CHAPTER 3

BRIEF HISTORY OF BANKING IN INDIA PRIOR TO 1969
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The Indian banking system has undergone major changes in the past fifty years. Structural, financial and geographical changes have been taking place in Indian banking system. The banking activity has now reached the common people. When we trace back the history of Indian banking system, we observe that Indigenous Bank was an old form of Indian banking system.

Money-lending operation in India was found in the Vedic period i.e. 2000 to 1400 B.C. In the Buddhist period, ample evidence of the existence of sresthis or bankers has been obtained. They were mainly engaged in lending money to traders, to merchant-adventurers for going to foreign countries, to explorers to extract valuable materials from forests and to kings for meeting financial difficulties due to war or other reasons against the pledge of movable or immovable property or personal surety.

According to the laws of Manu it is observed that when people realized the importance of money-lending and allied problems, deposit banking in some form was created.

It is known from the writings of few Muslim historians, European travelers, State records and the Ain-i-Akbari that under the early Muslim and Mughal rulers in India indigenous bankers played a major part in lending money, financing internal and foreign trade and giving financial assistance to rulers during periods of stress.

During the Mughal rule, the business of money-changing became profitable for indigenous banking by the issue of various kinds of metallic money in different parts of the country.

The indigenous bankers were usually known as kothiwals, sarafs, shroffs, seths, chettis or mahajans. They varied in their size from petty money-lenders to substantial shroffs who carried on large and specialized business. Generally they were of three types—(a) those whose entire or principal business was banking (b) those who combined their banking business with trading and commission business and (c) those who were mainly traders and commission agents but who did a little banking business also. Their business
was generally a family concern: They employed their own working capital. They granted
loans against all kinds of securities such as gold, jewellery, land, promissory notes,
hundies etc. They also lent against personal credit of the borrowers. They also bought and
sold remittances and discount hundies.

But the indigenous bankers, however, could not achieve performance in the system
of obtaining deposits regularly from the public and paying interest on them because
majority of them combined trade with banking business and their capital engaged in
banking could not be distinguished from that engaged in trade. This combination reduced
the stability of their banking business which resulted in an unfavorable reaction upon
banking development in India.

During the 17th Century English traders came to India. But they could not make
much use of the indigenous bankers because they ignored language of indigenous bankers
and indigenous bankers had no experience about the English trade. Although the East
India Company established connections with these bankers, borrowed funds from them
and for the first few years collected a portion of the land revenue through them, the
English Agency Houses in Calcutta and Bombay began to conduct banking business
besides their commercial business. From this time, the business and power of the
indigenous bankers began to wane, although the East India Company successfully
prevented the establishment in India of banking on Western Lines for a considerable time
on the ground that the agency houses and the indigenous bankers were more suited to the
banking requirements of the country.

The continuous warfare and chaos resulting from the break-up of the Mughal
Empire hampered the activities of indigenous bankers. Further, after the establishment of
a uniform currency in 1835 they lost their profitable money-changing business. With the
development of railways, steamships, post and telegraph, pattern of trade of India
changed that affected their business adversely. In regard to their banking business they
still continued their antiquated methods, kept accounts according to the vernacular
system. Decline of the indigenous bankers and the gradual expansion of English trade and
power in India compelled the East India Company to establish banks on Western lines in
India. As a result, such banks and Government treasuries came to be established.
Indigenous bankers with reduced resources and a smaller scale of business could not able to compete with the commercial banks. Therefore, they had to give place to them.

In spite of the progress of the joint-stock banks, indigenous bankers still carried on a large amount of banking business throughout India. Because, area of work of joint-stock banks was restricted to metropolitan areas and important commercial centers. But work of indigenous bankers was still concentrated in rural areas. In spite of rural banking expansion programme of the nationalized commercial banks, agriculture and the internal trade in rural areas are still dependent to a large extent upon the services of the indigenous bankers. Many of them also serve as middlemen between the internal traders and the banks, issuing and discounting the bills of exchange.

The English agency houses in Calcutta and Bombay were mainly concerned with trade. In fact, they were shop-keepers, proprietors of breweries, tanneries, distilleries, cotton, flour and saw-mills etc. Like the indigenous bankers they combined banking with trading. Most of the agency houses were organized by foreigners employed in civil or military services in India.

With the increase in their banking business, many agency houses started commercial banks, more or less of the modern type. Most of these banks were established on the basis of unlimited liability. They conducted ordinary banking business, financed internal trade and issued notes.

The first joint-stock bank under European management in Calcutta known as the 'Bank of Hindustan' was established in 1770 by Alexander & Co., one of the leading Agency Houses. This was the first bank to issue notes. This bank went into liquidation in 1832 with the fall of the Agency House of Alexander & Co.

'The Bengal Bank' and 'the General Bank of India' were established about 1785 and chartered by the East India Company. 'General Bank of India' was voluntarily liquidated in 1791 owing to inability to earn profits. 'Bengal Bank' failed a little later owing to a severe run upon it caused by the temporary reverses inflicted upon the company by Tipu Sultan.

Thereafter, East India Company established three Presidency Banks in India. 'The Bank of Bengal ', the first of the Presidency Banks was established in 1806 as 'the Bank
of Calcutta’ and received its charter as ‘the Bank of Bengal’ in 1809. It facilitated East India Company to borrow from it and the operations of the English traders. The company contributed one-fifth of the banker’s capital of Rs. 5,00,000 in order to keep it within safe limits and obtained the right to appoint three of its directors. The charter imposed certain restrictions on its working. In 1823 it was allowed to issue notes and in 1839 to open branches and to deal in inland exchange but not in foreign exchange.

Other two Presidency Banks ‘the Bank of Bombay’ and ‘the Bank of Madras’ were established in 1840 and 1843, with a share capital of Rs. 50 lakh and Rs. 30 lakh respectively. East India Company contributed Rs. 3 lakh in each case and obtained the right to appoint some of their directors. Their secretaries and treasurers were members of the I.C.S. Both the banks had right to issue notes in their respective regions. The bulk of the shares of all these three banks were subscribed by Europeans. In 1862 Government took over the right of note issue of these banks and gave the use of Government balances in the Presidency towns free of charge to them as compensation.

Several restrictions were imposed upon all the three banks as per The Presidency Banks Act to protect the interests of Government and the public. Chief restrictions were as follows: They were prohibited from (i) dealing in foreign bills and borrowing abroad (ii) lending for more than six months and (iii) lending on the security of immovable property. These restrictions undoubtedly increased their stability and in spite of these restrictions the banks showed much vitality and power of expansion.

The Presidency banks established branches at many important trade centers in India, but lack of contact was found between them. It was felt strongly that there should be only one bank of this kind for the whole country. In 1898 some witnesses before the Fowler Currency Committee proposed the establishment of a Central Bank, but the Government of India under Lord Curzon refused to implement the proposal. The Presidency Banks themselves desired to retain their individuality and were opposed to amalgamation. However, Chamberlin Currency Commission of 1913 appointed a small expert committee in India to examine the situation. It was observed that the country had no co-ordinated banking policy and each bank conducted its business entirely in its own way without any control of a central institution. But the banking crisis of 1913-17 would
defect and endanger India’s free banking system. During the later part of the war Presidency Banks realized that there should be co-operation and co-ordination in the banking policy and also realized that if they remained as isolated, one of the big five English Banks or Japanese or American banks would influence and predominate over the financial system of India by amalgamating with or absorbing some of the banks in India. Therefore, Presidency Banks and Government withdrew their opposition against amalgamation. Imperial Bank of India Act, 1920 amalgamated these three Presidency Banks into the ‘Imperial Bank of India’ in 1921. It had right to hold government funds and manage the public debt and not to issue currency. The branches of this bank were performing their functions as clearing houses.

After the enactment of Act of 1813, the English Agency Houses established several banks on the basis of unlimited liability. They conducted ordinary banking business, financed internal trade and issued notes. But most of them failed during the crisis of 1829-33 owing to the combination of banking with other business and speculation, mismanagement and fraudulent use of their funds despite company’s assistance and being properly managed by Europeans during the crisis. In 1860, an Act had given permission to joint-stock banks to start on the basis of limited liability. But they also failed. Further, the currency confusion during 1873-93 caused trade uncertainties and created an atmosphere unfavorable to the establishment of new banks. Consequently, between 1870 and 1894, only seven new banks were started, out of which four survived. The most important bank ‘Oudh Commercial Bank’, first purely Indian joint-stock bank was registered in 1881 with head office at Faizabad and came into existence in 1889. ‘The Allahabad Bank’, the oldest among Indian banks was set up in 1865 with European management. During the last part of 19th Century and early phase of 20th century, a number of banks under Indian Management were established as a result of Swadeshi Movement. For example, ‘The Punjab National Bank’ in 1895, ‘The Peoples Bank’ in 1901, ‘The Bank of India’ in 1906, ‘The Canara Bank’ in 1906, ‘The Indian Bank’ in 1907, ‘The Bank of Baroda’ in 1909, ‘The Central Bank of India’ in 1911 and many other banks were established on the same line. But most of the weak banks became bankrupt due to wrong policy decisions taken by the management and severe banking crisis during
1913-18. Such as 'The Peoples Bank', the 'Indian Specie Bank', 'The Bengal National Bank', 'the Credit Bank of India', the 'Bombay Merchants' Bank', the 'Standard Bank of Bombay' and the 'Bank of Upper India' etc. went into liquidation. However, stronger and well managed banks survived during the crisis. An important point to be noted is that no commercial bank was established during the First World War but about twenty commercial banks came into existence after independence. 'The United Bank of India' was formed in 1950 by amalgamating four existing commercial banks.

It has been said earlier that in 1921 three Presidency Banks were amalgamated to form the 'Imperial Bank of India'. It was hoped then that the Imperial Bank should gradually be developed into a full-fledged Central Bank. In fact, it performed certain central banking functions such as banker to Government. But after the establishment of Reserve Bank it ceased to function as a central bank. It functioned purely as a commercial bank.

On the basis of the recommendation of the Hilton Young Commission of 1926, the Reserve Bank of India Act was passed in 1934 to establish a Central Bank in the country as a share-holders’ bank. Reserve Bank of India commenced its operations on 1st April 1935. It was originally constituted as a private shareholders’ bank with a fully paid-up share capital of Rs. 5 crore. In order to bring integration between its policies and those of Government it was nationalized on 1.1.1949.

Revolutionary changes were found in the Indian banking structure after Second World War. Many banks began to open branches in different places. The banks started investing funds on government securities. But till the time of independence, Indian banking system was not sound even if there were hundreds of small banks under unscrupulous management. In this situation, a separate Act i.e. legislature framework for the banking sector was considered to be necessary in order to establish a sound banking system in the country. In 1949 Banking Regulation Act was passed with a view to restructure commercial banks in India. For the first time, the Act introduced the licensing system for banking business. This Act gave extensive controlling powers to the Reserve Bank of India and the Government over the commercial banks. It had laid down rules and
regulations for the opening of banks, their branches and minimum capital required for opening a bank etc.

In 1955, the State Bank of India Act was passed. Rural Credit Survey Committee recommended that the Government should establish a strong state-owned commercial bank which would undertake rapid expansion of banking facilities in rural areas. For this purpose, it suggested the Government to nationalize the Imperial Bank and other state associated banks. Imperial Bank of India was nationalized in 1955 according to the recommendations of this committee. Its about 92% shares were acquired by the RBI. The State Bank of India (Subsidiary Banks) Act was passed in September 1959, enabling the State Bank of India to take over eight state-owned or state-associated banks as its subsidiaries. The eight subsidiaries of State Bank of India were as follows: (i) The State Bank of Bikaner (ii) The State Bank of Jaipur (iii) The State Bank of Indore (iv) The State Bank of Mysore (v) The State Bank of Patiala (vi) The State Bank of Hyderabad (vii) The State Bank of Saurashtra and (viii) The State Bank of Travancore.

In 1963, the first two banks were amalgamated under the name of ‘The State Bank of Bikaner and Jaipur’. Under a statutory obligation the SBI and its associate banks had to open new offices in semi-urban and rural areas and even in those sections of people which were never still served by the modern banks. This attempt proved to be fruitful judged by increasing quantum of deposits of commercial banks.

It was observed that considerable progress in deposit mobilization of commercial banks has taken in this period. Finally, in order to protect depositors, Government took an important step by setting up the Deposit Insurance Corporation on January 1, 1962. It enhanced the confidence of the people on banks and helped in the mobilization of more and more deposits.