CHAPTER III

CONSTITUTIONAL POWERS OF RESERVE BANK OF INDIA REGARDING CREDIT CONTROL
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REGARDING CREDIT CONTROL

Before we go into the details of the work done and the measures taken by the Reserve Bank of India from time to time, in the field of credit extension and its control, it is necessary to analyse the legal powers conferred upon the Reserve Bank of India. We may now, therefore go into a detailed analyses of the legal provisions under which the Reserve Bank may extend credit facilities to scheduled banks and state cooperative banks. The several kinds of business which the Reserve Bank is authorised to transact, and the bills and securities against which the bank may make advances and which it may purchase sell and rediscount are governed by Section 17, 18 and 19 of the Reserve Bank of India Act 1934.

(A) REDISCOUNTING AND LENDING POWERS.

In delimiting the functions of the Reserve Bank as described in these Sections, the framers of the Act made it
clear that the business of the Reserve Bank should be limited
to liquid, short term and generally self liquidating papers.
This was based on the then prevailing theory of the self-liqui-
dating short-term real bill doctrine. At that time, Government
securities did not form an important part of the banks' invest-
ment portfolio, as at present and there were no economic develop-
ment programmes like the Five Year Plan.

The conditions under which the Reserve Bank of India
is authorised to purchase and rediscount papers, and make loans
and advances to scheduled banks and state cooperative banks are
mainly contained under Section 17 (2) to (4) of the Act. Provi-
sions for emergency advance and discount are described in Sec-
tion 18 of the Act. Section 19 of the Act may be called a restric-
tive one, because it prohibits the bank from undertaking any
business which is not covered by the Sections 17 and 18 of the
Reserve Bank of India Act 1934.

Sec. 17 (2) (a): DISCOUNT AND PURCHASE OF BILLS OF
EXCHANGE AND PROMISSORY NOTES.

This section authorises "The purchase, Sale and redis-
count of bills of exchange and promissory notes drawn on and
payable in India and arising out of bonafide commercial or trade
transactions bearing two or more good signatures, one of which
shall be that of a scheduled bank, and maturing within ninety days
from the date of such purchase or rediscount, exclusive of days
of grace."

This section explains that the Reserve Bank may discount
promissory note or bill of exchange for scheduled banks which meet
the following requirements :-

(i) It is a bill of exchange or a promissory note as defined in the Indian Negotiable Instruments Act and drawn and payable in India.

(ii) It arises out of bonafide transactions of trade or commerce. As the Reserve Bank explains in the Reserve Bank of India Memorandum dated December 8, 1938, to all scheduled banks explaining the circumstances and conditions under which scheduled banks can obtain accommodation from Reserve Bank under Section 17 of the Act, such commercial papers must be drawn for financing the movement or marketing of goods or produce and not a bill of exchange or a promissory note the proceeds of which are to be used for fixed or permanent investments or for speculative purposes. When the Reserve Bank accepts bills for discounting, it expects the scheduled bank concerned to supply the Reserve Bank with detailed information relating to the parties from whom they take these bill, their financial standing, the line of business in which they are engaged, their other liabilities so far as is known to the borrowing bank and other relevant data so as to enable the Reserve Bank to maintain a continuous check both as to the soundness or the security and the nature of the transaction to which it relates. In addition, the Reserve Bank may itself make an independent investigation of the standing of the party and of the nature of the transaction for which the bill
was drawn.

(iii) It bears two or more good signatures, one of which is that of a scheduled bank.

(iv) It has a fixed maturity, not exceeding ninety days excluding days of grace, from the date of purchase or rediscount by the Reserve Bank. "In other words a Bill of Exchange or a Promissory Note must, at the time of rediscount or purchase by the Reserve Bank, have a definite currency embodied in the instrument itself and in case such an instrument is payable on demand it should be accompanied by a separate written agreement modifying the terms of the instrument to render it acceptable under this section. Reserve Bank cannot obviously accept a demand Promissory Note or a Bill of Exchange alone, as these instruments have no fixed maturity. The effective use of this provision, therefore, depends on the availability of a large amount of time bills and time Promissory Notes. Bills of Exchange or Promissory Notes to be eligible under this section must have a maturity not exceeding ninety days. As demand promissory notes have no maturity, the Reserve Bank is of the opinion that such notes are not eligible under this section.

This provision is very similar to Section 13, paragraph 2 of the Federal Reserve Act in the United States. According to it, any Federal Reserve Bank may discount notes drafts, and Bills of Exchange arising out of the actual commercial

1. The Reserve Bank of India Memorandum Dec. 8th, 1938.
transactions. However, "Notes, drafts, and bills of exchange admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than 90 days, exclusive of grace."¹

As far as Central Bank's discounts or advances to commercial banks are concerned, the Federal Reserve Act in United States is more liberal than the Reserve Bank of India Act. While in India, the Reserve Bank may discount a bill of exchange maturing only on a fixed date, Federal Act in United States permits any Federal Reserve Bank to discount any bill of exchange or promissory note whether maturing on a fixed date or payable at sight or demand. "Upon the endorsement of any of its member banks,......any Federal Reserve Bank may discount or purchase bills of exchange payable at sight or on demand which grow out of the domestic shipment or the expiration of non perishable, readily marketable agricultural and other staples and are secured by bills of lading or other shipping documents covering or securing titles to such staples......provided that no such bill shall in any event be held by or for the account of a Federal Reserve Bank for a period in excess of ninety days."²

Originally the Federal Reserve Act in the U.S. also prescribed rigid legal limitations on the kinds of papers that were eligible for obtaining Federal Reserve Credit. It was based on the theory that Central Banks should make advances only against short-term self liquidating papers i.e. commercial loan theory.

¹ The Federal Reserve Act- Sec. 13, paragraph 2.
But later on it was recognised that the liquidity of any asset for the banking system as a whole depended upon the ability and willingness of the Reserve Bank to lend upon it, the eligibility requirements were relaxed. The Federal Reserve Banks can now extend credit on a wide variety of assets. The entire theory upon which rediscount was originally based has been virtually abandoned.

In place of introducing new system or demand or time notes and bills it will be rather more convenient to delete the word "fixed maturity" from this section of the Act. This will not affect the soundness of the security by any means. (When the commercial papers are endorsed by scheduled banks, it amounts to a guarantee by these banks, and therefore, the Reserve Bank in rediscounting papers endorsed by the commercial banks need not be too much concerned about prompt payment, unless the commercial bank endorsing the paper is itself financially unsound. The purpose of the regulations should be to make sure that funds are advanced for productive purposes, as far as possible.) Really speaking the Reserve Bank should have the power to examine whether the papers have arisen out of the bonafide commercial transactions or not. In all probability when this provision was incorporated in the Act, the framers copied it from some foreign country without considering applicability in India.

Sec. 17 (2) (b) : DISCOUNT AND PURCHASE OF AGRICULTURAL PAPERS.

The Reserve Bank has got the authority to purchase sell and rediscount bills of exchange and promissory notes arising out
of agricultural transactions, from the scheduled banks and state co-operative banks, if the following conditions are satisfied:

(i) They are drawn and payable in India.

(ii) They bear two or more good signatures, one of them being that of a scheduled bank or a state Co-operative bank.

(iii) They are drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops; and

(iv) They mature within 15 months from the date of purchase or rediscount by the Reserve Bank, excluding the days of grace.

Commercial Banks make very few advances for agricultural purposes in India. For example as of March 1953, only 4% of the total advances of the scheduled banks were for agricultural purposes.¹ Thus it falls to the lot of State Co-operative Banks only to make use of this provision, to obtain credit facilities from the Reserve Bank. Even State co-operative banks began obtaining advances from Reserve Bank under this section only after 1946 when they were offered concessional rate of 1½ %.

Sec. 17 (2) (c): DISCOUNT AND PURCHASE OF BILLS AND NOTES FOR THE PURPOSE OF TRADING IN GOVERNMENT SECURITIES.

The Sec. 17 (2) (c) authorises the Reserve Bank to make loans and advances to scheduled banks and state co-operative banks.

¹ Upto 1950 the R.B.I. accepted only those agricultural papers which matured within 9 mths. Now the R.B.I. purchases and discounts bill and P. Notes maturing within 12 mths., and in spl. cases upto 15 mths. (rend & Progress of Banking in India
repayable on demand or on expiry of fixed periods not exceeding ninety days, against such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Reserve Bank. Just as in discounting papers under section 17 (2), demand bills and demand promissory notes are not considered eligible by the Reserve Bank for making advances.

From the data on advances of the Reserve Bank, it will be observed that only after the new bill market scheme was adopted in 1951, by which the banks were allowed to convert some of their demand promissory notes into time notes, that commercial banks have used this provision to any considerable extent to obtain advances from the Reserve Bank. At present both the scheduled commercial banks and state Cooperative banks procure credit under this section.

Sec. 17 (4) (d) : ADVANCES AGAINST PROMISSORY NOTES SUPPORTED BY DOCUMENTS OF TITLE OF GOODS.

This section authorises the Reserve Bank to grant loans and advances to scheduled commercial banks and state co-operative banks against their promissory notes supported by document of title to goods, which have been transferred, pledged or assigned to such banks as security for cash credits or overdrafts granted by the banks for bonafide commercial or trade transactions, or for the purpose of financing seasonal agricultural operations or the marketing of crops.

In view of a legal interpretation of this section the Reserve Bank may provide loans and advances only against 'docu-
ments of title to goods', and not against the security of goods themselves. Even though the customers' goods pledged to the commercial banks are kept in the bank's own premises, such goods cannot be obtained legally from the Reserve Bank, since the Act specifies that only 'documents of title to goods', and not goods themselves can be used for this purpose.\footnote{1}

This provides another example of copying a law from another country without meeting its practicality in Indian circumstances. Rather than adapt the law to suit the Indian conditions, the Reserve Bank is now trying to create conditions to suit the law, by encouraging the establishment of warehouses in India. Once warehouses are established, it is hoped that customers will be able to obtain credit from the banks against warehouse certificates rather than the security of goods themselves.

Therefore, until such time as the law is changed, or until the banks can make advances to customers against documents of title to goods,\footnote{1} this section will remain inoperative. To enhance the erection of warehouses, various states have already passed warehousing legislation. Rural Credit Survey recommended the setting up of a National Warehousing Development Fund. That India should have modern warehouses is most desirable; but it is most unfortunate if we have to create warehouses just because we do not want to change the law to suit the existing conditions in India.

\footnote{1} R.B.I. Memorandum of Dec. 8, 1953.

1. Document of title to goods include bills of lading, dock warrants, warehouse keepers certificates, railway receipts, and other similar documents used in the ordinary course of business. Only those documents which are fully negotiable instruments are eligible for collateral under this subsection.
Thus Sec. 17 (2) and 17 (3) authorise the Bank "to purchase and sell bills and promissory notes arising out of bonafide commercial or trade transactions or for the purpose of seasonal agricultural operations.

Section 18: EMERGENCY ADVANCES

To enable the scheduled commercial banks which do not have sufficient "eligible" securities to borrow in times of emergency, in 1946 Sec. 18 of the Act was amended so as to authorise the Reserve Bank to grant advances to banks against "such other forms of security as the bank may consider sufficient". This provision has been strengthened by Section 36 (c) of the banking companies act of 1949. Only during the banking crises in Bengal during the years 1948 to 1950 were loans extended to scheduled banks under this emergency powers.

In spite of the fact that there are several provisions in the Act by which the Reserve Bank may make funds available to scheduled and state co-operative banks, till 1952 only one section of the Act - Section 17 (4) (a) - was really used by the banks. This section under which the bank may obtain advances against Government Securities is the most convenient form of borrowing against commercial paper under the new bill market scheme at 1/2% below the usual rate. In addition to providing substantial assistance to banks in form of advances against Government securities, the Reserve Bank of India, at its discretion, also buys Government Securities under the open market operations. The facility of emergency loans under Sec. 18 of the Act were made
applicable to non-scheduled banks also in 1949.

(B) **POWERS REGARDING "OPEN MARKET OPERATIONS"**

The nature and quality of the assets in which the Reserve Bank of India could 'operate' are originally defined under Section 17 of the Reserve Bank of India Act 1934. Principally there are two ways assigned to the bank to influence the credit by its operations. The first is the old and traditional way of purchase and sale of Bills of Exchange, Promissory notes, Treasury Bills and Government Securities. The second instrument of operation in the open market policy of the Reserve Bank is provided by Section 17 (12) of the Reserve Bank of India Act, whereby the bank is empowered to purchase and sell gold coin and bullion and foreign exchange (till 1947 'sterling'). Section 17 (2) and 17 (3) of the Act authorise the bank to "purchase and sell bills and promissory notes arising out of bonafide commercial or trade transactions or for the purpose of seasonal agricultural operations."

Section 17 (2) has already been discussed in detail while enumerating the statutory powers of the Bank with regard to rediscounting and lending operations. Now we may discuss Section 17 (3) with reference to the powers conferred upon the bank 'to operate' in the market.

Sec. 17 (3) (a) : "Purchase & Sale of Sterling".

This section empowers the Reserve Bank to "Purchase from and sale to Scheduled banks of sterling in amounts of not less
than the equivalent of one lakh of rupees." By purchasing or selling from or to the scheduled banks, the bank may influence the volume of currency and credit available in the money market. However, such operations have been limited to an amount equivalent to rupees one lakh. Thus sterling operations have thus direct effect upon the cash reserves of the scheduled banks, and consequently upon their capacity to expand credit only up to a limited extent.

Sec. 17 (3) (b) : Operations in Bills of Exchange including Treasury Bills drawn IN U.K.

The Reserve Bank is empowered to operate in the bills of exchange even if they are drawn in the United Kingdom. The word 'operation' here includes purchase, sale and rediscounting. In terms of this section the bank is authorised to conduct purchase, sale and rediscount of bills of exchange (including treasury bills) drawn in or on any place in the United Kingdom and maturity within ninety days from the date of purchase, provided that no such purchase, sale or rediscount is made in India except with a scheduled bank. In this way the bank cannot sell, purchase or rediscount the bills of exchange withdrawn in U.K. with a non-scheduled bank in India.

Sec. 17 (12A) : Purchase & Sale of Government Securities of any Country.

The Reserve Bank of India was originally authorised under Section 17 (7) of the Act to purchase and sell without any
limit the Government Securities of the U.K. maturing within ten years from the date of purchase. This provision of the Sec.17 (7) was, however, subsequently omitted in 1948, and a new amendment was introduced widening the scope of the Reserve Bank's dealings in such securities. Now under section 17 (12A), which was inserted to the Reserve Bank of India Act in 1947, the bank is authorised to purchase or sell the Government Securities of any Country.

Sec. 17 (8): Purchase & Sale of Securities of Indian Govt., Local Govt. & State Govt.

Section 17 (8) of the Reserve Bank of India Act 1934 authorises the Reserve Bank to purchase and sale the securities of the Government of India or of a local government of any maturity or of such securities of a local authority in British India or of such states in India as are specified in this behalf by the Central Government. Such securities should be fully guaranteed as to principal and interest by the Government of India, a State Government or a local Government. Restrictions have been laid down regarding the amount of such securities held by the Banking department of the bank. Amount of such securities has got to be so regulated that the total value of such securities does not exceed the aggregate amount of the share capital of the bank, the Reserve fund and three fifths of the liabilities of the banking department in respect of deposits. Further, the value of such securities maturing after one year cannot exceed the aggregate amount of the share capital of the bank, the Reserve Fund and two
fifths of the liabilities of the Banking Department in respect of deposits. In case of such securities maturing after ten years the value has been limited to the aggregate amount of the share capital of the bank and the Reserve Fund and one fifth of the liabilities of the Banking Department in respect of deposits. In this manner the field of operations of the bank in Central Government, State Governments and Local Governments' securities has been clearly specified and defined in this section.

Sec. 17 (8A) : Operations in Shares & Securities Of Companies.

The bank has no power to engage in the purchase and sale of shares. Section 17 (8A) of the Act, however, empowers the bank to engage in the purchase and sale of shares in or the capital of the State Bank of India or any other bank or financial institution notified by the Central Government in this behalf. Originally, under Section 17 (11) (b) of the Act the bank was authorised to conduct the purchase, sale, transfer and custody of bills of exchange, securities or shares in any company. In this way the Act defines the scope of operations of the Bank in various types of securities, papers etc. Really speaking, this line of operations has been followed in almost all the countries where Central Banks are in power to control the credit.

Sec. 17 (12) : Purchase & Sale of Gold Coins, Bullion etc.

Originally in the Reserve Bank of India Act 1934 under Sec. 17 (II) (a) the bank was empowered to the purchase and sale
of gold or silver. Further, Sec.17 (12) of the Act made provisions whereby the bank is authorised to deal in gold coin, bullion and foreign exchange. Open market operations in these assets had potentially unlimited scope provided they were available in the market. But here also the scope of operations in sterling was subject to a two-fold limit.

In the first place the amount of foreign exchange available in the market at any time is largely conditioned by the state of export trade in the preceding year. The extent of the purchases as well as their timing were, therefore, outside the bank's control except within certain limits. Secondly, even at a time when there was sufficient sterling in the market, the response of the market was dependent on the state of the cash-reserves of the scheduled banks, with whom only the bank could enter into such dealings in sterling.

In this manner the bank has been armed with the powers to operate in various items. The Reserve Bank is authorised to operate in sterling, foreign government Securities, bills drawn in the U.K., Indian Government, Local Government and State Government and State Government securities, gold coin and bullion and in the shares and securities of various companies. Framers of the Act have thus not been conservative in defining the papers in which the Reserve Bank of India is empowered to operate in the market.

(C) POWERS REGARDING RESERVE REQUIREMENTS

After having discussed the scope of operations of the
bank in the open market, we may now probe into the powers enjoyed by the bank regarding the minimum reserve ratio. This provision was made originally under section 42 of the Reserve Bank of India Act 1934, the brief discussion of which is given below:

Sec. 42 (1): Cash Reserves of the Scheduled Banks to be kept with the Bank.

Under this section every scheduled bank has to maintain with the bank a balance the amount of which cannot at the close of business on any day be less than five per cent of the time liabilities of such bank in India as shown in the returns of the scheduled banks. For the purpose of this section liabilities do not include the paid up capital or reserves or any credit balance in the profit and loss account of any loan taken from the Reserve Bank. The capital and reserves of such scheduled banks would aggregate to not less than 5 lakhs of rupees. The Reserve Bank has to pay no interest on such reserves.

Demand liabilities, contrary to the practice in the U.S.A., South Africa and New Zealand, were interpreted as liabilities to be met on demand i.e. 24 hours, instead of thirty days. It is worth noting that the obligation of minimum reserve was imposed on scheduled banks and was designed essentially to give the Reserve Bank a minimum amount of funds with which it could operate and also to give it some measure of control over the banking and credit situation. In the U.S.A. also only member
banks are required to hold cash reserves with the Federal Reserve Banks. In South Africa, New Zealand, Argentina and Mexico, it is compulsory for every bank to maintain with their Central Banks minimum statutory balances of their demand and time liabilities.

By an amendment to the Reserve Bank of India Act 1934 in 1955, the Reserve Bank was armed with the power to vary the reserve ratios. According to this provision, the bank has been empowered to vary reserve requirements of scheduled banks, within the range of 5 to 20 per cent in respect of demand liabilities and 2 to 8 per cent in respect of time liabilities, and to require than to maintain additional reserves in respect of any increase in deposits with them after a specified date and the additional reserve required to be maintained may be up to 100 per cent of the such increase. The overall reserves to be maintained cannot, however, exceed 20 per cent of the demand and 8 per cent of the time liabilities. These percentages are the outer limits and within them the Reserve Bank is authorised to prescribe ratios in such a manner as to immobilise the maximum amount of deposits necessary, without at the same time adversely affecting such banks as have not participated in the rise in deposits.

Sec. 18 of Reserve of Non-Scheduled Banks. Banking Cos. Act

Enactment of Banking Companies Act 1949 brought under this provision even the non-scheduled banks. Non-scheduled banks also have to maintain by way of cash reserve in cash with itself or in account with the Reserve Bank, or partly in cash with itself.
and partly in such account, a sum equivalent to at least 5 per cent of its demand liabilities and 2 per cent of its time liabilities.

This power of varying the cash reserve ratio with the bank has really enhanced its control over the bank-credit. This power combined with the powers to operate in the market and to rediscount the various papers are expected to make the grip of the Reserve Bank more firm and accurate.

(D) POWERS REGARDING SELECTIVE CREDIT CONTROLS

To arm the Reserve Bank with the powers of selective controls, no provision was made in the Reserve Bank of India of India Act 1934. The Provisions with regard to purchase and re-discounting of 'eligible bills' may be said to have some qualitative implications on the distribution of bank loans; the inclusion of such provisions, it may be asserted, was inspired more by desire to conform to the practices of the bank of England and to improve banking standards rather than to any conscious efforts to introduce qualitative credit control. The bank had to issue warnings to all banks against dangers of granting too large a proportion of loans against shares and stocks, in 1946. This step was necessitated by an abnormal expansion of banks loans to the stock market in 1946. The Governor of the bank in his speech at the Annual General Meeting of the bank regretted that, "this warning does not seem to have been needed in some quarters. " He observed that "the Bank did not possess the power
to deal with the situation.

The statutory provision in this direction was, therefore, made in September 1948, more than ten years after the birth of the bank, when the Banking companies (Control) Ordinance authorised the Reserve Bank to issue directives to the banks in respect of their lending policies in general and any transaction in particular. With the enactment of banking legislation, permanent powers were conferred upon the bank in 1949 to effect selective credit control in the country. Now we may discuss the various sections of the Banking companies Act which define the powers of the Bank in respect of selective controls.

Sec. 20 (3): Direction of Lending Policies in Public Interest.

Section 20 (3) of the Banking Companies Act authorises the Reserve Bank that "if any loans or advances...... are granted by any banking company to the detriment of the interest of the depositors, the bank may, by order in writing, prohibit the banking company from granting any such further loans or advances ...... and may like order direct the banking company to secure the repayment of any such loan or advance within such time as may be specified in the order." In this way any loans which are not in the general interest are controlled by the bank under this section.

Sec. 21: Powers to give Directions and determine margins and lending policy.

In terms of Section 21 (1) the bank, in case where

it is satisfied that is is necessary or expedient in the public interest to do so, may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular. When the policy is so determined, all banking companies or the banking company concerned, as the case may be is bound to follow the policy so determined. Further sub-section 2 of the section 21 empowers the Reserve Bank to give directions to banking companies or group of companies in particular, as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances, and the rates of interest to be charged on advances and each banking company is bound to comply with any directions so given.

Thus section 21 of the Banking Companies Act brings the lending activities of the various banks under the active control of Reserve Bank.

Sec. 35A: Power to issue Directives in Relation to matters of Policy or Administration.

This section was inserted by an amendment to the Banking Companies Act in 1956 to empower the bank to issue directives to banking companies in relation to matters of policy and administration in the national interest or in the interest of the institutions themselves. This new Sec. lays down that "Where the Reserve Bank is satisfied that in the national interest; or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner as prejudicial to the interest of the banking company;"
or to secure the proper management of any banking company generally it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time issue such directions as it deems fit. The banking companies or the banking company, as the case may be, are bound to comply with such directions. In other words the bank enjoys a great control over the direction of policy or management of advances.

Sec. 36: Power to Prohibit Particular Transactions.

Section 36 of the Banking Companies Act further empowers the bank to prohibit banking companies against entering into any particular transactions. According to this section the Reserve Bank may caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions and generally give advice to any banking company.

From the foregoing discussion it is clear that the bank has been conferred upon with wide powers to control credit at any time. Various measures of credit control can be adopted by the Reserve Bank of India in the light of the statutory provisions which are in no way deficient or insufficient. The bank has utilised these powers regarding discounting of various papers and providing accommodation to banks through them to the betterment of economic fibre of the country. Extensive powers regarding the banks operation in the open market, variation in reserve ratios, additional reserve requirements and several other powers
regarding selective credit controls, of course, have filled the armoury of the bank with various instruments to fight disastrous movements in the various parts of the credit structure. With these powers in view we shall study in the next few chapters, the manner in which such powers have been exercised by the bank from time to time.