</td>
<td>9.80</td>
<td>-34.7</td>
</tr>
<tr>
<td>(b) Investments in unquoted shares and debentures</td>
<td>21</td>
<td>21.02</td>
<td>24.84</td>
<td>+18.2</td>
</tr>
<tr>
<td>5. Investment in shares and debentures of companies in which Bank's directors are interested</td>
<td>4</td>
<td>74.00</td>
<td>83.33</td>
<td>+12.0</td>
</tr>
<tr>
<td>6. Inadequate investments in Govt. securities</td>
<td>11</td>
<td>1.75</td>
<td>5.92</td>
<td>+338.3</td>
</tr>
<tr>
<td>7. Meagre liquid assets</td>
<td>23</td>
<td>37.79</td>
<td>89.37</td>
<td>+137.8</td>
</tr>
<tr>
<td>8. Total of advances (of banks whose advances were high in relation to their total resources)</td>
<td>112</td>
<td>11937.49</td>
<td>14895.96</td>
<td>+24.8</td>
</tr>
<tr>
<td>9. Unsecured advances (high proportion in relation to their total advances)</td>
<td>68</td>
<td>1207.30</td>
<td>1201.81</td>
<td>+10.5</td>
</tr>
<tr>
<td>10. Granting large advances against immovable properties</td>
<td>52</td>
<td>612.83</td>
<td>535.61</td>
<td>-12.6</td>
</tr>
<tr>
<td>Nature of defects</td>
<td>Number of Banks</td>
<td>Amount outstanding as on the date of First inspection</td>
<td>Subsequent or latest re-inspection</td>
<td>Increase (+) or Decrease (-) percent</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------</td>
<td>-----------------</td>
<td>-------------------------------------------------------</td>
<td>-----------------------------------</td>
<td>-------------------------------------</td>
</tr>
<tr>
<td>11. Large proportion of deemed and doubtful debts</td>
<td>30</td>
<td>19.22</td>
<td>6.37</td>
<td>-65.8</td>
</tr>
<tr>
<td>12. Large number of irregular and dormant advances including advances having undesirable features</td>
<td>28</td>
<td>49</td>
<td>3.58</td>
<td>-91.1</td>
</tr>
<tr>
<td>13. Concentration of advances in the hands of a few borrowers</td>
<td>58</td>
<td>4219.30</td>
<td>6016.97</td>
<td>+42.8</td>
</tr>
<tr>
<td>14. Large advances to directors, their relations and associates and concerns in which any one of them interested</td>
<td>24</td>
<td>1988.47</td>
<td>2122.30</td>
<td>+6.7</td>
</tr>
</tbody>
</table>

SOURCE: Trend And Progress of Banking In India, 1961. Statement 33A.
### TABLE 4.2

Progress made by banks in the rectification of defects pointed out to them.

(Amount in lakhs of rupees)

<table>
<thead>
<tr>
<th>Nature of defect</th>
<th>Number of Banks</th>
<th>Amount outstanding as on the 1st inspection</th>
<th>December 31, 1961 (on the basis of the progress reports)</th>
<th>Increase (+) or decrease (-) percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Inadequate and poor reserve</td>
<td>133</td>
<td>104,19</td>
<td>147.72</td>
<td>+ 41.6</td>
</tr>
<tr>
<td>2. Insufficient reserves against bad and doubtful debts</td>
<td>19</td>
<td>7.36</td>
<td>6.76</td>
<td>- 8.4</td>
</tr>
<tr>
<td>3. Frequent borrowings</td>
<td>11</td>
<td>194.32</td>
<td>183.98</td>
<td>- 5.3</td>
</tr>
<tr>
<td>4. (a) Large investments in shares &amp; debentures of joint stock companies</td>
<td>9</td>
<td>156.15</td>
<td>119.13</td>
<td>- 24.7</td>
</tr>
<tr>
<td>5. (b) Investments in unquoted shares and debentures</td>
<td>19</td>
<td>144.70</td>
<td>79.30</td>
<td>- 45.3</td>
</tr>
<tr>
<td>6. Investments in shares &amp; debentures of companies in which Bank's directors are interested</td>
<td>9</td>
<td>42.10</td>
<td>38.46</td>
<td>- 32.4</td>
</tr>
<tr>
<td>7. Meagre liquid assets</td>
<td>40</td>
<td>102.44</td>
<td>129.03</td>
<td>+ 26.6</td>
</tr>
<tr>
<td>8. Total of advances (of banks whose advances were high in relation to three total resources)</td>
<td>93</td>
<td>4553.16</td>
<td>5513.47</td>
<td>+ 13.6</td>
</tr>
<tr>
<td>9. Unsecured advances (high proportion in relation to total advances)</td>
<td>97</td>
<td>1702.61</td>
<td>2327.66</td>
<td>+ 32.8</td>
</tr>
<tr>
<td>10. Granting large advances against immovable properties</td>
<td>63</td>
<td>772.78</td>
<td>211.39</td>
<td>- 45.3</td>
</tr>
<tr>
<td>11. Large proportion of decreed and doubtful debts</td>
<td>128</td>
<td>1139.78</td>
<td>1175.80</td>
<td>- 3.0</td>
</tr>
<tr>
<td>12. Large number of irregular &amp; dormant advances including advances having undesirable features</td>
<td>215</td>
<td>4361.70</td>
<td>3782.42</td>
<td>- 13.3</td>
</tr>
<tr>
<td>13. Concentration of advances in the hands of a few borrowers</td>
<td>40</td>
<td>2099.33</td>
<td>3085.28</td>
<td>+ 47.7</td>
</tr>
<tr>
<td>14. Large advances to directors, their relations and associated &amp; concerns in which any of them is interested</td>
<td>33</td>
<td>640.86</td>
<td>915.14</td>
<td>+ 43.8</td>
</tr>
</tbody>
</table>

**SOURCE:** Trend And Progress of Banking In India 1961. Statement 33B
of the directors concerned. Inadequate branch supervision resulted in
the deficiency of control. But these defects were, however, associated
with the non-scheduled banks. This class of banks again operated far
below the satisfactory level of reserves. Though section 17 of the
Act required statutory reserves to be built up by banking companies,
yet a number of non-scheduled banks had worked with poor reserves, the
strengthening of which would take some time due to their small reserves
and moderate earning capacity. Other defects included their very low
level of investment in government securities and inadequate provision
for investment depreciation. The defects observed during the inspection
were pointed out straight to the banks concerned for early eradication.
Whenever necessary the banks were asked to submit periodical reports
to enable the Reserve Bank to watch steps taken by the banks and to
assess the progress made in the rectification of defects.

It can not be denied, however, that on the whole the banks had
generally taken steps to remedy defects and had been willing to imple-
ment the advice tendered by the Reserve Bank. There was no doubt that
the prospect of periodical inspection by the Reserve Bank and the penal-
ties which could be imposed under the Banking Companies Act on the basis
of such inspection were definitely operating as a powerful deterrent to
banks which resorted to or continued unsound policies and practices.

The periodical inspections undertaken by the Reserve Bank had also
revealed several defects and weaknesses in the banking system. "Undoubtedly
the prospect of periodical inspection and the penalties on the basis of such inspection were operating against the continuance of unsound banking policies and practices at a time. If the fact findings called for a stricter control over the affairs of the banking companies, suitable conditions had been imposed upon. Whenever the management of a banking company was in need of constant guidance, the Bank insisted upon the appointment of a banking adviser. In extreme cases, however, the Reserve Bank deputed officers as observers for attending the board or committee meetings of the banking companies concerned. These officers were, again, directed to carry out the periodical scrutiny of the affairs of the banking companies. Thus in a way the bank supervision had extended its field of work even in controlling the affairs of management of the banking companies.

Much improvements had been recorded during the process of second inspection. The reserves of the banks were being built up; outstanding borrowings were also being reduced. The over extension of advances, another common defect, had also shown the sign of improvement and the other defects like insufficiency of reserves against bad and doubtful debts and granting advances either against no security or against immovable properties were on the way of eradication.

The presence of any objectionable features in the periodical progress reports submitted by a banking company was seriously noted down and stricter controlling measures were imposed by the Reserve Bank. It can not be denied that although the scheduled banks, especially the
big banks, had shown the sign of improvement, the small banks were still associated with various defects even after a couple of years of first inspection. The defects were the inadequacy of reserves and liquid assets, the high proportion of advances in relation to resources, the relatively large volume of unsecured advances and advances against immoveable property, the concentration of advances in the hands of a few borrowers and the low level of advances of a few borrowers and the low level of investment in government securities. In majority cases the procedural and organisational defects had been removed. But the improvement in relation to operational defects was not as significant as it was desired. The policy of the Reserve Bank, was therefore, directed to take more energetic steps to those banks whose progress was not only far from the level of satisfaction but also relatively very slow. The Bank had started informal discussion with representatives of banks to impress upon them the need for speedy reforms. Necessary conditions were also being imposed upon a few banks for improving their workings. The issue of directives to banks and the appointment of observers was a regular feature after 1957. The banking companies whose position was considered as beyond repair was refused licence.

LEGISLATIVE AMENDMENTS:

Among the legislative measures enacted for the improvement of banking system, the amendment to the Banking Companies Act in 1950 was a significant one which intended to facilitate amalgamation and to speed up the disposal of winding up proceedings. The Amendment Act was sought to encourage bank amalgamation "by obviating recourse to Courts of Law, by minimising legal formality and by eliminating the possibility of a few
Again in the administration of the provisions of the Banking Companies Act on questions of suspension of business and winding up banking companies the monetary authority had been confronted with several difficulties and the provisions of Part III of the Act had proved to be inadequate in actual practice. The quick disposal of cases relating to the claims by or against a company in liquidation was not possible under the earlier Acts. By amending legislation this legal gap was narrowed to a considerable extent. With the enactment of the Banking Companies Act, 1949 and the amendment of section 42(6) of the Reserve Bank of India Act, the power relating to inspection of both the scheduled and non-scheduled banks were enlarged to a considerable extent. The Bank was thereafter empowered to conduct inspection for a variety of purposes and on its own initiative. The amendment to Section 17(a)(b) of the Reserve Bank of India Act had also been intended to improve credit condition in the country by enabling the Reserve Bank to grant financial accommodation to a state cooperative bank on a larger scale.

The Banking Companies Act of 1949 made it compulsory on the part of the banking companies to obtain licence from the Reserve Bank, to commence or carry on banking business and to open new branches in the country. The Amendment Act of 1950 had empowered the Reserve Bank to regulate the opening of branches of Indian banks outside India. This power of the Reserve Bank was further extended to the whole of India.

26. Ibid.
excepting Jammu and Kashmir. With the passing of the Part B States (Laws) Act in 1951, the "Banking Companies incorporated in and restricting their activities to Part B states" were brought within the jurisdiction of the Banking Companies Act. Banking Companies Rules were made applicable by a special notification to those areas in 1952. In the same year the Government of India appointed, on the recommendation of the Reserve Bank, the Banks' Liquidation Proceedings Committee. On the basis of the recommendations of the Committee, the Banking Companies Act was, again, amended in 1953 to extend the jurisdiction of the High Court and "prescribed a summary procedure for the realization of outstanding debts and for expediting execution of orders and decrees passed against debtors of banking companies and provided for expedited enforcement of the liability of directors and compulsory public examination of their conduct in relation to the affairs of the banking companies." 27

The introduction of a new section 43A made the Reserve Bank the supreme authority in dealing with the banking companies. Henceforth, no suit or other legal proceedings should lie against the Reserve Bank or its officers for anything which was done in good faith in pursuance of Section 43 and 43 28 of the Act. Coming to the exemptions granted by various legislative provisions to the banking companies, the Reserve Bank of India Act was amended several times during the period. "In order to grant relief to the displaced scheduled banks from the provisions of Section 42(1) of the Reserve Bank of India Act, 1934, in respect of liabilities relating to the "closed fund", Regulation 11 of the Scheduled Banks' Regulations was amended with effect from May 31, 1950 so as to grant power to the Reserve Bank to waive penal interest. The Reserve Bank of India Amended Act, 1951.

28. Ibid P.737.
had further empowered the Bank to exempt any scheduled bank from the provision of section 43 of the Act with reference to all or any of its offices or with reference to the whole or any part of its assets and liabilities. Concurrently, with this amendment the scheduled Banks' Regulations were revised. 29

The remittance facilities available by earlier legislations were also liberalised. The scope of the form of weekly return to be submitted by the banking companies to the Reserve Bank was extended to include the "balances with other banks in current accounts", money at call and short notice, investment in government securities etc. The form of weekly return was further modified in order to include within its scope "foreign bills purchased and rediscounted". 30 The temporary exemptions granted earlier to scheduled banks from including their borrowings from the Imperial Bank of India in computing their demands and time liabilities had been placed on a permanent footing by the passing of the Reserve Bank of India (Amendment and miscellaneous provisions) Act in 1953. 31

THE BANKING COMPANIES (AMENDMENT) ACT, 1956:

The money market was further consolidated by the introduction of the Banking Companies (Amendment) Act, 1956. The administration of the Banking Companies Act, 1949 had brought to the lime-light certain loopholes in the prevailing law in dealing with managerial irregularities of the banking companies. The powers of the Reserve Bank over the terms of the

29. Ibid 736-737.
30. Ibid 737.
31. Ibid 737.

* At present Banking Regulation Act.
appointment of the directors, managing directors and chief executive officers and the issue of directives to banking companies in relation to matters of policy or administration were proved to be inadequate. Besides, the restriction on voting rights of shareholders imposed by section 12 of the Act did not apply to a large number of banks which had been incorporated before January 15, 1937.22

Again, under the principal Act, the authorities of the Reserve Bank had no power to appoint observers on the board of directors of banks to watch and report on the conduct of the affairs of the banking company. To meet the above gaps in the workings of the banking legislation the Banking Companies (Amendment) Act, 1956 conferred upon the Reserve Bank extensive powers to control and strengthen the affairs of the money market. The Reserve Bank had been empowered to issue directives to banks in regard to matters of policy for administration in the national interest or in the interest of the institutions themselves and to approve the appointment or reappointment of managing directors as well as managers or chief executive officers and also to regulate the terms of appointment of these officials. 33 The Reserve Bank was further authorised to appoint observers on the board of directors of banks to report on the conduct of affairs. 34

The employees of the bank had now been made "public servants" for the purpose of Chapter 9 of the Indian Penal Code so that action could be taken whenever they take illegal gratification. 35 Amendment of Section 27

32. Trend and Progress of Banking in India 1956, P 18.
33. New Section 35A and 35B inserted in the Principal Act.
34. Section 36 of the Act as amended.
35. A new Section 46A.
of the Act had extended the powers of the Reserve Bank to obtain statement
and information relating to the business affairs of a banking company
including any business or affairs with which such banking companies were
concerned.

The amendments to section 12 and 18 of the principal Act were
aimed at the prevention of misuse of voting rights through the concen-
tration of shares in the hands of a few. The exemption granted to banks
incorporated prior to January 15, 1947 under Section 12 of the Act had
been withdrawn. Section 16 of the principal Act prohibited the director
of a banking company from becoming a director of another banking company
at a time. The amending Act, went a step further in dictating that
"no banking company shall have a director of a company which among them-
selves were entitled to exercise voting rights in excess of 20% of the
total voting rights of all its shareholders." 36.

BANKING COMPANIES (AMENDMENT) ACT 1959 *

The Banking Companies Amendment Act, 1939 was sought to achieve some
degree of flexibility in the operation of commercial banks on the one hand
and to extend powers of the Reserve Bank over the banking system on the
other. The question of remuneration of brokers and other non-employees
on a commission basis had brought about certain anomalies in the original
 provision. Any banking company under the Banking Companies Act was allowed
to pay dividends "on its share, without writing off depreciation, if any,
(1) on the value of its investment in approved securities, where depre-
ciation has not been capitalised, or otherwise accounted for as a loss

36. Trend and Progress of Banking in India during the year 1958 - P 20.
* Presently Banking Regulation Act.
and (2) on the value of its investment in shares, debentures or bonds in respect of which adequate provision for depreciation has been made to the satisfaction of the auditor of the banking company.  

Again the Banking Companies Amendment Act of 1959 had empowered the Reserve Bank to remove the chairman or director or manager or chief executive officer of any banking company from office if he was considered by any court of law or any such body to have acted in contravention to the provision of any law and consequently, if his presence in the office was considered by the Reserve Bank as objectionable. The Banking Companies (Amendment) Act, 1966 urged that an amendment of any provision relating to appointment of a managing director, manager or chief executive officer of a banking company must be approved by the Reserve Bank. But now under the present Act the approval of the Reserve Bank was required also in case of any such appointment or reappointment or remuneration of a director of any banking company. It was also necessary to obtain the approval of the Reserve Bank for the grant of retirement benefit to any such persons. Again, in some cases the Reserve Bank was authorized to apply to the court of law for winding up of a banking company. Still again if any banking company sought to wound up it must obtain certificate from the Reserve Bank that the company would be able to pay its full all its debts to the creditors. Any change of name or alteration of the memorandum of the banking company was required to be approved by the Reserve Bank.

38. Trend and Progress of Banking, 1959.
The policy of licensing had gathered momentum within a very short period of time. At the end of the year 1953 the total number of banks received licenses reached 34. The year 1954 was not associated with any increase in the total number of licensed banks. But the number of licences refused had increased considerably. As at the end of the year, the total number of banks being refused licences stood at 11 of which one was scheduled and ten were non-scheduled banks. The total number of banks that had applied for licenses to carry on banking business under the Act of 1949 was 722 of which 540 were, in fact functioning. The rest of the companies had either gone into liquidation or ceased to be banking companies or were reported to be taking steps to convert themselves into non-banking companies. At the close end of the year applications of 490 banks for the issue of licences were pending. In disposing of these applications, the Reserve Bank was to be satisfied by inspection or otherwise that the banking companies were in a position to pay the depositors in full if so required and that their affairs were not being conducted to the detriment of the depositors' interest. (39) Section 22 had also allowed the banks which existed before the commencement of the Act, 1949 to operate till they were refused licences under the proviso. (40)

Under the proviso, the Reserve Bank could not serve notice to any bank, ordering suspension of its work, before the expiry of three years from the commencement of the Act, viz. March 16, 1952. The banks which were under the investigation of the Reserve Bank and were passing through trial and error methods were not also refused licences. Their licences were withheld till they were standardised. The policy behind it was to improve the condition of affairs of the banks and the issue of a licence was nothing but a seal of approval by the Reserve Bank of the soundness of Banks' financial position and their methods of operation.

During the period of inspection for the grant of licences it was found that the defects of the banking companies were chiefly due to the ignorance of sound banking practices. In this case the Reserve Bank had directed the banking companies to appoint banking advisers in consultation with the Reserve Bank. In some cases, however, officers of the bank had been deputed to attend the meetings of the Board in order to keep a close watch over the affairs. The number of pending applications of the banks for the grant of licences had been reduced to 422 at the end of 1955. Licences were issued to 12 Indian Scheduled banks bringing the total number of licenced banks to 42. On the contrary, there were four banks which were not within the domain of section 22 of the Banking Companies Act. They were the State Bank of India and other major state associated banks. This year had recorded the refusal of 14 non-scheduled banks whose activities were considered by the bank as detrimental to the interest of the depositors. Total number of banks thus refused licence reached 30.

The granting of licences was going on very cautiously year after year. During the year 1957 only 3 scheduled banks were granted licences as against one scheduled bank and 3 non-scheduled banks in 1956 bringing the total number of licensed banks from 49 in 1956 to 52 in 1957. In 1956, however, 9 banks were granted licences of which 6 were scheduled and 3 were non-scheduled while the refusal of licences was moving fast. As in the year 1956, 47 banks were refused licences bringing the total number of banks refused licences to 77. In the year 1957 the refusal of licences was 30 and in 1958 21, bringing the total number of banks refused licence to 128. The number of applications pending for the grant of licences were disposed of at a very slow rate viz. 393 in 1956, 333 in 1957, 323 in 1958 and 283 in 1960. At the end of June 1961 the total number of licenced banks stood at 65 and the total number of banks to which licences had been refused stood at 136. Only two scheduled and 2 non-scheduled banks were granted.

42. Trend and Progress of Banking in India, 1955.
licences during the last year of the Second Plan. One scheduled bank was given a conditional licence according to the amendment provision of the section which came into force on October 1, 1959. The slow rate of progress of licensing of banks was due to the adamant attitude of the banking companies on question of the rectification of defects pointed out to them by the Reserve Bank. But the responsibilities lay with the Reserve Bank too.

However, in the organisation of money market the monetary authority should have focussed its attention either to improve the condition of affairs of the weak and small banks by removing the defects associated with them, or to eliminate them at all. The question of the issue of licence should have been finished much earlier. If there were any weak banks the Reserve Bank should have directed its attention to remove the defects and difficulties associated with these banks and thereafter granted licence as were necessitated by the Banking Companies Act, 1949. But it is strange that those banks operating on sound lines had obtained the licences after a considerable period of time due to the idle attitude of the Reserve Bank. It is also a matter of regret that a bank like Palai had been operating for long until its death without being licensed at all. Palai Bank was, undoubtedly, a big bank having so many defects which were not being removed by the inspection and supervision of the Reserve Bank. It is amazing that a large number of banks operated throughout the period of our study without being licensed at all. Yet the Banking Companies Act, 1949 made it necessary for a particular bank to obtain a seal of licence from the Reserve Bank as a mark of its soundness. Of course, a bank should not function unlicensed. For, it should not have any right to function and play game with the deposits of the people at large. Even the new banks must not have been allowed to function without being licensed. Either they should have been amalgamated with larger banks through the hospitality of the Reserve Bank or been suspended by it. Simply by keeping the applications pending for investigation and keeping in abeyance the licences the Reserve Bank was not expected to finish its duty.
AMALGAMATION OF SMALL AND WEAK BANKS

Shortly after the amendment to the Banking Companies Act in 1950, four scheduled banks in West Bengal were assisted by the Reserve Bank in 1950 to amalgamate and to form the United Bank of India, Ltd. In later years the Reserve Bank considered other proposals for amalgamation that were tabled before it and one of these was sanctioned under section 44A by it after being fully satisfied that the scheme would be able to create a strong unit.

In cases where proposed amalgamation was not considered desirable for one reason or other the Reserve Bank tendered advice involving the transfer of assets and liabilities of Banking Companies by a mutually agreed arrangement. Subsequent to this new formula the assets and liabilities of Bharat Bank, Ltd, were transferred to the Punjab National Bank of India, of Mercantile Bank of Hyderabad Ltd, to the Hyderabad State Bank and Maharashtra Apex Bank, Ltd, and of the Southern India Apex Bank, Ltd, to the Canara Industrial and Banking Syndicate Ltd.

Proposals for amalgamation of banking companies had always been encouraged by the Reserve Bank if they were considered by the Reserve Bank in conformity with the interest of the depositors and would lead to the improvement of the banking companies as a whole. As in 1953, initiative was taken up by some banking companies for the amalgamation and transfer of certain assets and liabilities as well. One of the proposals for amalgamation was considered by the Reserve Bank as desirable for which it suggested the banks concerned to draw up an agreed scheme of amalgamation and to approach the Bank thereafter. Another proposal which was not sanctioned by the Reserve Bank was suggested for the transfer of assets and liabilities to the other.43. In the following year, among the various proposals for amalgamation, only one which had been approved by the Share holders

43. Trend and Progress of Banking in India during the year 1953. p 23.
of the respective banks was taken up by the Reserve Bank and called for certain other informations for the final sanction for amalgamation under section 44A of the Act\textsuperscript{44}. Two proposals for the transfer of assets and liabilities cropped up during the year to which the Reserve Bank had no objection\textsuperscript{45}.

In 1955 a proposal for amalgamation which was pending at the end of the previous year was dropped by the Reserve Bank as it was found, after examination, not to be in the interest of the depositors\textsuperscript{46}. In the same year the Bank gave consent to three proposals for the transfer of assets and certain liabilities initiated by the banking companies concerned. In the year 1956, a number of proposals for amalgamation had received consideration of the Reserve Bank\textsuperscript{47}.

On December 24, 1957 a scheme of amalgamation of the Orient Central Bank, Ltd (Kottayam) with the Collayam Bank Ltd was sanctioned. On December 26 of the same year another scheme of amalgamation of the Corporation Bank, Ltd (Bijapur) with the Union Bank of Bijapur and Sholapur Ltd was sanctioned\textsuperscript{48}. Two other non-scheduled banks which approached the Reserve Bank with proposals for amalgamation suggested certain modifications in their scheme of amalgamation\textsuperscript{49}.

The year 1957 was associated with another interesting feature for an attempt by a big bank like the Bank of Baroda to absorb the business of the Hindi Bank, Calcutta, in order to form larger and stronger banking units\textsuperscript{50}. This scheme of amalgamation was, however, pending for the year for the sanction of the Reserve Bank.

In the following year, this amalgamation was sanctioned. In the same year...

\textsuperscript{44} Trend and Progress of Banking in India during the year 1954. p 23.
\textsuperscript{45} Trend and Progress of Banking in India during the year 1954.
\textsuperscript{46} Trend and Progress of Banking in India during the year 1955. p 24.
\textsuperscript{47} Trend and Progress of Banking in India during the year 1956. p 27
\textsuperscript{48} Trend and Progress of Banking in India during the year 1955.
\textsuperscript{49} Trend and Progress of Banking in India. 1955. p 13.
\textsuperscript{50} Ibid. p 14.
year other two schemes of amalgamation were also sanctioned. They were the amalgamations of The South Indian National Bank (Mavelikara) with the Bank of India (Trivandrum) and the Alliance Bank of India (Madras) with the Bank of Madura.

On the question of transfer and liabilities, in December 1958 the Madras City Bank (Ooty) had transferred its assets and liabilities to the Cochin Commercial Bank. Proposals for both amalgamation and transfer of assets and liabilities of one bank to the other were also at a progress at the close of the year. In 1959 the Reserve Bank sanctioned schemes of amalgamation of Adoor Bank, the Swadeshi Bank (Pathanamthitta) and the Industrial Native Bank (Manipally) with the Bank of New India (Trivandrum) and the Eastern Midland Bank (Kottayam) with the Sessa Bank (Alleppey). On the question of transfer of assets and certain liabilities two non-scheduled banks namely, the Bank of Mangalore and the Nagaracore Bank in Mangalore transferred their liabilities to the Canara Industrial and Banking Syndicate (Udipi) with which another non-scheduled bank had also agreed to transfer its assets and liabilities earlier.

Again, the Indo-Mercantile Bank in the Southern Area transferred certain agreed liabilities and assets to the Travancore Bank in the same year and the balance to the Kerala Government.

During the year 1960 the Bank had approved the scheme of amalgamation of a United India Bank, Chengannur and Society Bank, Tiruvalla with Martandam Commercial Bank, Trivandrum. On question of transfer of assets and liabilities, the Asiatic and Mercantile Bank had transferred its assets & liabilities to the Canara Industrial and Banking Syndicate (Udipi) and that of the Stringer Sri Sarada Bank, Sringeri transferred to the Karnataka Bank (Mangalore).

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51. Trend and Progress of Banking in India, 1958, p 15.
52. Trend and Progress of Banking in India, 1959, p 21.
53. Ibid p 24
54. Trend and Progress of Banking in India, 1960, p 37.
In the same year, the National Crust Bank, Calcutta agreed to transfer its deposits and equivalent amount of cash to the Bank of Bankura, Calcutta. The Thomos Bank, Trivandrum transferred its deposits, liabilities and equivalent assets to the Bank of Madurai. A merger was also finalised between the Mayurbhanj State Bank and the State Bank of India.

During the year another striking feature was observed in the execution of a compromise or arrangement between the two banking companies for amalgamation under section 391 of the Companies Act, 1956. All these were required to be certified by the Reserve Bank under section 44b of the Banking Companies Act, 1949. A scheme between the Bank of Bhopal, Bhopal and United Commercial Bank, Calcutta on the question of transfer of certain of its assets and liabilities was approved. But on the question of modification of the scheme of arrangement under which the Bank of Deccan, Kottayam was operating was not certified by the Reserve Bank.

But in spite of all these attempts, no striking progress had been achieved in matters of reconstruction and amalgamations of small banking units because of absence of any clear cut statutory provision for the purpose. To sum up, the existence of a large number of small and uneconomic units made the Indian Banking System structurally weak. The policy to amalgamate these smaller units was sought to strengthen the Indian money market in general and the banking system in particular. With a view to assisting banks coming with schemes of amalgamation, the Reserve Bank sponsored an amendment to the Banking Companies Act, 1950 minimising the legal formalities involved in the process. But throughout the decade no statutory power was conferred upon the Reserve Bank to compel the smaller units to amalgamate. It could only tender and consider any scheme for amalgamation proposed and initiated by the banks themselves for its sanction. As a result, the progress in the field of amalgamation had been comparatively slow.

55. Ibid pp 37-38
The policy of maintenance of minimum paid up capital and reserves was intended to rectify the widespread tendency among the smaller banks to operate with a narrow capital base which acted as a deterrent to the interest of the depositors. One of the major defects of the banking structure in India was found to be inadequate capital in the case of a large number of banking companies. It can not, however, be denied that Section 277(1) of the Act urged Rs.50,000 as the minimum paid up capital for every banking company incorporated on or after the 15th January, 1937. But this prescription lost the very purpose for which it had been proposed. A large number of banking companies incorporated prior to that date were unaffected by this section. The administration of the banking companies revealed a tendency on the part of some small banking companies to extend their field of operation by indiscriminately opening branches in different parts of the country with insufficient capital, as a check to this tendency the insertion of the Section 11 of the Banking Companies Act, 1949 was a logical necessity. To comply with the requirements of Section 11 of the Act, however, the Reserve Bank had allowed a period of three years from its commencement to those banking companies which were in existence. No immediate action was, therefore, called for on the part of banking companies towards compliance with this section. In addition, all banking companies, which were incorporated in Part B states and which till September 27, 1951 confined their activities to these states, were granted further exemption upto March 31, 1955. Exceptions had also been granted in individual cases on merit even after that period. Upto the December 1958 twenty-five banks had been enjoying such exemption. It was thus intended to minimise any genuine hardship that might be caused to banks by the requirement of minimum capital. In consultation with the Reserve Bank the policy of the central government on question of control over capital issues was also modified to enable the banks to issue capital for the purpose of complying with this clause. In order to

56. Trend and Progress of Banking in India during the year 1958, p.18
conform to the minimum capital requirements, 60 banking companies had raised their paid-up capital and 14 banks reduced their area of operation from 1951-53. On the other hand, 173 banks either went into voluntary liquidation or converted themselves into non-banking companies. Again, until the reserve fund of the banks reached the paid-up capital, the banks were required under the Act to transfer 20% of their net profits each year to their reserves.\(^{(57)}\) However, 267 banks had contravened this provision of the Act. Subsequently, they were urged by the Bank to make up deficiency either from surplus funds in the relative year or from the profits of the subsequent year.\(^{(58)}\) This provision of the Banking Companies Act had nonetheless helped to organise the money market so that 35% of the scheduled banks was able to raise their reserves 'equal to or more than' the paid up capital at the end of 1953 as against 28\% in 1951. Similarly the corresponding percentage of the non-scheduled banks rose to 24\% in 1953 from 18\% in 1951.

6. MINIMUM LIQUID ASSETS RATIO

As a second line of defence in addition to the normal cash reserves, the Banking Companies Act also urged the banking companies to maintain a minimum ratio of 20% of liquid assets to total demands and time liabilities of banks. In majority cases the Banking Companies did not feel any difficulty to comply with these requirements. During the process of inspection of banks whenever any continued defaults were brought to notice of the Bank the banking companies were served with notice containing the penal provisions of the Act.\(^{(59)}\) Banking Companies which felt this provision as onerous went into voluntary liquidation. In some cases, however, licences were refused which helped the process of elimination of weak banks. The institution of systematic bank supervision revealed that a large number of banks in the erstwhile Travancore-Cochin State were not in a position to comply with this

57. Ibid P.136
58. Ibid P.16
59. Trend and Progress of Indian Banking 1953, p.19
provision of the Banking Companies Act because of the peculiar banking operations. In considering their difficulties, on May 1953, a general exemption was granted to these banks on this question and they were permitted to maintain a minimum liquid assets ratio of 12% up to March 31, 1954. (60) It is, however, interesting to note that the exemption limit had since then been renewed every year. This flexible adjustment had undoubtedly helped to serve the process of consolidation of banking system throughout the decade. As at the end of June 1961 more than 70% of the banks were in a position to comply with the requirements of the section of the Banking Companies Act.

5. CONTROL OVER BANK ADVANCES:

Next to the minimum paid up capital Reserve and Minimum Liquid Assets Ratio, control over bank advances is no less important in organizing the money market. Section 21 of the Banking Companies Act gave the Reserve Bank powers to determine what should be the policy of the banking companies in general in relation to their advances for the interest of the people at large. Moreover, the Bank was empowered by the Act to determine the policy to be followed by any particular bank if it was necessary for the public interest. The Bank was also authorized to give directives to banking companies of either generally or to any banking company or a group of banking companies in particular, as to the purposes for which advances may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances. In strict sense, the provisions under section 21 were first invoked seriously by the Bank in May 1956 to control advances against foodgrains, and certain other commodities. Hereinafter, the control over advances became a regular feature. (61)

60. Ibid, P.15
61. This aspect has been analyzed in greater detail in Chapter 10.
THE BANKING DISASTER IN 1960

Upto the end of the fifties the Reserve Bank of India had acted as a custodian of banking interest of the country. But the year 1960 was associated with the failure of Lexmi Bank and Palai Central Bank which brought about a terrible shock in the banking atmosphere. The failure of Lexmi Bank in June and Palai Central Bank in August, 1960 under the very nose of the Reserve Bank of India highlighted the weak joints of the banking system as a whole. It is this jolt which challenged the efficacy of the Reserve Bank as a leader of the money market in India. It can not be denied that the Bank was armed with considerable powers at the hour. The Palai Bank was inspected in 1951 and during this time, a disquieting position was noted.

It was re-inspected in 1953 revealing no improvement whatsoever. The same position was also noted again in inspection report in 1956 and again in 1958. The bank was continually running aground. Even at the beginning of 1960 a precarious condition was noted during the inspection of the bank. Of late, it was clear that about 30% of the bank advances were irrecoverable and other 20% were not easy to recover, finally, the bank was in the lap of a havoc.

Quite naturally, the operation of the monetary policy had been questioned. Throughout the period beginning from 1951 to 1960 the Reserve Bank was hesitant to take a stern measure towards the management of the banking company inspite of its repeated failure to observe the directives of the Bank. It was also pointed out as to why the bank was actually allowed to operate upon inspite of its repeated sickness. The Reserve Bank as a saviour of the money market could not avoid its responsibility simply by inspection, pointing out the defects and giving so much latitude in condoning the management’s weakness so many times.
The failure of the Laxsi Bank and the Palai Central Bank had underlined the urgent need for action to consolidate and strengthen the weaker segments of the banking structure. Although the Reserve Bank had been carrying out inspections of banks and pursuing the rectification of defects observed in their workings, it was found that a large number of small and medium-sized banks had still not come up to the eligibility standard required for the grant of a licence under Section 22 of the Banking Companies Act. The existence of a number of weak units with numerous small depositors spread all over the country placed the banking system in a vulnerable position and the refusal of licences to so many banks would have led to undesirable repercussions on the banking system. This had emphasised the need for elimination of sub-standard and non-viable banking units through a process of amalgamation and mergers. In the absence of statutory provisions for compulsory amalgamation/merger, no significant progress had been made in this direction. It was, therefore, considered necessary to provide statutorily for the compulsory amalgamation of banks.

REVISION OF POLICY:

Indeed the failure of the Palai Central Bank was an eye-opener to the monetary authorities and the banking companies as well to pursue a careful policy in the affairs of the banking institutions in future to avoid any such happenings. It was the failure of the Palai Bank that had filled up, hereinafter, so many gaps in the banking legislation of the past. It had brought about a change in the banking legislation on question of amalgamation and on question of interest of the depositors. Legislative amendments had been made (1) to expedite liquidation proceedings of banks, (2) to assure small depositors of the safety of their funds by making them preferential creditors, (3) to provide for the declaration of a moratorium to facilitate the process of compulsory reconstruction or amalgamation...
of banks and finally, (4) to provide for compulsory amalgamation of banks with other banks including the State Bank of India and its subsidiaries. The Banking Law was also amended to allow banks to maintain secrecy regarding their inner reserves in matters relating to industrial disputes.

In order to quicken the process of liquidation of a bank the Amendment Act of 1960 provided for the appointment of an individual as an official liquidator as and when necessary, if the Reserve Bank so desired in its application to the High Court. Incidentally, it should be noted that prior to this Amendment Act, only the Reserve Bank of India, State Bank of India and any other bank, instead of an individual notified by the central government, could be an official liquidator. This naturally involved delay in the process of liquidation in the earlier legislation. To eradicate the defects of delay involved in earlier legislation the present Amendment Act, along with others, was expected to take part in the process of organisation of the money market.

The Amendment Act also provided for the quick disbursement of the preferential payment to the depositors of banks in liquidation. Prior to the passing of the Amendment Act, the procedure for determination of claims of secured creditors and other persons entitled to preferential treatment of a bank in liquidation involved much delay in the payment of the depositors. Under the present amendment this preferential payment were to be made within 3 months from the date of winding up order and three months from the date of commencement of the Act in case of those banks which went into liquidation earlier than the passing of this Act. (62)

The Amendment Act 1960, empowered the Reserve Bank to apply to the Central Government for the grant of a moratorium to any banking company. Henceforth, according to the Amendment Act this grant of moratorium would be for the maximum period of six months. During the period of moratorium the Reserve Bank could

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(62) Trend And Progress of Indian Banking 1960, p.27.
prepare a draft scheme for the reconstruction of the bank or its amalgamation with another bank and thereafter submit it to the Central Government. The Central Government, however, in granting the same could modify it if necessary. The scheme after the sanction was binding upon the banking company as well as on the members and creditors of the bank concerned. (63)

The Banking Companies (Amendment) Act, 1960 was supplemented by the Banking Companies (Amendment) Ordinance on February 4, 1961 which conferred upon the Reserve Bank a dictatorial power in matters of compulsory reconstruction/amalgamation of the banking companies. The Ordinance had also enabled the compulsory amalgamation of a banking company with the State Bank of India or its subsidiaries. Besides, amalgamation was now possible between more than two banking companies by a single scheme of amalgamation. The Ordinance was subsequently enacted on March 24, 1961. The Act, 1961 was a green signal for the reconstruction of the banking system at large. It is this Act which had enriched the Reserve Bank with more powers to deal with the small and weak banking units quite effectively in matters of amalgamation by its own initiative. Indeed, it had paved the way of consolidating the structure of money market in general and pursuing a sound banking system in particular. (64)

63. The Reserve Bank of India Bulletin 1961 P.1299
CONCLUSION

In consolidating the structure of the money market the Reserve Bank had better exercised the provisions of the Banking Companies Act, 1949 along with the Reserve Bank of India Act, 1934 with various amendments according to the changing needs. The Bank had instituted, as a first step for the supervision of the banking companies, inspection of all banks. The defects observed during the inspection were pointed out straight to the banks concerned for their early eradication. It cannot, however, be denied that the process of developing sound banking is not an easy task. In the absence of any indigenous tradition of the modern banking method and the establishment of a large number of mushroom banks in 1942-47 by persons having no experience of banking business whatever made it very difficult for the monetary authority to control the affairs of banks. The guidance and the instructions offered by the Reserve Bank to pursue a sound banking system were undoubtedly considered by most of the banking companies as a blessing to them. They have taken steps for the realisation of unsatisfactory investment and recovery of doubtful advances. But this could not be achieved at a short period of time because of the technical, administrative and judicial difficulties associated with the process of working. The Reserve Bank had also delayed too much in granting licences to some efficient banks for safeguarding the interest of the depositors of the banking companies. Moreover, the mere cancellation or refusal of licences was not at all effective in supervising the affairs of banks. The allowance of banking companies to continue their banking operations without licences went against the spirit of supervision and the policy of sound banking system. Incidentally, it should be noted that the Palai bank was not a licensed bank. The Reserve Bank observed both organisational and operational defects of the bank throughout the period of fifties. The
progress report did not show any sign of progress. The condition of affairs of the bank revealed continuous deterioration. Yet the Reserve Bank was silent in the affairs of the bank and that in the interest of the depositors, by allowing the bank to operate. And that was directly responsible for the failure of the Palai Bank.

The failure of the Palai Central Bank and Laxmi Bank dashed all future hopes to the ground. It exposed the hollowness of a series of banking legislations. The long felt legal gap—the compulsion of amalgamation of the weak banks was not filled up. The Amendment Act, 1950 made only amalgamation easy but not compulsory on the part of the weak banks. The Reserve Bank could not initiate any amalgamation. The impact of the Palai failure and the indifferent attitude of the Reserve Bank was seriously felt on the weak and small banks. Had this gap been filled up earlier then the failures of these two banks could easily have been averted.

The sense of urgency of this hour called for a bold effort to make a series of legislative amendments not only to save the interest of the small depositors but also to strengthen the weak joints of the banking system. Legislative amendments had thus been made during the last year of the Second Plan (1) to expedite legislation proceedings of banks, (2) to assert small depositors of the safety of their funds by making them preferential creditors, (3) to provide for the declaration of a moratorium to facilitate the process of compulsory reconstruction or amalgamation of banks and finally (4) to provide for compulsory amalgamation of banks with other banks including the State Bank of India and its subsidiaries. The provisions of these new amendments now gave the Reserve Bank of India a dictatorial power over the banking companies, especially in dealing with the small, sick and uneconomic banks in the country. By the passing of these amendments, the organisational aspect of the monetary policy took a fresh turn. It was thus expected to play a great role in organising and consolidating the structure of the Indian money market in near future.