INTRODUCTION

Banks are caterers for the economy in a Country. From the start of banking two thousand years ago in Babylonia till the present date, a country’s monetary and fiscal matters are controlled through banking.

Banking system is one of the many institutions that impinges on any economy and affects its performance for the better or the worse. In what measure a given banking system contributes to economic development depends upon the governing policy of the Government. As a rule, banking systems are adapted to the structure and needs of the particular economy they exist in. Indian economic policy has been founded on the philosophy of the economic growth with social justice.

"An institution such as the banking system which touches and should touch the lives of millions has necessarily to be inspired by a larger social purpose and has to subserve national priorities and objectives. That is why there has been a widespread demand that major banks should not be only socially controlled but publicly owned."\(^1\)

---

\(^1\) Statement made by the then Prime Minister Mrs. Indira Gandhi in the Parliament on nationalising the banks in 1969 as quoted in The Banker, July (1969), p.366.
Viewed in futuristic perspectives, India is at present passing through an evolutionary as well as revolutionary stage of transaction wherein an under-developed country is somehow breaking the barriers of growth and crossing into a dynamic and progressive socio-economic system. In this march towards economic development, besides human endowments, social attitudes, political conditions, historical accidents and technical know-how, capital formation plays a very important role. In the process of economic development, banking and other financial institutions help in the capital formation, entrepreneurial ability and employment opportunity.

Banks are operating today in a highly competitive and rapidly changing environment. Too many institutions are in the fray eying the common man who can afford to save. Changes around us are taking place with speed and force unmatched in human history and in future it is going to become even more turbulent. This quick-sand character of change underlines on the one hand, the ephemerality of all forecasting, and on the other, the imperative necessity of being futuristic. Paradoxical as it may be, the necessity to develop and sharpen the futuristic temperament becomes more pronounced as changes becomes faster. Infact one of the challenges that we face is to develop a breed of those managers who have futuristic orientation and do not
feel threatened by the so-called instability or impermanence which will increasingly characterise our future.

The financial sector reforms currently underway in India must be seen as a component of the overall scheme of structural reforms. The overall package is aimed at enhancing the productivity and efficiency of the economy of the country as a whole and also increasing international competitiveness. An efficient financial system is a necessary condition for higher saving, productive investment and healthy growth.

India has a large and varied financial system, which comprises besides the RBI numerous commercial and co-operative banks, specialised development banks for industry, agriculture, external trade and housing, social security institutions like insurance, pension and provident funds, collective institutions like UTI and various mutual funds. During the last few years, several new institutions such as merchant banks, leasing companies, housing finance companies, venture capital funds, financial advisory services and credit rating agencies have come into existence. The capital market has grown phenomenally. There has been considerable development of money and capital markets and numerous financial instruments have appeared on the
scene. The strong points of the financial system are its ability to mobilise savings, its vast geographical and functional reach and institutional diversity.

Despite its commendable progress and expansion, India's financial system suffers from several weaknesses. The major deficiency of the banking industry is its low profitability and the consequent inability of several banks to provide adequately for loan losses and to build their capital. This is a serious drawback as only financially viable banks can serve their clients efficiently. The position however varies from bank to bank. Besides there are organisational inadequacies within the banks due to their rapid expansion, weakening of management and control functions, excessive staff, growth of restrictive practices and erosion of work culture, gaps in credit management and serious flaws in introducing computer technology, to handle the massive growth of banking transactions.

Banking in India may not be as old as our ancient heritage, but existed as early as in the Mauryan Empire. Contrary to the misconstrued western interpretation of our spiritual ethos 'Artha uparjan' has not only been a 'way of life' but was one of the essential 'karmas'. As early as in the Kautilya's 'Artha Sastra' it has been mentioned that one has not only to earn money, but save it and invest in profitable ventures because it is not only
necessary for the individuals physical security but necessary for his
development, nay that of society itself. Indians by and large are skillful in the
art of saving. It is a habit with them. One of the major reasons for the growth
of banking in India is our firm belief in savings and a secure future.

The banking systems as we understand today perhaps came into
being during the British period. It blossomed, flourished and refined itself into
an art and science as well during the pre-independence era. Though Indian
banking system was performing all the major functions as it is doing today, its
basic economic ethos was that of money lender. Early banking in India was
considered merely a debit-credit system of book entries. For decades, the
thumb rule of book-keeping prevailed in the old banking system. There was a
lack of objectivity in business approach. It was more or less trading in money.
Customers were less, bankers knew them personally and could dictate terms.

However, this scenario has changed in recent times the world over
and more particularly in India, when there was social banking regulation in
1970. The banking system has taken upon itself the role of most important
development agency of the Country. From the commercial whole-sale banking
it has come to retail social development banking. From large cities, banks
moved to towns, villages and to unheard of hamlets, from large and medium
industry to small scale units, from big agency houses to small business, from qualified professional to barbers and washerman, to the tribals and to the physically handicapped, from the privileged to the altogether underprivileged. Infact, this is unprecedented in the history of banking anywhere in the world.

While talking about social banking, Government’s views were put forth in the following words,- “the banking system touches the lives of millions and has to be inspired by longer social purposes and has to subserve national priorities and objectives”. This created the need for re-orientation of banking services to meet the credit needs of the neglected sectors of economy and poor sections of society. As a result, banking system has become more complicated in terms of procedures and functions. It is no more a debit and credit system of yester years. It now had to fulfill social obligations. That is, it has become responsive to the genuine needs and expectation of society. Consequently the banking industry is now facing the problems of controlling and monitoring of their business that had spread through vast network of branches. Banks perform many promotional functions in addition to the main banking function. In the industrial field, banks serve as a friend, philosopher and guide to industrial units.
In building India of the 21st Century, in which the poorest will enjoy those living standards that are now available in western countries such as modernisation of economic apparatus, liberalization of economic policies, modernisation of technology, effective and efficient manpower is of utmost necessity. For all this, a sound banking system is highly essential.

Modernisation and upgradation of technology are sure to accelerate the pace of economic growth as has been in the case of Japan. Japan's incredible economic growth had not been due to abundance of resources, natural or human but the instinct and fullest utilisation of the services available in the country or offered by any of the other countries in the world. It is evident from the World Bank statistics that in the past Japan has been one of the largest clients to one of the world's largest bankers. This is an example as to how it graduated from a principal borrower of developmental capital to a principal supplier of capital. The functions of commercial banks have undergone changes, both conceptually and technologically such that the traditional role of accepting the deposits for the purpose of lending remain only at the embryonic level. That is why fundamentally commercial banks still remain financial intermediaries that give rise to maturity and price transaction, though the banking organisations has acquired many dimensions.
All these expectations, challenges and revolutions have put lot of pressures on managements of banks to be innovative and take actions to make several suitable changes in their organisational structures. These changes have brought with them industrial relation problems, human resource development problems, poor credit management including problems of mounting overdues and lack of monitoring of accounts, weak fund management, etc., which are weakening the financial structure of the banks in particular and economy in general. This has led to rethinking for future banking in India.

Over a period of time the prevailing environment created a mind set where one began to look for guidance even in matters where it was not necessary. There was comfort when approval, guidance or confirmation of action taken was received from higher authorities. The Japanese refer to it as a case where broken widow panes are replaced only after being cleared by the proper authorities. The new policies necessitate attitudinal changes. After nationalization there was need to bring about development orientation, i.e., from class to mass banking. However there is a need once again to break with this orientation and change the mind set to be able to effectively meet the challenges and deal with the task ahead. For the first time, bankers are facing a situation where the Government is leaving them to chart their own course. To
deal with the emerging situation bankers have to shed a lot of old ideas, change practices and adopt a distinct approach to meet the challenges ahead. This will be easier if there is a clear appreciation of the forces that brought about these changes. A lack of understanding of these factors could result in incorrect management responses, inadequate preparation or half-baked systemic changes because of which the institution could suffer. It is therefore absolutely essential to understand and appreciate the politics, economics and philosophy of the reform process.

The business of banking primarily rests upon trust and confidence. A person will not entrust his savings unless he is sure that he will be able to get the desired amount back whenever he wants. So anything which fosters trust in banks will lead to their progress and on the contrary anything creating distrust in them will lead to the devastation of the system. And in the latter category comes the bank failure. A banking failure not only deprives the depositor of his hard earned savings, but its repercussions on trade and industry, by stopping the supply of credit, may be far more disastrous. Such an economic catastrophe is always against the public welfare.

The history of banking in India perhaps presents a most tragic tale. India has faced many banking failures. Even with the establishment of the
Central Bank and the general masses having become more intelligent and nationalistic, there continue to be many banking failures, creating greater and greater confusion in the public mind. The failures in fact have been sporadic and confined to certain banks. The only effect of such failures was a short time distrust. But why all these banking failures in our Country? Is it because of the incapacity of Indians to conduct organised banking of modern type? An empirical and exhaustive study was felt necessary to identify the loopholes in an endeavor to formulate a pattern for the overall efficient functioning of the banking system.

A major development objective in this Country has been the building up of a financial infrastructure geographically wide and functionally diverse to help in the process of resource mobilisation and to meet the expanding and emerging needs of a developing economy. The prime focus of attention has been the banking system and the nationalisation of banks in 1969 was seen as the major step to ensure that timely and adequate credit support would be available for viable productive endeavours.

Nationalisation was a recognition of the potential of the banking system to promote broader economic objectives such as growth, better regional balance of economic activity, and diffusion of economic power. It was
designed to make the system reach out to the small man and the rural and semi-urban areas and to extend credit coverage to sectors hitherto neglected by the banking system and through positive affirmative action provide for such expansion of credit to agriculture and small industry in place of what was regarded as a somewhat oligopolistic situation where the system served mainly the urban and industrial sectors and where the grant of credit was seen to be an act of patronage and receiving it an aspect of privilege.

The decades since nationalisation has been progress with respect to its various objectives. The impact of nationalisation on the banking sector can be visualised through the change in the complexion and the generation of new ethos in the realm of society oriented financial schemes of Indian banks. As engines of development and vehicles of silent socio-economic revolution in the country side, Indian banks have assumed new responsibilities in the fields of geographical expansion, functional diversification and personal portfolio. The number of commercial bank branches has increased over seven-fold to a little over 60,000 offices. Such a pace of expansion has few, if any, parallels in the history of banking development anywhere. The result of this expansion has been a sharp increase in the density of banking coverage as reflected in the sharp fall in the number of people served by a banking office. While in 1969
each office served 65,000 of the population, the figure now is down to 12,000. Most of the branch expansion has occurred in the rural and semi-urban areas, reflecting the concern to achieve a more balanced spatial distribution of credit and today there is a bank office in almost all the 5000 odd development blocks of the country. The fact that banks have expanded so rapidly in rural areas, in many of which they have been circumscribed by inaccessibility, poor infrastructure and other discomforts is a tribute to their devotion to the public purpose.

Despite tremendous growth in the banking sector in the post nationalisation period, there are several areas which need immediate attention if the banking sector has to play its role effectively in economic growth of the country. In the field of Indian banking, there still remains an unevenness of institutional framework, particularly with regard to deposit mobilisation and credit distribution, inadequate business planning, excessive concentration of authority in decision-making, lack of delegation of power to lower level of management, lack of effective communication between policy-making and implementation, absence of development oriented outlook and urban centered organisation and system, lower degree of professionalisation of management
and absence of standardised method and simplified procedures in the working of the financial system.

The impressive progress made by the Indian banking sector in achieving social goals has exacted a heavy toll in the form of decline in productivity and efficiency of the system and in consequence a serious erosion of its profitability even to the point of raising doubts about the viability of some important constituents of the system. This erosion of profitability has adversely affected and continues to affect the ability of the system to expand further its range of services, especially in the context of assisting in the creation of competitive vitality and efficiency in the real economy. Though the erosion of profitability of banks is not an exclusively Indian phenomenon, the ratios of profitability to assets or working funds of the Indian banking system are certainly much lower than they are in relation to international averages and impairs their prospects for continued and healthy growth. Banks have used their social obligations to rationalise their inadequate performance in terms of low productivity and profitability. Nationalisation may be considered to be merely a means rather than an end in itself, if the financial institutions have to play an accelerated role in the economic growth of the country.
It is nearly thirty five years since the banks have been nationalised in 1969, but the balance sheet of the majority of the public sector banks are in the red. In fact many of them are struggling to stay afloat as a result of which the Government had to contribute funds. Thus the future of banks particularly the nationalised at no time is as uncertain and shaky as it is now. By and large operational efficiency of banks is reflected in their profit. It is an indicator of growth, soundness and viability. Inspite of manipulation under a veil of secrecy, profitability of PSB’s has shown continuously declining trend. The edifice built over three decades is crumbling and the emphasis laid down is on the viability of the system than in meeting social obligation. Quantitatively, what the Indian banks have achieved has very few parallels in the history of banking development anywhere in the world. Unfortunately, this very size has contributed to the present malaise of commercial banks. Simply put, banks found it difficult to operate keeping in view both socio economic criteria and commercial considerations. Banks have also suffered because of the excessive control and management exercised by the Government through the RBI and also political and bureaucratic interference at every stage.
Financial services are globalized in the sense that Indian financial service has to compete with world financial systems. And the banking management is not given a free hand to take decisions to meet this competition. But this freedom should not be detrimental to the rights of the depositor. Regulation of banking business was made at a period when legal paternalism was prevailing. A series of regulations beginning with the RBI Act, 1934 continuing through the Banking Regulation Act, 1949 and its subsequent Amendment Act, 1968 and culminating in the two phases of nationalization of banks have ensured that the Government maintains a tight grip over this sector.

But the recent move towards liberalization heralds a new era where competitiveness and efficiency, the keys to profitability are stressed. Naturally dimensions of legal rules should change to ensure quality of service and investors' protection. All this calls for a drastic overhauling of the banking system. The major thrust is to improve the operational and allocative efficiency of the system by gradually doing away with many of the exogenous and structural factors affecting the performance of banks. Banks must become efficiency conscious and focus on balancing profitability with liquidity while also servicing the necessary socio-economic objectives of the developmental efforts.
India while framing its constitution heavily relied on the Government of India Act, 1935 and adopted one suited for a liberal, capitalistic and democratic Government. Adding socialism in the preamble does not materially change the character of the constitution. The Constitution in its preamble resolved to constitute a sovereign, socialist, secular, democratic republic which replaced the original draft of sovereign, democratic republic by virtue of the forty second Amendment, 1976. The preamble also contains an assurance about economic justice. Constitutions of socialistic countries are supposed to contain provisions about central economic planning, institutions of such planning, execution, monitoring and allocation of resources. Constitution of India in this respect does not contain any provision for putting responsibility on the union or the State Government to adopt any macro-economic policy in a time-frame. Excepting Entry 20 of the List 3 in the Seventh Schedule which contains economic and social planning, the constitution does not impose any clear mandate on the Government. The question here is how far the RBI is able to pursue the objectives laid down in the preamble of the RBI Act? What is its constitutional position? Is there any political pressure or interference in the functioning of the Central Bank?
The reforms process initiated in 1991 posed challenges before bankers as never before. Bankers who worked with public sector banks during 1970-90 had their tasks defined for them. The Government as the owner decided on the agenda for action, directing the flow of credit and even determining the percentage of credit flows to specific sectors. Competition was restricted and insulation from World financial markets complete. Thus a degree of system safety was ensured. The most serious problem encountered is likely to be one of moral hazards. Are bank managements, who for their own petty gains take money from the depositors at high rates and lend it for risky ventures justified in doing so? Are they not indulging in outright cheating?

These developments lead to a situation where the support enjoyed by the banks through deposit, insurance or lender of last resort policies is now being questioned. Attempts at bailing out banks that get into difficulties through budgetary support from the Government are stiffly resisted by taxpayers. In U.S. the tax payers strongly protested against the attempts at salvaging savings and loan institutions by the Government. Similarly in Japan, the tax payers were not at all happy at salvaging the bankers whom they perceived to be not profitable. Allowing banks to go under is an alternative that does not necessarily cause tremors. Bank of England did not come to the
aid of Baring Bank. Alan Greenspan of the Federal Reserve in the U.S.A. did not hesitate to state that if banks suffered on account of risky transactions, it would be folly to rescue them. These hard realities of the market place force even policy framers to accept the fact that they have to find out ways to raise themselves from the morass of ineptitude.

Indian banking is still in the controlled and economic regime of the Govt. of India. Why the required reforms to address the changes of a market oriented system, which is inevitable in an emerging and liberalized economy like India is not being perfectly enacted? Why is the system being slow in enacting such laws? What are the constrains ahead of RBI? Is there any structural anomaly of Indian banking in the era of financial reforms and a consequent failure of the legal system to keep pace with economic reforms? Does the constitution of India give any indication that it is designed for a liberal market driven economy? Does it give an impression that the country’s Government shall determine the economic policy? The word ‘socialism’ in the Preamble to the Constitution express the nation’s aspirations. Can a

---

2 Collapse of the Barings Bank in Britain in February 1995 is perhaps the perfect example where financial risk management decision went wrong. A striking feature of the banks collapse is that it was both sudden and total. No one had the least suspicion of impending catastrophe despite the emergence of clear signs of malfeasance.

Constitution, which does not have any rule of governance relating to planning, resource mobilisation and distribution of resources needed for macro-economic management, usher socialism?

The hitherto followed banking system is enough to carry on the contemporary financial system because the preceding system never gave autonomy to public sector banks to work as a corporate entity to create profit and enact laws of their own to fulfill the banking objectives. But whether the existing Government control over banking business is conducive to make them meet the challenges of the globalisation of the financial services is to be analyzed especially as the Government is proposing to reduce its ownership in public sector banks. This study is highly relevant in terms of banking function and legal reforms in the changing face of lending and credit making, in the period of low risk and high profit bearing objective of the banks. For banks to survive and grow strongly it is inevitable that they restructure and reposition themselves, if they are to be the winners in the new era as we move away from a secured environment which posed few threats for banks.

Objectives of the Study

1. To study the existing structure of banks and to give suggestions for improving the efficiency and effectiveness of the system
2. To identify the inadequacy of the existing legal machinery as to the Govt. control of the banking sector in the changed atmosphere of today.

3. To identify the difficulties and limitations faced by the banks in their operations due to the control exercised by the RBI.

4. To study the success and failure of the Government control over banking to exercise fiscal and monetary policy.

5. To analyze the dilution of social objectives with decrease in Government control and the gravity of the problems resulting therefrom.

6. To identify the lapses on the part of the RBI to have an effective supervision over banks and suggest modifications.

7. Autonomy of the Reserve Bank and that of the public sector banks in a more liberalized and competitive environment.

8. To look into the various process of political pressure and politicisation of the appointments in the banking system.

9. To review the Narasimham Committee Report and its effect on the banking industry.

10. To study the role played by banks in promoting the economic objectives of the nation.
Methodology

The scope of the study is undoubtedly vast. The present study is however, confined to the functional efficiency of the existing legal machinery as to the Government control over the banking management and to highlight the important issues to find out whether it is conducive to meet the challenges of the liberalized financial sector.

The primary data relating to crucial ones are taken from the reports of various Government appointed agencies, official sources, commissions, reports of the RBI Bulletins, official website of the RBI, excerpts from the original speeches of Governors at varying periods.

The researcher also relied on the judgments of the Supreme Court and the High Courts for ascertaining the real objectives of the various provisions in the Banking Regulation Act and the RBI Act. An overview of the statutes existing in countries like the USA, UK and Japan was also taken. The study and the recommendations made by the Banking Commissions and the financial reports were also used to analyze the loopholes in the existing system.
For the collection of data the researcher has visited various libraries, namely, the Reserve Bank of India in Kochi and Chennai the Central Library and that of the School of Legal Studies, CUSAT, Government Law College, Ernakulam, School of Indian Legal Thought, Kottayam, Centre for Legal Studies, Thiruvananthapuram, Library of SBT Zonal Office, Kochi, National Law School of India University, Bangalore, New Indian Express Office, Kochi, The Hindu, Kochi, Ambedkar Law College, Chennai, Centre for Development Studies, Thiruvananthapuram and the RBI Staff Training College, Chennai. Discussions and interviews were held with academicians, bank officers, economists, advocates and RBI Governors for their views and valuable opinions.
CHAPTER II