CHAPTER 6

MIXED BANKING

6.1 COMMERCIAL BANKS AND INDUSTRIAL FINANCE

Finance and the institutions purveying it act as a bridge between those who require access to savings and those who supply savings even as the use of money facilitates transactions among groups of people without coincidence among their wants. Money extends the boundaries of the market beyond the narrow limits of barter and loaning of money adds a new dimension in time to the multilateral growth of the exchange economy. The role of commercial banks is not confined to the mere acceptance of savings and their transmission to those who are in a position to use them for acquisition of capital assets; they are also the main instruments of credit creation. Though banks act as a repository of savings of the community, they are not merely safe deposit vaults for the savings. They also create deposits in the process of their lending operations.

This is possible by what is known as the 'fractional reserve system' under which a bank keeps a certain proportion of the deposits it receives as cash and the remaining is lent out and in due course accrues again as deposits with the same or another bank. The continuance of this system ultimately leads to the phenomenon of 'multiple credit creation'. In the developing countries, in the beginning stages, the use of
bank deposits as a mode of payment is less important, but as
development proceeds, the importance of bank deposits tends
to grow. The capacity of commercial banks to create credit,
in the words of Professor Schumpeter, makes them 'essentially
a phenomenon of development'.

Commercial banks as an important part of the network of
financial intermediaries assist in the more efficient use of
available savings. Since banks have to pay for the accrual
of deposits by way of interest, they are in constant search of
more profitable channels of investment, so that their net
earnings are maximised. The predominant part of the facilities
of commercial banks are extended to large scale industry and
trade and a comparatively small part of their credit goes to
such vital sectors as agriculture and small scale rural
industries. These basic sectors depend for their long, medium
and short term credit requirements largely on the unorganised
credit market where the rates of interest charged on funds are
usually exorbitant. In India, the rates charged by money
lenders are in the range of 18 to 24 per cent. The high
dependance of these important sectors on the unorganised agencies
for their credit requirements acts as an obstacle to growth.

"Commercial banks have to refashion in several ways their
functions and outlook, if they are to be effective partners in
the process of growth. The main function of commercial banks,
as evolved out of the traditions of British banking remains
that of lending for short term working capital purposes. While this orthodox basis of commercial banking functions derives logically from the nature and structure of deposits of banks, which are withdrawable at short notice, banking operations need not be confined to short term lending only, particularly in the developing countries. There is a general shortage of capital in such economies, but capital for medium and long term purposes is even more scarce than that for short term.

The essence of the system of mixed banking is the provision by the commercial banks of short term, medium term and long term capital to the industries. This practice of the banks financing industries has got its own merits and demerits. "Banking history provides two different examples in this connection. On the one hand, British Banks have stayed off from the provision of long term finance for all the time, insisting that banks should restrict their role strictly to the provision of short term credit. On the other hand, in continental countries, especially Germany, banks have provided all sorts of assistance to the development of industries. This however does not mean that there are two different theories of banking, but only reflects the different order of events.


in economic history on the two sides of the Channel\textsuperscript{3}. The example of Germany has amply demonstrated that industrial financing can be resorted to by the commercial banks without any serious risks and that the mixed system of banking is not altogether incompatible with sound banking principles. From the point of view of the banks, it is but proper that they should have a well balanced portfolio of loans. Short term loans of banks should be coupled with the granting of loans to industry for their modernisation and expansion\textsuperscript{4}.

The main line of argument advanced against mixed banking by the bankers is that concerning their liquidity position. We may recollect here that the banks have the onerous duty of striking a balance between the two opposing canons of liquidity and profitability. The banks in general will find it difficult to carry on business, if a considerable portion of their assets are locked up in long term investments. There is much truth in the statement that if they resort to long term financing and that too on a large scale, their liquidity position will be at stake. As Prof. Basu observes, "The policy of long term investments is apt to be frequently carried beyond the limits of prudence. The banks will then be placed in a hopelessly unliquid position"\textsuperscript{5}. This is more true in a period of


\textsuperscript{4} Report submitted by E.M. Bernstein and others: "Economic Development with Stability". (Refer Ch. V on 'Bank Credit and Resources'.

\textsuperscript{5} S.K. Basu: "Industrial Finance in India". p. 103.
depression, during which period, there is even the possibility of their assets becoming frozen and unrealisable. This precipitated bank failures in many countries during the twenties and thirties, resulting in the Government stepping in and introducing legislative prohibitions and restrictions against the banks combining deposit with investment banking.

This should not lead us to the conclusion that banking should not be of the mixed type. The only thing to be remembered here is that it should not be carried too far, so as to make the banks shoulder heavy responsibilities and undertake serious risks. As the Macmillan Committee would feel, the financial and industrial worlds should be closely integrated through appropriate organisations.

Sir George Erskine, in his Presidential address to the 'Institute of Bankers' in 1955 suggested that the British banks should undertake some industrial financing as a sideline to their 'bread and butter' business. This eminent British banker has come forward with a threefold suggestion, which should form the cornerstone of the future policy of bank lending in that country. Firstly, the banks should render assistance in the marketing of new issues. This is done by banks directly participating in the sub-underwriting of new issues. Secondly the banks should widen the range of industrial activity with special reference to the amount of bank advance and the period for which it is made, e.g. following the examples of the United
States of America, they may begin granting term loans. Thirdly, the banks should widen their investment policy, so that they can take new issues of debenture stocks and preference shares. 'Mutatis Mutandis', these suggestions may well be followed by banks in other countries as well. Again Lord Bruce, Chairman of the Finance Corporation for Industry Ltd., expressed himself in favour of some departure from the existing practice of banks, by making available medium and long term credit to industry.

Banks in India like their counterparts abroad, follow the practice of rolling over a substantial part of their advances — while most of the credit is made on demand basis, a fair proportion of it is in effect allowed to run for considerable periods either through not being recalled or if recalled, through constant renewals. This implies that the basic character of much of the short term credit is not very different from that of formal term credit. Where short term credit is in fact performing the same function as medium term credit e.g. financing expansion of a plant which is expected to repay itself over a term of a few years, a formal term loan has the advantage of regular repayment of instalments and recurrent cash inflow, into the bank as the function of credit in financing expansion is fulfilled. As such, a formal term loan is a more appropriate method of financing than credit

6. Vide the Eleventh Annual General Meeting held on 26th July 1956.

7. In U.K., for example a lot of medium term and even long term advances by banks go as short term lending.
which though short term, in form, is in effect, medium or long term.

It appears therefore that it would be a worthwhile exercise for commercial banks to examine their credit portfolios and to the extent possible adapt the form of some of their loans to the purposes they fulfil. That a moderate amount of medium term lending constitutes no threat to the stability of commercial banking is also indicated by considerations pertaining to the nature of resources of commercial banks. Most deposits of commercial banks are short term and individual deposits are in fact being constantly drawn upon and even withdrawn. But the total volume of deposits at the same time, normally tends to rise steadily; and the proportion of term deposits as against demand deposits has also been on the increase in several countries. Banks therefore need not look upon the tenure of loans as such as affecting the quality of their advances portfolios. In this context, we may recollect that the Refinance Corporation has helped the primary lending institutions to replenish their resources in respect of a part of their medium term lending.

Commercial banks' direct participation in long term lending is likely to remain limited in many developing countries owing to the increasing vogue of specialised long term lending agencies termed, development banks. Commercial banks may contribute to the share capital of these institutions along
with Government, the central bank and insurance and other institutions. "A weakness of the capital market in less developed countries is the absence of specialised institutions or adequate facilities for the underwriting of new issues. Though this function is essentially to be undertaken by specialised financial institutions and other persons with the necessary expertise and knowledge e.g. stock exchange brokers commercial banks too can assist in rendering this vital service to the new entrepreneur by sharing in the growing business of this type and thereby help in filling an important lacuna in the financing mechanism in developing countries."^8

The link up of commercial banks with the specialised institutions is significant, as it marks a step towards integration of the short term money market as represented by commercial banks with the long term capital market and towards a more effective and responsible coordination of movements of rates in the two markets. Commenting on this subject, the Committee on 'Finance for the Private Sector' rejected the suggestion made, that commercial banks should be prepared to undertake long term finance of industries, provided in case of need they can obtain loans from the Reserve Bank of India against such advances. "The Committee is definitely of the opinion that commercial banking practice has proved sufficiently helpful in providing finance to industries within the limits

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of the resources available today to banks in India.\(^9\)

According to this Committee, banks in India should try in an indirect manner to make increased finance available to the private industrial sector, and this can be done in any one or more of the following methods:

(a) by taking up shares and debentures of first class industrial concerns to a greater extent,
(b) by making larger advances to approved parties against such shares and debentures and
(c) by subscribing to a greater extent to the shares and bonds of the industrial and state finance corporations.

Among other things, the Committee came forward with the suggestion that banks in cooperation with the then insurance companies should form "a consortium or syndicate for underwriting or investing in new issues of shares and debentures of industrial companies wherever they are satisfied about the soundness and prospects of the projects.\(^10\) This is a matter which deserves further attention.

10. Ibid. P. 49.
5.2 SCHEDULED BANK ADVANCES TOWARDS INDUSTRIES: AN ANALYSIS:

Scheduled bank advances in general rose by Rs. 230 crores or nearly by 12 per cent during 1965. The magnitude of the rise during 1963 to 1965 was of the order of Rs. 484 crores; the major part of the rise (76%) being on account of advances to industry which rose by Rs. 366 crores to Rs. 1287 crores as on March 31, 1965.

The average annual rate of increase in industrial advances at 19.9 per cent during 1963-64 and 1964-65 was somewhat above that for bank credit as a whole (at 15 per cent). Consequently, the share of industry in total advances rose from 57.2 per cent at the end of March 1963 to 61.5 per cent as at the end of March 1965. The bulk of the remaining advances was concentrated in the commercial sector. This is seen from the Table No. 5.1.

A breakdown of advances to each of the principal sectors points out that out of this total rise of Rs. 366 crores in industrial advances between 1963 and 1965, the major part was absorbed by the textile and engineering groups. Within the textiles group, advances to the cotton textile industry accounted for over half (Rs. 50 crores). The total scheduled bank advances to the cotton textile industry outstanding at the end of March 1965 were over Rs. 247 crores which was 12 per cent of total bank credit and nearly one fifth of total advances to industry. Advances to the Jute industry rose by Rs. 15 crores, to Rs. 64 crores. Advances to the engineering industry rose
Table No. 5.1

SECTOR WISE CLASSIFICATION OF SCHEDULED BANKS' ADVANCES

(Amount in Crores of Rs.)

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>March 1963</th>
<th>March 1964</th>
<th>March 1965</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>% to Total</td>
<td>Amount</td>
</tr>
<tr>
<td>1. INDUSTRY</td>
<td>921</td>
<td>57.2</td>
<td>1104</td>
</tr>
<tr>
<td>2. COMMERCIAL</td>
<td>444</td>
<td>27.6</td>
<td>487</td>
</tr>
<tr>
<td>3. FINANCIAL INSTITUTIONS</td>
<td>84</td>
<td>5.2</td>
<td>99</td>
</tr>
<tr>
<td>4. AGRICULTURE</td>
<td>4</td>
<td>0.3</td>
<td>9</td>
</tr>
<tr>
<td>5. PERSONAL</td>
<td>99</td>
<td>6.1</td>
<td>102</td>
</tr>
<tr>
<td>6. PROFESSIONAL</td>
<td>12</td>
<td>0.8</td>
<td>12</td>
</tr>
<tr>
<td>7. ALL OTHERS</td>
<td>46</td>
<td>2.8</td>
<td>52</td>
</tr>
</tbody>
</table>

TOTAL OF 1 TO 7 1611 100.0 1865 100.0 2095 100.0

Notes: Figures may not add up to the total in this and the subsequent table due to rounding off of figures.

sharply by Rs. 108 crores from Rs. 196 crores as on March 31, 1963 to Rs. 304 crores as on March 31, 1965, at which level it formed 15 per cent of total bank credit and nearly one fourth (24%) of total bank credit to industry.

Table No. 5.2, presents data in respect of industrial and commercial advances classified according to the type of borrowers. It may be observed therefrom that as in the previous years, advances to limited companies formed the major part (62.8%) of total industrial advances. The share of 'partnerships and others' amounted to 12.6 per cent. The share of the state owned and state managed industries rose to 4.4% from 3.9% a year ago and 2.9 per cent two years ago, the rise in absolute terms in these advances being substantial from Rs. 27 crores in March 1963 to Rs. 56 crores in March 1965.

As regards commercial advances, the major part (68.9%) was outstanding on account of 'partnerships and others'; advances to limited companies formed 27.9 per cent of the total commercial advances. Advances to the agricultural sector which had risen from Rs. 4 crores as on March 31, 1963 to Rs. 9 crores as on March 31, 1964, declined to Rs. 4 crores as on March 31, 1965. Personal loans stood at Rs. 109 crores in 1965 showing an increase of Rs. 10 crores over the level as on March and 1963. As a percentage to total bank advances, they stood at 5.2 per cent compared to 5.5 per cent a year ago and 4.1 per cent as on March 31, 1963. The number of personal
<table>
<thead>
<tr>
<th></th>
<th>March 1963</th>
<th>March 1964</th>
<th>March 1965</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Accounts ('000)</td>
<td>Amount Rs.in crores</td>
<td>% to total</td>
</tr>
<tr>
<td>1. State owned and</td>
<td>-</td>
<td>27</td>
<td>2.9</td>
</tr>
<tr>
<td>State managed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>industries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Limited Companies</td>
<td>16</td>
<td>776</td>
<td>84.3</td>
</tr>
<tr>
<td>3. Partnership and</td>
<td>32</td>
<td>118</td>
<td>12.8</td>
</tr>
<tr>
<td>others</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>48</td>
<td>921</td>
<td>100.0</td>
</tr>
</tbody>
</table>

**Note:** In respect of state owned and state managed industries, the number of accounts was 90 in March 1963, 152 in March 1964 and 153 in March 1965.

**Source:** RESERVE BANK OF INDIA BULLETIN, January 1966.
accounts, however, rose considerably from 634 lakhs in 1963 and 596 lakhs in 1964 to 726 lakhs as on March 31, 1965.

5.3 MIXED BANKING IN GERMANY: A CASE STUDY:

The example of Germany is rather unique in the sense that banks have helped the industries right from the stage of their promotion and have kept along watching their progress and helping them in times of distress. The continental banks compared to the German banks are less specialised and combine with short loan banking, other functions particularly the equipment of undertakings with permanent capital.

A brief historical review of the relation between banks and industries in Germany is worth recording. In the words of Prof. Barrett Whale, an authority entitled to high respect, credit banks "are joint stock banks carrying on general banking and acquiring their constitution under the general law relating to companies". German credit banks may be said to have originated in the fifties of the last century.

The first bank to be established during this period was the one started by A. Schaufhansen'scher, chartered in 1848. This bank financed several mining and metallurgical undertakings. The next important bank to be established was the Disconto, started in 1851 with a capital of 30 million marks. The foundation of the Darmstadt Bank was looked upon as a 'new model'. Its primary aim was to promote industrial development. A noteworthy feature is that this bank was started at a time
when there was a general shortage of capital in Germany. It was a time when investment was misdirected. This period also witnessed Germany emerging as a manufacturing nation, from the position of an agricultural country. "The comparative poverty of Germany about the middle of the last century and the great demand for capital to supply the needs of her rapidly growing industries led naturally to the development of banks which took a large and active part in providing the capital requisite for the creation and extension of business undertakings, both by the grant of long term loans and by the flotation of joint stock companies"11. Efforts were made to attract deposits and again company promotion became an important branch banking function.

A study of the first stage of the development of German credit banks, placed between 1848 and 1870 is marked by the rising of new banks started deliberately with a distinct industrial bias. It is of interest to note here that the Darmstadt Bank participated in the construction of railways, by financing the Silesian Railway Company, the Alsatian Railway Co. etc. "It is interesting to note that the German banks in this period, carried on their business with their own capital resources and were not dependant upon deposits from the public"12. So Prof. Basu would christen them more as investment trust companies, than as banks.

This intimate relationship between banks and industries in Germany, as emphasised by Dr. Jeidels, the German expert on industrial financing runs as follows: "The banks attend an industrial undertaking from its birth to its death, from promotion to liquidation, they stand by its side while it passes through the financial processes of economic life and at the same time profiting from it."

As expressed by Deutsch-Oekonomist, "Any one who observes impartially the development of the German banking system and the policy of the guiding minds must see that, without the vigorous and in some ways daring initiative of the banks, the present proud edifice of the German National Economy could not have been created in so relatively short a time."

Between 1870 and 1913, we can visualise the formation of groups in banking. Deposits of banks rose from 1932.16 million marks in 1889 to 9641.89 million marks in 1913 of which a major portion was held by nine important Berlin Banks. By this time the four famous D' Banks have come into operation. The trend from mixed banking to pure banking is noticeable. "They combined the investment trust business of the former period with the deposit business of this period; their business became mixed and varied."

15. (a) Deutsche, (b) Dresdner, (c) Disconto and (d) Damstädter.
During the third stage or period of their growth, lending to public authorities became their main business. The transition from peace to war, the interruption of foreign trade and the change in the course of domestic demand were naturally accompanied by losses in which the banks also shared.

The following features are noteworthy of this period of development of German banking:

(a) Increase in deposits,
(b) Preponderance of public borrowing as against that of private business and
(c) The comparative insignificance of transactions in connection with the stock exchange.

Prof. Basu would single out eight Berlin Banks and notices a decline in security holdings.\[16\]

<table>
<thead>
<tr>
<th>Berlin Banks</th>
<th>1913</th>
<th>1914</th>
<th>1915</th>
<th>1916</th>
<th>1917</th>
<th>1918</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$2</td>
<td>$2</td>
<td>$2</td>
<td>$2</td>
<td>$2</td>
<td>$2</td>
</tr>
<tr>
<td></td>
<td>13.0</td>
<td>13.9</td>
<td>11.8</td>
<td>9.1</td>
<td>6.6</td>
<td>6.2</td>
</tr>
</tbody>
</table>

This decline continued its trend till 1922, when it reached an all time low of 0.23 per cent. Post War German Banks were tending to develop very much along the lines of pre-war English deposit banks.

Banking legislation also tended to favour this tendency of reversing the tradition set up. The German Credit Act of

1934 advocated sound views on banking. For the first time in the banking history of Germany, banking business came to be regulated. The Act put a restriction on the speculative aspects of German banking business. A minimum cash reserve was fixed and the Syndicate's participation in industries declined. In 1924, 168 million marks were provided by the 'Konsortiums' to industries.

"Since the outbreak of the war, German industry came to rely to a much greater extent not only upon self financing but also upon direct advances from Government departments. In the circumstances, the importance of German banks as a source of industrial credit declined in recent years". The German banking system has been decentralised in the post war era. The centralised banking system was regarded by the Allied Powers as a potential danger for peace. So they abolished the central offices and the head offices of the 'Big Six' were liquidated.

Divided Germany is a concrete example of the fact that the type of a country's banking system is closely connected with and in fact to a great extent determined by the type of economic system that it has. In West Germany, the Law of Regional Scope of Credit Institutions enacted on March 29, 1952 advocated the sound principle of decentralisation of banks.

As regards the long term finance for industries, it may be observed that the currency reform of the country carried out in 1948 had some very good effects upon the bank's policy towards industries. The Currency Reform of 1948 exterminated the liquid funds held by industries in general with the result "trade and industry were again forced to fall back upon bank credits in very high degree".

It has generally been regarded that the part played by the banks was one of the most important factors in German industrial development. The successful working and achievements are wholly due to the following factors:

(a) High proportion of owned resources of the German banks, compared to their deposits. Based on an enquiry conducted on 169 banks, Dr. Reisser found that the paid up capital and reserve of these banks was 45 per cent of their liabilities while this proportion in England at that time was only 9 per cent.

(b) "Contrary to the common belief, lasting participation in industrial enterprises had not been part of the general policy of German credit banks, although there had been occasions when securities remained with them on account of the difficulty of placing them in the open market".

(o) The combination of diverse functions in one and the same institution helped in creating closer contact between the banks and their customers. They had full knowledge of the undertakings concerned and were in a position to advise their customers as to the prospects for placing an issue in the capital market. Also, we cannot deny the fact that there was efficient management, over and above these things.