CHAPTER ONE

INTRODUCTION

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CHAPTER ONE

INTRODUCTION

Banks have played an important role in the economic development of the country. On the one hand banks accept money in the form of deposits from those who have surplus with them and lend to those who starve for that. Thus a bank is primarily an organisation where spare money is deposited for those who want are in need of it. Crowther believes, "It (bank) collects money from those who have to spare or who are saving it out of their income and it lends this money out to those who require it. This is valuable and necessary in any community." However the role of a commercial bank is not confined to 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 rural credit. They serve like arteries in a human body in supplying credit to the body-economic of a country.

In view of this, the role of commercial banks in under developed and planned economies, like India, becomes particularly important. In under developed countries savings tend to remain idle owing to the inherent imperfection of

the money and capital markets. There are pockets where savings accrue but they do not find appropriate avenues for employment, while at the same time at other points in the economic system, real possibilities of investment remain unfulfilled owing to lack of resources. The growth of widely spread network of financial institutions, of which commercial banks constitute a large and significant component, helps to connect these scattered pockets of savings and investment. Thus the aggregate investment tends to increase. In particular, commercial banks as the most important of the financial intermediaries, assist in a more efficient use of available savings. As admitted by a lending Indian banker not long ago, 'banking is the kingpin of the chariot of economic progress. As such its role in expanding economy of a country like India can neither be underestimated nor overlooked. The success of our gigantic second Five Year Plan is dependent among other things, on the smooth and satisfactory performance of the role by banking industry of our country.2

Condition Prior to 1949

The world war II gave rise to mushroom growth of bank offices in the country. The number of offices increased

2. C.H. Bhabha, 'Better Climate for Expansion of Indian Banking Needs Commerce; Annual November-December 1956; p. 50.
rapidly during this period from 1951 in 1939 to 5,335 in 1945. The growth in the number of bank offices, during the war was just like the uncontrolled growth of trees in jungle; the strong elbow came out destroyed the weak. The jungle contained all kinds of plants and trees poisonous weeds as well as wholesome plants each trying to push out the other for space and sunshine. With the closing of war, it was felt necessary to regulate the expansion of branch to check mushroom expansion of branches which involved heavy capital expenditure beyond their means and concentration of bank offices in large cities. The banking companies (Restriction of Branches) Act was passed effective on 22nd November 1946. Now banks were required to secure the prior permission of the R.B.I. for opening new branches and for changing the location of the existing offices. There was, however, no provision in the Act under which banks could be compelled to close any of their existing non-remunerative branches. As an improvement to this, Banking Legislation was passed in 1949 to regulate and control the growth and development of banks in the country.

1949 - A Landmark -

The banking companies Act was passed in the year 1949 and the R.B.I. was entrusted with the responsibility to assist as an intermediary or otherwise in proposals for amalgamation of banks. It was in the fitness of things,
therefore, that the R.B.I. was authorised as an intermediary in such proposals for amalgamation if such proposals came from the banking companies themselves. In R.B.I. began to play an important role in the merger of weak and inviable banks with strong and viable units. It was observed that the procedure of amalgamation was dilatory; it was slow and complex. The necessity of simplifying the procedure and expediting the matter was, therefore, felt with great urgency. The legal formalities and the possibility of a few dissenting shareholders holding up the scheme of amalgamation made implementation of bank mergers rather difficult. A new section 44(A) was therefore, inserted in the Banking Regulation Act 1949 by the Amendment Act of 1950. Between 1960-1965 the total number of mergers and amalgamation under various provisions of the Banking Regulation Act were 188, out of which voluntary amalgamations accounted for 20, that is only 10.0 percent of the whole. Two transferee banks (under section 44(A) of the Banking Regulation Act 1949) were further granted moratorium under section 45 of the Act. 3

But in spite of all these legislative powers and within elaborate machinery of bank inspection, Palai Central Bank Limited, came to grief on Aug 9, 1960 bringing

torn to many middle class family. Writing about the failure of Palai Bank one of the journal reported "The condition of small depositors was pitiable. Sobbing women with infants in their arms, clutching the gates of the banks New Delhi Office, a washerman who had deposited all that he had earned in his life time, several employees who had just credited their pay cheques, retired officers who had placed provident funds and gratuity in the fixed deposit were adversely affected by the bank failure." It shows that even after Banking Companies Act 1949 the banking system in India was suffering from the structural and operational deficiencies.

Conventional Methods

While the objective of economic planning was to develop urban and rural sectors of economy simultaneously for the advancement of the masses, the banks on the other hand were urban-oriented in their working. The bank credit flew in the channels which offered attractive investment. Being guided solely by the principle of maximum profit, they neglected some of strategic and most desirable ventures of planned economic development. They did not find it profitable to invest in the advancement of priority sectors. Thus priority sectors remained almost outside the area of operation of commercial banks.

The following table shows the percentage of share in the distribution of the bank credit made available by the commercial banks to agriculture and small scale industry.

<table>
<thead>
<tr>
<th>End of March</th>
<th>Rs. Crores</th>
<th>As percentage total advance.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>40.54 (Relates to April end)</td>
<td>3.1</td>
</tr>
<tr>
<td>1963</td>
<td>43.83</td>
<td>2.8</td>
</tr>
<tr>
<td>1964</td>
<td>52.79</td>
<td>2.7</td>
</tr>
<tr>
<td>1965</td>
<td>58.26</td>
<td>2.8</td>
</tr>
<tr>
<td>1966</td>
<td>56.54</td>
<td>2.4</td>
</tr>
<tr>
<td>1967</td>
<td>56.56</td>
<td>2.1</td>
</tr>
<tr>
<td>1968</td>
<td>67.13</td>
<td>2.2</td>
</tr>
</tbody>
</table>


The table shows that the percentage of total credit to agriculture diminished from 3.1 percent in the 1961 to 2.2 percent in 1968. It proves that in pre-nationalisation period commercial banks adopted indifferent approach towards the priority sectors.
Resource Mobilisation

Since the network of commercial banks was not very extensive they could not mobilise resource successfully. The record of commercial banks in mobilising savings of the community was poor. The per-capita deposit were rupees 88 in June 1969. Before nationalisation banks served limited number of people. They cherished the idea of class-banking. The bank groupwise performance in the resource mobilisation have been shown in the following table.

GROUP-WISE BANK DEPOSIT IN 1969

<table>
<thead>
<tr>
<th>Rs. in Crore</th>
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<tbody>
<tr>
<td>1. State Bank of India, its associate Banks</td>
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<tr>
<td>2. 14 Nationalised Banks</td>
</tr>
<tr>
<td>3. Public Sectors Banks (Total)</td>
</tr>
<tr>
<td>4. Private Sector Banks</td>
</tr>
<tr>
<td>5. All Commercial Banks (Grand Total)</td>
</tr>
</tbody>
</table>

Source - Eastern Economics - Volume 67
July 23, 1976 - No. 4, p. 212
Since the initiation of planned economic development in the country, a high degree of emphasis has been placed on deposit mobilisation. The deposits mobilised by the bank are expected to be used in the manner conforming to the requirement of planned growth in the economy. The banks with their attractive schemes and prompt service were expected to mobilise the saving of the community, so that they may not be diverted into unproductive avenues. In this respect banks did not prove to be very effective.

Social - Control

Social control over banks was the rectifying measure adopted by the Government. Though agriculture has been most important sector in the country's economy, it received very little credit from the commercial banks. The All India Rural Credit Survey 1954 revealed that co-operative credit institutions which were considered the main source for providing credit to agriculture, played and almost in significant role in this field. Besides, commercial banks also failed indviderting the flow of credit to small scale industry. As a result, credit gaps of substantial magnitude remained to be covered in these sectors. It required some correctives in the banking system of the country. Social control over banks was the first step taken in this direction.

1. All India Rural Credit Survey Committee
   Report - Volume II, page 413.
The purpose of social control was to achieve some social ends without actual take over by the Government. Speaking in the Parliament on December 14, 1967, then minister of finance Shri Morar Ji Desai said, "The basic postulate of the social control scheme was to ensure that particular clients are not favoured in the matter of distribution of credit and whatever the character of shareholding its influence is neutralised in the constitution of the Board of Directors and in the actual credit decision taken at different levels of bank management." The scheme of social control was announced by the Government in December 1967. It was introduced in 1968. It was considered necessary to reorient the bank management to the changing concept of goals of banking. Consequently two banking laws amendment Act which came into force on Feb 1, 1969, provided for organisational changes in the re-constitution of the Board of Directors of a bank with the majority of Directors representing persons who had special knowledge or practical experience of agriculture and rural economy small scale industry, co-operatives banks etc. The social control legislation envisaged the establishment of National Credit Council (N.C.C.) to formulate credit policy. The main functions of N.C.C. were to assess periodically the credit needs of the various sections of the economy and determine the priority in granting loans and advances. The composition

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of council gave representation to different sectors of the economy. It was in conformity with the concept of mixed economy.

The main object of social control of banks was to make banking industry more helpful to the common man and to ensure flow of banking resources in accordance with the objective of planned economic growth by making the management of banks broadbased and progressive. Thus the objective of nationalisation of commercial banks and that of social control were almost common. But the progress made by the banks in following the programmes and policy directions under the social control scheme was found to be too slow and inadequate. The Banking Commission in its report also observed that "Although the banking system had taken certain steps for achieving the objectives of social control, the progress made in this regard was not adequate.\(^7\) There cannot be any denial of the fact that the social control scheme in this respect did not bring much tangible results. But at the same time it is to be noted that this scheme was given insufficient time for its operation as the time of few months was too short to test various provisions of the scheme. The Manu Bhi Shah Commission was appointed to study the working of nationalised banks after seven years of their nationalisation. While

\(^7\) Report on Banking Commission 1972
Chapter II, P. 40.
it gave up the scheme of social control over banks within few months of its introduction.

Reserve Bank of India's Role:

The main functions of the Reserve Bank are broadly the same as those of other Central Banks all over the world. These are, to act as the note issuing authority, bankers bank and banker to Government and the promote the growth of the economy within the framework of the general economic policy of the government consistent with the need for maintenance of price stability. The preamble to the RBI Act sets out the objectives of the bank as to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability of India and generally to operate the currency and credit system of the country to its advantage within these overall objectives, the Bank also performs a wide range of promotional functions which are designed to support the country's efforts to accelerate the pace of economic development with social justice through the process of planning.

The Reserve Bank has the sole right to issue notes and it also acts as banker to the commercial bank holding custody of their cash reserves and granting them accommodation in a discretionary way for the performance of its duties as the regulator of credit, the bank possesses...
not only the usual instruments of general credit control such as the Bank rate-open market operations and the power to vary the reserve requirements of banks, but also extensive powers of selective and direct credit regulation. The power of the suasion has also been employed in a comprehensive manner. Another important function of the bank relates to the conduct of the banking and financial operation of the Government and tendering advice to it on economic matters in general and on financial problems in particular. The bank has also an important role to play in the maintenance of the exchange value of the rupee in view of the close inter-dependence of international trade and national economic growth and well being, it acts as the agent of the Government in respect of India's membership of the I.M.F. It exercises control over payments and receipts for international trade transactions in conformity with the trade central which is operated by the Government, it also regulates various other kinds of transactions on foreign exchange for subserving the national interest, especially on the context of the competing demands on the limited resources available.

A special feature of Reserve Bank of India Act was the provision made for granting financial accommodation to the co-operative banking sector (Besides the scheduled Banks) for financing agricultural operations and the
marketing of crops. Moreover in accordance with the mandate of the Act, the bank set-up the Agricultural Credit Department mainly to study and provide consultative service to the Government and banks and generally co-ordinate its activities in the area of agricultural credit with these of agencies engaged in purveying such credit.

The bank was set-up on the pattern of the central banks in the advances countries at that time and its role was conceived to be mainly regulatory. The demands and events during the first 15 years of its existence were marked by the consolidation of its traditional central banking functions, namely those of note issue and banker to Government, a part from attending to problems of war and post war finance, repatriation of sterling debt, setting up of a system of exchange control, and tackling the banking and monetary problems. Which arose from the partition of the country, with economic development assuming a sense of urgency in the 'fifties' with the launching of the Five Years Plans, a variety of developmental and promotional functions came to be performed by the bank. Which is the past were regarded as being outside the normal purview of central banking while the enlargement of the Bank's role has been a continuous and evolutionary process, for the purpose of our discussion here, noteworthy developments can be grouped into two divides, namely the pre-1969 era and the post 1969 era, with the nationalisation
of the 14 major commercial banks serving as a benchmark.

The central bank very often adopts the policy of open market operations to regulate and centralize credit in the country by open market operations. It is meant the sale and purchase by the Central Bank of Government securities, first class bills and promissory notes in the market. In other words, the central bank of the country resorts to the sale and purchase of government securities in the open market to control and regulate the volume of credit in the economy. Like other Central Banks, the Reserve Bank of India also buy and sell the securities of the Central and State Governments from time to time in the Indian money market to control the volume of credit.

The regulation of credit for the specific uses or specific sectors of the economy is known as qualitative or selective credit control is to encourage certain specific economic activities in the country. In other words, the idea underlying selective credit control is to encourage the consideration to be essential for the working of the economy.

In a developing economy the selective credit controls acquire still greater significance, because certain industries are given priorities in its economic plans. The member-banks are, therefore, asked to give liberal credit to meet the requirements of these industries. The Central Bank, in such a country, can prohibit the
the member-banks from extending credit for unnecessary and undesirable business and trades in the economy. The Reserve Bank encourages the scheduled banks to follow its credit policy through persuasion. To achieve the objective, the Reserve Bank calls the meeting of the representatives of the scheduled banks from time to time, and prevails upon them to follow the policies laid down by it. In addition, the Reserve Bank also suggests to the scheduled banks the necessity and desirability of regulating credit by sending circular letters to them from time to time.

The important issue that deserves our attention during pre-nationalisation is the lower deposit base of commercial banks. Banks have done well in deploying credit in rural areas. The mobilisation of deposits has not been satisfactory. The credit operation of the bank itself did not result in higher level of income for the beneficiaries turn did not bring larger volume of deposits for these banks. This has not happened in a desired level, which has necessitated the nationalisation of banking industry.

Thus R.B.I. plays an important role in deposit mobilisation and credit deployment through various banks in the country.

The study leads to the finding of following unhealthy features of the banking system in pre-nationalisation period. They are -
Deposit mobilisation by commercial banks was not very satisfactory. As such banks have also not done well in deploying credit in various sectors of economy. The credit operation of the banking industry itself did not result in higher level of income for the beneficiaries which in turn did not bring large volume of resources for the banks.

Lending was confined to financing to working capital requirements of large and medium industries and commerce.

The network of branches was concentrated in certain well developed states and within each state in well developed towns and districts. They comparatively neglected those states and areas which were economically backward.

In 1969 total deposits of commercial bank Rs. 4665 crore, of this some of Rs. 145 crore was mobilised in rural areas. It could not only 3.1% of the total deposits. It shows the poor performances of the commercial banks in respect of deposit mobilisation in pre-nationalisation period.