CHAPTER - VII

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India, in her hoary past, did have a banking system admirably suited to meet the requirements and conditions prevailing in those days. But banking on modern lines in India, an exotic growth, owes its origin to the early European settlers, the agency houses and foreign banks. Indian entrepreneurs too did pioneering work in this field in later years.

The Indian banking system consists of two sectors, the organised and the unorganised. The organised sector is composed of the Reserve Bank of India, the scheduled banks - the State Bank of India and its subsidiaries, the nationalised banks, other Indian scheduled banks and the foreign banks - the non-scheduled banks and the co-operative banks. The unorganised sector consists of money lenders and the indigenous bankers known by different names in different parts of the country.

The Reserve Bank was constituted under the Reserve Bank of India Act, 1934, and started functioning with effect from April 1, 1935. The main functions of the Reserve Bank are the management of money, providing banking facilities to Government, acting as banker to other banks, administration of exchange control, and collection and publications of financial statistics. With economic development assuming a
new urgency, the functions of the Reserve Bank have steadily widened. It now undertakes promotional and developmental activities as well. Accordingly, various specialised agencies have been constituted by the Reserve Bank, such as the Deposit Insurance Corporation, the Unit Trust of India, the Agricultural Refinance Corporation, the Industrial Finance Corporation of India, the State Financial Corporation, the Industrial Development Bank of India, etc. In view of several undesirable features in bank practices and in order to protect the interests of depositors, a comprehensive banking law, known as the Banking Regulation Act, 1949 was passed, conferring extensive powers on the Reserve Bank of India. Thus, at present the Reserve Bank is fully armed with powers to regulate and control effectively the activities of the various constituents of the Indian money market, including the foreign banks. For the control of money and credit in India, the Reserve Bank uses various instruments and powers in its possession such as the bank rate, open market operations, variable reserve ratio, suasion and selective credit control by restricting loans and advances as well as guarantees given by the banks. By making use of all these instruments of monetary and credit control, the Reserve Bank has really assumed leadership of the Indian banking system.

Among the scheduled banks, the State Bank and its subsidiaries and the nationalised banks are the most powerful as a group. The State Bank was formed on July 1, 1955 by taking over the entire assets and liabilities of the Imperial
Bank of India. The emergence of the State Bank of India was an important milestone on the road to the establishment of an integrated commercial banking unit with branches all over the country under effective state control. The achievements of the State Bank and its subsidiaries in the fields of branch expansion, provision of credit to the rural sector and small scale industries are indeed worthy of appreciation.

After the nationalisation of fourteen major commercial banks, the strength of the public sector banks was doubly reinforced. The foreign banks operating in India were, however, not covered by nationalisation. With nationalisation, the public sector in banking accounts for 83 percent of the total deposits of the banking system, 84 percent of total bank credit and 82 percent of the number of branches (Table -1).

During the period from 1969 to 1976, the percentage increase of deposits of the nationalised banks was 228.3 percent. The non-nationalised scheduled banks (excluding the foreign banks) recorded deposit increase by 388.6 percent. The foreign banks, on the other hand, showed 87.4 percent increase in their deposits (Table - 6). During the same period the corresponding percentage increase of advances is 228.6 percent for nationalised banks, 389.6 percent for non-nationalised scheduled banks and 52.2 percent for the foreign banks (Table - 7).

As far as foreign banks are concerned, their perform-
-ance during the period 1969 to 1976 has not been impressive in the matter of percentage increase of deposits as well as advances. Similarly, there has been no branch expansion, the number remaining the same at 130 both in 1969 and 1976.

Non-scheduled banks do not occupy a significant place in the country's banking structure either from the point of view of their number or of their share in the aggregate deposits. In recent years their number shows a declining trend (Table - 10).

As far the unorganised sector, it did play a dominant role in the past as supplier of funds to the agriculturists, small traders and manufacturers. Till the 'Sixtees of the present century, it used to finance the internal trade of India to the extent of 90 percent. But with commercial banks establishing a large number of branches and simultaneously opening their doors to small industrialists and traders, the share and the importance of the unorganised sector have been steadily declining.

II

It may be noted that the Banking Regulation Act of 1949 has been the first ever banking legislation comprehensive enough to cover the entire banking structure in the country. Prior to this, some provisions of the Indian Companies Act of 1913 used to deal with banking activities. In between, a few banking enactments, ad hoc, such as the Banking Companies
Ordinance (Inspection) 1946, and the Banking Companies (Restriction of Branches) Act, 1946, were passed.

The powers of the Reserve Bank over the commercial banks are derived in a large measure from the Banking Regulation Act, 1949 as well as from the earlier Reserve Bank of India Act, 1934. Under the provisions of these two Acts, the Reserve Bank regulates the banking business in India right from the establishment of banks to their final liquidation. It has the sole authority to issue licences, to limit the amount of capital and reserves, to permit branch expansion, to limit liquidity of their assets, amalgamation, reconstruction, to control over management and to give instructions to the banks regarding methods of working. Complete control over the banks, including the foreign banks, in India is exercised by the Reserve Bank through periodic inspections conducted by its own staff and by calling for returns and other necessary information from the banks.

Thus, the Reserve Bank has wide-ranging powers over the banks in India. These powers include every aspect of banking, like capital structure, management, or lending policy. It has used these powers on different occasions to meet the needs of a complex and varying economic situation. In recent years, particularly after nationalisation, control and regulation of the banking system by the Reserve Bank of India have become more effective.
The crucial role played by commercial banks in a country's economic development needs no reiteration. They perform a number of interrelated functions such as custody of the community's money, supply of liquidity, saving and investment. The deposit a bank attracts does not remain with it. The excess funds it has, over the required reserves and cash requirements, are used for loans, advances, cash credit, investment etc., which may finance production, distribution, investment, consumption and the needs of the Government. Credit supplied by commercial banks bridges the time lag between production and consumption. Through the saving process, purchasing power is diverted from current consumption into the market for capital goods. Apart from these essential functions, they render many miscellaneous services to the public. Safe deposit facilities for holding securities and valuables of customers, rendering of financial guidance and other advice to businessmen, exporters and importers etc., are some of the services given by the commercial banks.

Since banks are economic institutions with undeniable social responsibility, there is naturally a political aspect to the questions of their objectives, ownership and management. Due to these and other reasons, some people demanded nationalisation of all commercial banks including the foreign banks. On this vital point academicians, bankers, industrialists, political leaders and workers joined issue. Several charges
were levelled against the commercial banks. Among the major allegations, the following were mentioned to justify nationalisation - their indifferent attitude towards the nationally approved priority sectors, diversion of funds towards speculation and hoarding of essential commodities, encouraging concentration of wealth and economic power, non-expansion of branches in rural areas and backward states, mismanagement and failure to mobilise effectively the community's savings. The foreign banks too were under attack for various malpractices.

There was, however, a feeling in some quarters that social control, rather than outright nationalisation, of commercial banks could remedy the situation, specially because the Reserve Bank had enormous powers which could be used to discipline the erring units. But the majority of the Parliament members expressed preference for nationalisation of the major commercial banks. For reasons stated elsewhere in this chapter, the foreign banks were not nationalised.

Now that the nationalised banks have been in operation for about 8 years, we are in a position to attempt an objective appraisal of their performance. This has been done in Chapter III of the dissertation. It may be said to the credit of the nationalised banks that they have achieved spectacular success in branch expansion, in mobilising savings and in financing the priority sectors including agriculture and exports. It is doubtful whether all these would have been possible, without nationalisation, in such a short period.
One important group of banks left out of the purview of nationalisation is that of foreign banks. The Government wisely decided not to nationalise them. Our foreign trade needs to be diversified and expanded. In this important task, these foreign banks can provide valuable assistance. The foreign banks are able to serve the country's export-import trade and industry well because of their global affiliations and connections with the major financial, industrial and commercial world centres. They can provide a meeting ground for Indian and foreign businessmen for facilitating and encouraging business collaboration, not only in India but in other countries also. They can be used as a channel for securing valuable foreign exchange and for promoting tourism. Nationalising foreign banks would produce international repercussions and provoke retaliatory measures which we can ill-afford in the prevailing context. Malpractices alleged against these foreign banks could be minimised and even effectively curbed by the Reserve Bank under whose supervision they operate in the country.

IV

A brief reference to the origin and history of foreign banks in India may be in order. Banking on European lines is comparatively of recent growth in India. Indigenous banking, however suited to the needs of the country, could not satisfy the needs of the English trader. While the East India Company and the English traders required some machinery to satisfy
their credit needs, they could not make use of the indigenous system. They, on their side, were not conversant with the language of the indigenous bankers, while the bankers had no experience of the finance of foreign trade. In order to overcome this difficulty, English Agency Houses were established in Calcutta and Bombay which took upon themselves the business of banking in addition to their commercial and trading activities. These agency houses worked as bankers to the East India Company and became the agents for the whole civil and military services and also for the European planters and merchants settled in the country. All these banks chartered by the East India Company failed owing to mismanagement, speculation and fraudulent use of bank funds, although they were managed entirely by Europeans. Over and above the banks under charters of the East India Company, there was another group of banks known as the Presidency Banks, which were established under Acts of Indian legislature. There were three Presidency Banks, the Bank of Bengal, 1806, the Bank of Bombay, 1840, and Bank of Madras, 1843. These were later, in 1920, amalgamated into the Imperial Bank of India.

In addition, a number of foreign banks with head offices abroad have carried on business in India through branches. They are all incorporated outside India. Their beginning dates back to the Oriental Banking Corporation in 1842 under Royal Charter, which failed in 1884. Two more banks under Royal Charter were established in 1883, the Chartered Bank of India, Australia and China and the Chartered
Bank of Asia. The Chartered Bank of Asia had to relinquish its Charter in 1893 and reconstruct itself under the English Companies Act as the Mercantile Bank of India. At present the only bank under a Royal Charter is the Chartered Bank of India. The profits these banks made naturally attracted other countries having trade relations with India to start their own banks for promoting their foreign trade and for providing facilities to their nationals. Banks belonging to different countries like England, France, Holland, America, Japan, Pakistan and Bengla Desh are, at present, operating in India.

Financing of foreign trade has been the main objective of these foreign banks. The financing of foreign trade consists of two operations, namely, the financing of the movement of goods from Indian ports to foreign ports or vice versa, and the financing from, or to, the Indian ports to, or from, the distributing or collecting centres. The financing of foreign trade used to be the monopoly of foreign banks till the 'fifties of the present century. Although there was no bar on the financing of foreign trade by Indian banks, they were not successful in this due to paucity of capital resources, want of access to the London money market and lack of trained personnel. Their resources were fully employed in internal business. Until 1935 the Imperial Bank was prevented by law from dealing in bills of exchange payable outside India. As a consequence the foreign exchange business remained practically a monopoly of the foreign banks.
Although originally the foreign banks were started with the object of handling of foreign exchange and financing of foreign trade, in course of time, these two operations became a smaller and less profitable part of their activity. While the foreign banks had near monopoly in the financing of foreign trade, they have not hesitated to compete keenly with the Indian banks in financing local and internal trade. Finance of foreign trade, both in theory and practice, is concerned only with import and export of merchandise between port and port but not with the distribution of imports into the interior or collection of exports from the interior. The practice of foreign banks in India evidently included both.

The activities of foreign banks in India were severely criticised by various witnesses who appeared before the Central Banking Enquiry Committee. To mention a few of them: the foreign banks drain away resources from India; the deposits in India are invested in foreign countries; they discriminate between Indian and European traders; they promote trade in raw materials; Indians cannot rise to responsible positions or hold superior posts in them; poor references are given about Indian customers so that D.A. (Documents on Acceptance) terms are not granted; they do not come to the aid of Indian banks in emergencies; they do not give reliable information about foreign markets and prices. At the present moment, most of these charges have only a historical significance, for, since the passing of the Banking Regulation Act and later
the nationalisation of major banks, the situation has changed radically.

Prior to the establishment of the Reserve Bank of India in 1935, there was no provision, statutory or otherwise, which laid an obligation on the foreign banks to furnish to any authority in India any figures relating to their business in India. These banks were not subject to any legal restriction in India, even to the statutory obligation to which the other Indian joint-stock banks have been subject. Their directors and shareholders being entirely foreign, control over them was exercised from abroad. Even the balance sheets supplied to Government once a year were apt to be misleading owing to the lumping together of Indian and non-Indian business. The result was that the activities and affairs of the foreign banks remained more or less a closed book to the public and even to the Government of India.

V

The deposits of foreign banks have grown very rapidly over the years from 1870 to 1975. The deposits increased from Rs. 52 lakhs in 1870 to Rs. 86654 lakhs in 1975 — in the course of about a century. The First and the Second World War years witnessed noticeable spurts in the banks' deposits. An analysis of the growth of deposits of banks belonging to different countries shows a clear dominance of the British banks over the others followed by those of America, Japan,
France and Holland in that order. When the deposits of British banks rose from Rs. 283.7 crores in 1965 to Rs. 543.2 crores in 1973, those of Holland rose from Rs. 4.1 crores to Rs. 14.1 crores during the same period. The growth of deposits of all foreign banks has been gradual except for the year immediately following nationalisation. During the period from 1960-61 to 1974-75, the demand deposits of foreign banks increased by less than 3 times, while time deposits increased by more than 4 times. As against this, the demand deposits of Indian scheduled commercial banks increased by 7½ times and time deposits by 7 times during the same period.

Although there has been a tremendous increase in the deposits of all commercial banks in India after nationalisation, the rate of growth is the lowest in the case of foreign banks. The percentage increase of deposits in 1976 over 1969 is just 87.4 percent in the case of foreign banks whereas that of public sector banks is 223.3 percent and of other Indian scheduled banks 382.6 percent during the same period. This evidently shows the growing confidence of the Indian public in their own scheduled banks.

The liquidity position of foreign banks measured in terms of loan-deposit ratios is quite comparable to those of Indian scheduled commercial banks. Although the loan-deposit ratio is important, a more significant one is the ratio of short-term assets - assets maturing within one year - to deposits. This ratio would indicate the amount of funds still
readily available to the bank to meet deposit withdrawals or to make additional loans. In terms of the ratio of short-term assets to deposits, the foreign banks are in a definitely better position than the Indian scheduled banks. In the case of foreign banks this ratio varied, except during 1965-66, between 21 percent and 31 percent; whereas in the case of Indian scheduled banks, the ratio varied between 17 to 23 percent. It shows that the foreign banks are in a better position than the Indian scheduled banks to meet any emergency such as sudden deposit withdrawals or demand for additional loans by their clientele.

As far as the investment policy of the foreign banks is concerned, the lion's share of the excess funds with them is invested in Government and other approved securities. A very small, almost negligible amount is invested in 'other investments'. While the foreign banks' investment in Government securities shows an upward trend, that of Indian scheduled banks shows a downward trend. Only the absolute minimum is invested in Government securities by the Indian scheduled banks. Even though the return is low, the foreign banks prefer Government and other approved securities because the risk element is the least.

The most important item on the assets side is the loans and advances. It increased from Rs. 189.32 crores in 1960-61 to Rs. 443.25 crores in 1974-75. But bills purchased and discounted, inland and foreign, were only to the tune of
Rs. 44.64 crores in 1960-61, which rose to Rs. 120.86 crores in 1974-75. This clearly shows that their main business is internal trade.

Another interesting and significant development is in the matter of financing of foreign trade. Foreign banks which had a near monopoly in this field have been, in recent years, relegated to the background. Whereas the foreign bill purchased and discounted by the Indian scheduled banks increased during the period 1960 to 1975 by nearly about 11 times, those of the foreign banks recorded an increase of less than 3½ times. Similarly, in the case of handling of inland bills as well, Indian scheduled banks show an increase of more than 8 times while that of the foreign banks' is less than 3 times. While Indian scheduled banks handled foreign bills worth Rs. 321.86 crores in 1974-75, the share of the foreign banks was only Rs. 62.03 crores.

In the matter of investment of funds in premises and immovable property, foreign banks in general have not evinced much interest, except for banks of British origin. Japanese banks have no premises of their own although they are among one of the oldest. Even American banks have invested only a very paltry amount. This may be because locking up of funds for business premises may not be a sound business proposition, although these are regarded as secret reserves.
VI

A brief statement relating to the earnings, expenses and profits of foreign banks may be made. Bank earnings have been increasing in recent years but increasing expenses have nearly kept pace with earnings. The foreign banks derive their income primarily from loans and advances, and then from purchasing and discounting of bills, investing and to a lesser extent from other sources. Current operating earnings increased by 92 percent during the period 1966-73, while current operating expenses increased by 88 percent. On the side of expenses the largest item is interest on deposits followed by establishment expenses. Establishment expenses increased by 88 percent during the period. Taxes on profits increased by 142 percent and employees' share by way of bonus increased by 122 percent. During the period the amount remitted to Head Office recorded an increase of 50 percent.

Bank group-wise, the percentage variation of earnings is the highest in the case of 'other Indian scheduled banks', followed by the public sector banks. The percentage is the lowest in the case of foreign banks. On the other hand, in the matter of percentage variation in expenses, the top position is held by foreign banks, followed by the public sector banks and the 'other Indian scheduled banks' in that order (see Table - ). This advantage in the matter of expenses is explained by the facts that the number of their
branches has remained constant, that their clientele is mainly constituted of big business houses and concerns and lastly that they generally undertake large-scale transactions.

The profits of all scheduled commercial banks show an increasing trend. During the period 1970 to 1975, the performance of private sector Indian scheduled banks has been the best. Percentage increase of profits in 1975 over 1970 is 182.4 percent for private sector Indian scheduled banks, 139.9 percent for the State Bank group, 121.1 percent for the nationalised banks and only 100.7 percent for the foreign banks (Table - ). The comparatively poor performance by the foreign banks is conclusive proof of the stiff, keen competition put up by the Indian banks in recent years.

In conclusion, it may be said that the foreign banks were established in this country primarily to serve the economic interests of the foreign rulers. As they expanded their activities, new ideas on the subject spread in the country stimulating local enterprise in modern banking. True, the early foreign banks earned huge profits and 'drained' the country's resources. This became possible because at that time there was no banking legislation to regulate their activities and to curb malpractices. With the establishment of the Reserve Bank in 1935, the country was enabled to gain control over their functioning. The Banking Regulation Act of 1949 further strengthened the power of the Reserve Bank to superintend the activities of all kinds of organisations
doing banking business. Under the new Act, the foreign banks are treated more or less on the same footing as the other Indian scheduled banks. An interesting feature of these foreign banks is that they are competing with the Indian banks not only in the financing of the country's external trade but also of the internal trade as well, though their share in both cases has been rather small. The Central Government rightly decided not to nationalise the foreign banks in 1969. There is no fear now of the repetition of the evils associated with such banks in the past. The Indian public is depositing more and more of its savings in Indian banks rather than in foreign banks, showing thereby that foreign banks hold no special attractions for the Indian depositors. The Government and other approved securities account for the bulk of their investments. These banks have also been promoting tourism and facilitating foreign collaboration with Indian entrepreneurs. It seems desirable that we should in our own interest, encourage the opening of more foreign banks in the country on reciprocal basis. As our economic and trade relations with the countries in Asia, Africa and Latin America expand, we would need the assistance of banks representing these countries. We should, therefore, induce the developing countries to set up their banks in India on the basis of reciprocity. The Reserve Bank should, however, ensure that information on all aspects of the working of the foreign banks is regularly published.