DEVELOPMENT OF BANKING IN INDIA –
A HISTORICAL APPROACH

The Banking system as it exists today is the product of a number of centuries and is not the development of any particular period\(^1\). In all the Countries of the world, banking has been in existence in one form or the other. The word ‘bank’\(^2\) owes its origin from the French word ‘bancus’ or ‘banque’ and the Italian word ‘banca’, both meaning bench. It was upon the bench in market place that early bankers, namely, the Medieval European money lenders and money changers used to display their coins and transact business. The word has been in use from the middle ages in connection with the business of banking as money changing was considered as the most important function of a bank\(^3\). There has been all round development in the world and the


\[^2\] Regarding the origin or etymology of the word ‘Bank’ there is no unanimous opinion among writers on banking. According to some, it is derived from the German word ‘Back’, which means a joint stock fund. The first version is likely to be the correct derivation and in case if bank failure, the people used to break up his banco – which is the origin of the word ‘Bankrupt’. S.R.Davar, *Law and Practice of Banking* (1976), p.1.

\[^3\] In 2000 BC Babilonians had developed a banking system. As the people had faith in their Gods, they deposited their cash and valuables with the Gods. It was on this account that the Temples of Ephesus and Delphi were very powerful and trusted Greek banking institutions..
banking today is not what it was in the earlier rudimentary form. It may be said that, banking in its simple form is as old as authentic history. This is true not only in the case of India but also of other countries\(^4\). The old order always changes and a new order takes place\(^5\). It would be necessary here to make a detailed analysis of its development during the course of century that is, how banking has come to its present stage.

**Historical Background of Banking in Ancient India**

Banking in India is of ancient origin\(^6\). Our Vedas, Manusrumiti and Kautilya’s “Arthasastra” were good testimony to the existence and efficient working of Banking in India in those good old days. It has gone through various stages of evolution and development\(^7\) since the Vedic times when the

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\(^3\) Banking industry in India has traversed a long path to assume its present stature. J.S.G.Wilson, *The Business of Banking in India* (1952) pp.202, 203.


\(^7\) Usury and loans were well understood in Ancient India. Usury was practiced but was held in contempt. Loans were incurred at dicing. Vasistha, the law giver prohibited Brahmins and Kshatriyas from practicing it. Debts were incurred without intention to pay. During 1740’s the local chettis were prominent in the south for their banking activities. R.C.Dutt, *Civilization in Ancient India* (1960), Vol.I, p.39.
money lending business was quite prosperous. Its origin can be traced as early as 500 B.C.  

In the economic history of India, Banking and Bankers have always occupied a respectable place. Even prior to the advent of western ideas, India was not a stranger to the concept of Banking. The ‘Smrti’ period which followed the Vedic Period also speaks of most of the functions which the banker performs in modern times. Chanakya’s ‘Arthasasthra’ is full of facts to show that there were in existence powerful guilds of merchant bankers who received deposits, advanced loans and carried on other banking functions. ‘Manusrumiti’ contains references regarding deposits, pledges, policy of

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8 Ibid.


10 There are references which prove that during the period of Ramayana and Mahabharata, banking has become a full fledged business. It is said that one Briddhipajivi accompanied Bharath to the jungles to bring Lord Rama back to Ayodhya. ‘Briddhipajivi’ means a member of the money lending community. Supra n.1.

11 Ibid.

12 Kautiliya mentions guilds as great military powers, who in times of need provided soldiers. Manu refers to the usage of guilds having the force of law. Some guilds acted as banks financiers and trustees. See Dr.R.Samashastri’s Kautilya’s Arthastra (1923), p.227.

13 Ibid.
loans and rates of interest\textsuperscript{14}. Interest rates\textsuperscript{15} were prescribed by almost all Hindu law givers\textsuperscript{16}. Loans and usury were well understood in those days occasionally.

According to Manu and Vasistha the interest rates were not to vary depending on the risk involved or the purposes for which the money was borrowed. But they were directly linked to the caste classification of the borrowers\textsuperscript{17}. However Chanakya’s interest rate structure was risk weighted\textsuperscript{18} since the rate of interest increased with the risk involved in the borrower’s business.

\textsuperscript{14} Manu has devoted a special section to the subject of deposits and pledges. He says “A sensible man should deposit his money with a person of good family, of good conduct, well acquainted with the Law, veracious , having many relatives, wealthy and honourable (Arya)”. B.L.Lal Nigam, Banking Law and Practice (1997), p.11. See Buller, Laws of Manu (1866), p.286.

\textsuperscript{15} A common base number was 15\% per annum and this is higher than prime lending rate of many banks. Dr.Premnath Banerjee, Public Administration in Ancient India (1966), p.36.

\textsuperscript{16} Manu, Vasistha, Yagnavalkhya, Gauthswa and Kautilya.

\textsuperscript{17} For example Brahmins 2\%, Vaishyas 4\%, Kshatriyas 3\% and Sudras 5\%. Banking business could be taken up only by men belonging to the Vaisya caste. In other words in ancient times your caste gave you the licence to banking and not RBI.

\textsuperscript{18} TheArthasastra prescribed the maximum legal rate of interest on secured loans at 15\% and that on unsecured loans at 60\% without any discrimination as to caste, the rate might go upto 120\% or 240\% according to the risk involved in special circumstances.
Manu specified the punishments to be given in case of disputes arising over loan repayment\(^\text{19}\). When a creditor sued a debtor for recovery of money, it was the duty of the king to ensure that the creditor got back his money. Manu permitted the king to employ all means, fair or foul to recover the dues\(^\text{20}\). In certain cases torturous punishments were prescribed such as to obstruct the movement of the debtor to the extent of killing his wife, children and cattle. According to Chanakya, sons should pay with interest the debts of the deceased persons or co-debtors or sureties\(^\text{21}\) debts. This fact is a fair evidence to show that the Banker has been an indispensable pillar of ancient Indian society. Banking was known and practised in India at a time when the rest of the world had yet to evolve a medium of exchange in the form of money\(^\text{22}\).

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\(^{19}\) Slavery existed for paying off gambling debts. Sons were sold or pledged in payment of debt or due to lack of livelihood by fathers. Dr. Sama Sastri, *Recovery of Debts* (1866), pp.214, 218.


\(^{21}\) Under Hindu Law, it is the sons obligation to pay his father’s debts and his liability thereof under the ordinary law. S.N. Gupta, *Law and Banking* (1970), p.28.

\(^{22}\) The institution called ‘Sreni’ was a corporation of men following the same trade, art or craft and resembled the guilds of medieval Europe. One of the most important functions of these guilds was to serve as local banks. People kept deposits of money with them with a direction that the interest accruing there from was to be devoted to specific purposes. This is the best proof of the efficient organization of these bodies, for people would hardly trust them with permanent endowments if they were not satisfied with their working. On the whole they are remarkable institutions of ancient India. Sethi, *Commentary on Banking Regulation Act and Banking in India* (1976), pp.VIII & IX.
**Buddhist Period**

During the Buddhist period\(^{23}\) even the Brahmins and the Kshatriyas started taking banking as business. In this period we find that the Bills of Exchange\(^{24}\) had come into use and practice. The banks in this period were known as 'Shreshtis'\(^{25}\), 'Sahukars'\(^{26}\) and 'Mahajans'\(^{27}\). Lending money on interest was common, the loans being secured by mortgage, by pledge of movables or by surety.

**Mughal Period**

In the Mughal period there was a great fall in the banking system due to the fact that Muslims regarded taking of interest as a sin\(^{28}\) and also there was the advent of East India Company during this period. Emporer Aurangzeb in his regime conferred the title of 'Seth' on the most eminent

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\(^{24}\) A document promising payment of certain sum on a certain date by one party to another. *Ibid*

\(^{25}\) They were bankers of great influence during this period, who occupied prominent positions in guilds of commercial and industrial activities. Their main function was to finance traders, merchant advertise or explorers in search of valuable materials and kings in times of war and financial stress.

\(^{26}\) Indigenous bankers, who in addition to making loans received deposits.

\(^{27}\) Money lenders who combined trading with lending money.

\(^{28}\) According to Koranic injunctions, taking of interest or byaz was a sin. D.S.Savarkar, *Joint Stock Banking in India* (1938), p.10.
banker of his time. But since Aurangzeb was a staunch practitioner of Koranic Injunctions, he adopted a negative approach towards money lending.

In the Muslim period Hundis\(^{29}\) were greatly used. Moreover issue of various kinds of metallic money in different parts of the country gave the indigenous bankers great opportunities for developing a very profitable business of money changing and most important amongst them were appointed as Mint Officers, Revenue Collectors, Bankers and Money Changers to Govt. in various parts of the empire\(^{30}\). But these bankers could not develop the system of obtaining deposits regularly from the public.

**Modern Banking**

Modern banking in India began with the rise to power\(^{31}\) of the British. The arrival of Britishers in our Country heralded a new era and brought about revolutionary changes in all aspects of Indian life. Individual bankers continued to prosper and Indian businessmen very often acted as

\(^{29}\) The word 'Hundi' is said to be derived from the Sanskrit root "Hund" meaning to collect. Its derivation expresses the purposes for which originally such instruments were used. G.S. Panandikar, *Banking in India* (1975), p.2.

\(^{30}\) The most important feature of the economic development during this period was the use of coins as common currency. The system of barter in vogue during the Vedic Period was gradually replaced by exchange in precious metals. Thousands of these coins found in different parts of India show that they formed regular currency for a long period. R.C. Majumdar, *Ancient India* (1967), p. 216.

\(^{31}\) The British consolidated their power and became the most powerful force in India after vanquishing Tipusultan in the Battle of Srirangapatnam in 1799.
lender to the European traders with a rate of interest lower than the market rate. They accepted deposits from British officers serving in India and financed trade with such funds and at certain times even helped the Government.

After the establishment of the East India Company, the downfall of the ancient Indian banking system began. The seeds of modern system of banking on British pattern were sown and they started taking roots. Since then the Indian banking has made many strides with occasional set backs.

To understand the inadequacies in the management of Indian banking and subsequent failure in the system, the history and development of banking system is divided into following periods:- periods from 1830 to 1920, 1920 to 1935 and 1949 to 1969.

*The period beginning from East India Company upto 1920.*

With the flourishing of East India Company, the Company greatly felt the necessity of the Banking concerns of the English type. They

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32 Sahukar’s method of banking became outmoded and the need for a modern banking system was felt. A.G.Sharma, *State in relation to commercial banking in the Developing Economy of India* (1968), p.54.

33 Division is based on the structural and functional changes in the management of the banks during the specified period.

34 The English traders could not make use of the indigenous bankers. Firstly because of the language difficulty, secondly they lacked experience of the finance of European trade.
established their own agency at port towns of Bombay, Calcutta and Madras—
their primary concern was trade. Like indigenous bankers the agency houses combined banking with general trading.

The majority of these agency houses were organized by foreigners employed in civil or military services in India. The need for starting a modern bank rose first with the decision in London, communicated to the East India Company in Madras to issue capital and accept deposits. Still it must be admitted that the agency houses actually, gave a start to the idea of modern banking in our country and thus they may be regarded as pioneers or forerunners of modern banking in our country. They performed three major functions namely receiving deposits, advancing loans and discounting of Bills. Bank of Hindustan had the right to issue Bank Notes. Three Presidency Banks were the first banking institutions to be set up in India.

35 English Agency houses were primarily commercial undertakings began to conduct banking business also so as to meet the needs of the company, the members of the services and European Merchants in India. C.J.Hamilton, Trade relations between England and India, 1600-1896 (1920), p.43.


37 In the year 1770 the Bank of Hindusthan was established in Calcutta by Alexander and Company Agency House. This bank was later closed in 1832. The Bengal Bank was established in 1785. It had a very short existence and closed down in 1791. Another bank, the General Bank of India was established in 1786. It was the first bank established on the basis of the principle of limited liability. H.Sinha, Early European banking in India with some reflections on present condition (1927), p.165.

38 Bank of Bengal (1866), Govt.Bank of Madras (1843) Bank of Bombay (1840).
These banks acted as Govt. banks and had the right of issuing currency notes till 1862. There were however too many restrictions on these banks and they could not deal in foreign business. They served the interests of the East India Company till 1920 when finally they were merged and Imperial Bank of India was formed in 1921. The intention was to create a central bank in the country with a monopoly of note issue and serve as bankers' bank and a Government bank. "Unnecessary continuation of restrictions made the working of these banks out of date and prevented them from playing the useful part in the Indian financial system."

In 1912, the Royal Commission under the chairmanship of Mr. Austin Chamberlain identified that some of the reasons for the need of a Central Bank as non-cooperation between the Indian and English Banks, weak and lax laws could not control the mushroom growth of banks and to check their unhealthy practices. This clearly pointed out the fact that strict Government control was required to win the confidence of the people and

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39 They were established by the Charter of East India Company and can be said to be the successors of Agency Houses – Combined banking with their commercial and trading activities. So it was unable to transmit Government revenue.


41 Act of 1860 – which for the first time accepted the principle of limited liability – See Sec.13 of the Act of 1860.

prevent fraud and misfeasance. The reasons for the failure of the Agency houses were due to gross mis-management, wild speculation and extravagant living on the part of the big merchant princes managing the agency houses.

The period from 1906 till 1913 was a period of boon for Indian banking but the development of these banks was hectic and lopsided. The period from 1913 to 1917 was one of bank failures. Indian banks with moderate financial resources and inexperienced second rate management could not face the situation.

A major cause of the crisis was said to be mis-management, due to incompetence of Directors and officers and also their deliberate and fraudulent misuse of funds. In pace with the fast expanding banking net work, there were not sufficient experienced and competent Managers and Directors.

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\[43\text{ 34\% of the paid-up capital of all Indian joint stock banks failed.}
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\[44\text{ The problems are first – the Swadeshi Movement was responsible for the opening of many banks by Indians who did not have sufficient knowledge and experience of banking principles and practices. Secondly the Indian money market was unorganized and the different components of it were pulling in opposite directions. Thirdly the credit and monetary system did not have sufficient flexibility. Hence with the differences in the demand for money, banks had to bear great strains. Fourthly and the most important one there was no central bank to look after the working of the commercial banks. Whenever these banks had to face difficult situations, there was no agency coming to their help. Lastly the First World War was greatly responsible for the crisis. See a study conducted by Dr.Elsy Jane - Monetary Problems of India during the period 1906 to 1920 in A.G.Sharma, State in relation to Commercial Banks development (1968), p.32.}\]
By 1917 the crisis was over and Indian banking saw better days. There was great expansion of currency in circulation and bank deposits leading to higher liquidity. It was mainly due to the creation of legal tender by the Govt. in such a way that every rise in the price level was a prelude to a fresh issue of currency notes. Businessmen and industrialists were making huge profits. The banking crisis had a silver lining too. It helped to draw the attention of the State and the public of the short-comings in the Bank. It was strongly felt that the state control of banking was very essential for its development in proper lines.

Under the Act of 1920, the Imperial Bank of India entered into an agreement with the Secretary of the State of India. The Bank was recognized from the beginning as a semi-public institution, with provisions for a certain measure of control by the Govt. It acted as a Govt.'s Bank. It was also

45 Ibid.
46 During 1911-13 the price of currency was high and at the time when trade was active the circulation of money did not expand to keep pace. This was in continuance of the Government's policy of neglecting India's interest.
47 Central Banking Enquiry Committee recommended that under the Imperial Bank of India, the general superintendence of the affairs and business of the bank was entrusted to a central board of governor which dealt with matter of general policy while the local boards established at Calcutta, Bombay and Madras had powers to deal with the day to day business. See Central Banking Enquiry Committee Report (1931), pp.274, 277.
expected to play the part of a Bankers' Bank, holding their cash balances, rediscounting their bills and assisting them in times of crises. But at the same time it was permitted to continue performing those commercial functions which it inherited from Presidency Banks. The bank was forbidden to deal in foreign exchange and was not given the power to issue notes. Thus the Imperial Bank of India had a peculiar position. It performed many functions of the central bank as well as a commercial bank. It assisted the development of banking in India.

The period from 1920 to 1935.

The effect of the post war inflation had a great impact on the economic conditions of practically all important countries of the world. The demand for a full fledged central bank was greatly felt. Though the establishment of the Imperial Bank of India satisfied the public for some time, yet by and by the failing of it brought the problem of the establishment of a

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49 From organizational view print, imperial bank was already a state bank, as it was specially created by Indian legislature, assisted, controlled and supervised by are Indian Govt within certain limits. From the capital view point, it was a private shareholders bank like the bank of England or the bank of France. Although it did not perform all the central, banking functions. O.P.Mathur, Public Sector bankers in Indian Economy - A case study of the State Bank (1978), p.15.

50 Ibid.

51 Many international conferences like International financial conference at Brussels in 1920 were held under the auspices of the League of Nations for finding solution to the many intricate financial problems. M.L.Tannan, Regulation of Banks in India (1931), p.26.
central bank into prominence again. The Imperial Bank was steadily becoming more and more unpopular with other banks.\(^52\) It competed with other commercial banks. It had huge resources at its disposal and enjoyed many privileges\(^53\) which gave it unwarranted advantages over other commercial banks. It came to be identified as another instrument of imperialistic preference.\(^54\)

Again in 1922 a period of bank failures started. There was panic and instability all around and the need was felt for a strong central bank. It was also observed by Ramachandra Rao\(^55\) that there was nobody to control the

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53 It was a private concern and especially open to suspicion on account of the strong representation of European interests on its management and allegation of social discrimination in appointments and grant of financial accommodation. Indian were denied general appointments and its attitude to other commercial banks was not friendly. See Central Banking Enquiry Committee Report – Dissenting view of N.R.Sircars (1931), p.525.

54 It was acting as a banker to the Govt. and to other banks, keeping balances of the Central and State Governments, providing rediscounting facilities to the Bankers. It was under foreign management and was closely connected with other foreign interests. Hence it could not develop into a national institution.

55 The state of Indian Banking at that time has been described by B.Ramachandra Rao as follows:-

"With no banking legislation, no official supervision, no fluid market for short term investments, which consequently leads to an over investment in gilt edged securities, no coordinated policy of the different joint stock banks, no centralized banking in the way of the rate of interest, no check against the frequent happenings of swindles by Directors or Officers of banks and no national policy on the part of the state, the Indian Joint Stock Banks have been unable to show any remarkable progress".


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activities of the commercial banks. From 1924 onwards there were some improvements in the Indian banking. The Hilton Young Commission was appointed in 1925 to study in detail the currency problems in India and to make necessary recommendations. One of the important recommendations was the establishment of a full fledged central bank in our country.

There were acute differences of opinion among the leaders regarding the degree of Government control – when the Bill for Reserve Bank was set up in 1927. One opinion that there is no charm in a State Bank unless it was under State Control. Secondly Reserve Bank should be free from Government control and influence of the Legislature. Thirdly, some favoured election of directors by and from the legislature. After a prolonged negotiation, the joint select committee recommended the establishment of a wholly State-bank with 6 of the 15 directors elected by the Central and provincial legislatures.

56 The people of India derived concentration of authority and state control over financial institutions. The need for a single state agency to meet the credit needs of the agricultural sector was emphasized by the Agriculture Finance sub-committee (1945-Chairman D.R.Gadgil) See, Report of the Agriculture Finance sub Committee (1945), RBI 1965 Reprint, p.38.

57 Ibid.

The Central Banking Enquiry Committee, 1931 as well as the White Paper on Indian Constitutional Reforms reiterated the importance of the establishment of a Reserve Bank free from political influence. Accordingly a fresh Bill was introduced in the Legislative Assembly in 1933 and Reserve Bank of India commenced its operations from 1st April 1935. The Committee was of the view that the regulation of banking was necessary to protect the interest of the public and banking education to Indian personnel in adequate numbers and with necessary qualification to meet the increasing needs of the country for a sound and well managed national system of banking.

The RBI was established to secure monetary stability in British India and generally to operate the currency and credit system of the Country to its advantage. Under the then disorganised conditions it was not possible to

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59 There was a controversy whether it should be a shareholders' bank or a state owned and state managed bank. The popular elements in the country apprehended that if the Reserve Bank was established under the ownership and management of the State it would fulfill British interests against India. So they opposed it and demanded it to be a shareholders' bank. The Govt. thought otherwise. So it could not be passed in early 1934.

60 See paras 545, 546, 755 of the Banking Enquiry Committee Report, 1931.

61 Established in 1934.
decide on a permanent basis, about the Indian Monetary System and therefore it was asked to maintain the prevailing system.

Under the Imperial Bank of India Act, 1920, the governing body of the bank was the Central Boards. Its functions were defined in the bye-laws. But with the establishment of Reserve Bank under the RBI Act, the Imperial Bank ceased to be the banker to the Government directing, but it was authorised to act as the sole agent of the Reserve Bank. Under the Imperial Bank of India Act, 1920, the central banking functions, ie., the regulation of Note issue and management of foreign exchange continued to be exercised by the Government. As pointed out by the Hilton Young Commission, this working of central banking discharge was not satisfactory, as currency was controlled by the Government and credit by the Imperial Bank. The principal causes cited were the incompetence of Directors unrestricted loans to Directors or the concern in which they were interested, dishonest management, bad, speculation and injudicious investments and no central banking institution for timely assistance.

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An analysis conducted by the Central Banking Enquiry Committee on Bank failures during the 23 year period from 1913-1936. Source: Reserve Bank of India Bulletin.
The period from 1935 to 1949:-

The establishment of the RBI heralded a new era in the development of Indian Banking. The health of Indian Banking at that time was not sound. It was expected from the Reserve Bank that it would act as a friend, philosopher and guide of commercial banks and help them to tide over crises and develop on sound lines. It was also the fulfillment of a long cherished desire of the public to have a central bank which could look after the financial and credit management in the country as well as regulate the development of commercial banks on right lines. The RBI classified the banks into scheduled and non-scheduled. It put certain responsibilities on the scheduled banks as well as provided certain facilities to them.

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63 The mushroom growth of banks in the 1920's and bank failures on a large scale during the Depression period were the indication of bad health. With the establishment of the RBI the Imperial Bank ceased to be the banker to the Govt. directly. Further the Imperial Bank of India (Amendment Act 1934) removed all restrictions, which were formerly imposed on its lending operations. Under the Amending Act the bank could transact foreign exchange business and undertake banking business of any kind. K.L. Pande, Development of Banking in India since 1949 (1968), pp. 10, 11

64 Ibid.

65 Scheduled Banks had to have paid up capital and reserves of the value of not less than Rs. 5 lacs and had to maintain statutory cash reserves of 5% of their demand liabilities and 2% of the time liabilities with the Reserve Bank.
The mushroom growth of banks in the 1920's and bank failures on a large scale during the depression period were on indication of bad health. With the establishment of the RBI the Imperial Bank ceased to be the banker to the Govt. directly. Further the Imperial Bank of India (Amendment Act 1934) removed all restrictions which were formerly imposed on its lending operations. Under the Amending Act the bank could transact foreign exchange business and undertake banking business of any kind. The demand for a special legislation regulating the activities of the commercial banks was keenly felt. Joint stock banks were registered under the Indian Companies Act, 1913 and were governed by its general regulations except in certain matters, such as the preparation of the balance sheet and the form in which the statement of affairs was to be published.

In the Companies Act, 1936, there were few Sections in the Act, which were specifically applicable to Banking Companies. The main provisions are those relating to definition of banking company, to restrict its business to banking, prohibiting the employment of managing agents, etc. But these provisions were inadequate and touched only the fringe of the problem.

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66 Main provisions are section 277F to 277N and Management of Banks is discussed in Section 277H.

67 Though RBI was the controlling body for banking none of the suggestions made by RBI found a place in the Amendment Act of 1936 in the manner the RBI wanted.
Consequently banks had weak capital structure and followed faulty policies of granting advances. Inadequacy in this provision was that the M.D. entered into an agreement for a long term with the banks entitling him to a high salary and to employ the bank’s funds to promote industrial advances owned by him or his friends. There was again a popular demand for a full fledged Banking Act which would protect the interest of the depositors.

Since the definition of banking was not clear many non-scheduled banks did not submit returns or maintain cash balance on the ground that they did not fall within the definition of banking companies. And many companies registered under this Act were allowed to call themselves a bank even though they did not conduct banking business as defined in the Act. The Act also did not provide sufficient deterrent for these banks which were in real difficulty, to protect the interest of the depositor. The failure of the Travancore National and Quilon Bank is an example of this inadequacies in the existing law to control and regulate commercial banking on healthy lines.

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68 The advances were granted against undesirable security like immovable property and speculative shares in or without any surety at all or most such advances were allowed to friends or persons connected with management. T.A. Vaswani, *India Banking Systems* (1968), p.184.

69 Bank failures were regular in nature. If we look at post Second World War period, dozens of banks in Bengal, Kerala and elsewhere went out of existence bringing ruin to the entire community of clientele in its period. J.P. Jain, *Indian Banking Analysed* (1953), p.34.
The failure of the Travancore National and Quilon Banks\textsuperscript{70} in 1938 again stressed the urgency of such legislation\textsuperscript{71}. But owing to the War developments, it was postponed till the end of the year.

The Second World War though a catastrophe of great magnitude had its impact on our banking too. Indian Banking registered noteworthy progress during this period. There was unprecedented growth of banking activities, increase in bank deposits and the expansion and extension of banking concerns\textsuperscript{72}. This banking expansion has been generally healthy and encouraging. Yet it was not without any undesirable trends. C.D.Deshmukh\textsuperscript{73} has summarized these tendencies under three broad heads.

\textsuperscript{70} In the absence of any regulatory framework for the protection of the depositors, these private owners of banks were at liberty to use people's money in any manner they liked. \textit{Ibid.}

\textsuperscript{71} The then Governor of the Reserve Bank Sir James Taylor circulated a memorandum among the directors of the Bank stressing upon the desirability of such legislation and outlined his proposals for it. These proposals formed the basis of the draft Bank Bill of 1939 which was circulated by the Govt. of India at the request of the Reserve Bank for eliciting public opinion. R.K.Seshadri, \textit{A Swadeshi Bank from South India} (1982), p.92.

\textsuperscript{72} This phenomenal growth was achieved without regard to sound administrative foundations and the bubble showed signs of bursting in the early post-independence period. The number of scheduled banks increased from 55 in 1939 to 96 in 1947. Branches were opened in many cases without proper consideration of their resources or personnel.

\textsuperscript{73} Former RBI Governor as quoted by K.L.Pandey, \textit{Development of Banking Since 1949} (1968), p.15.
a) Some banks are intended to acquire control of non-banking companies by purchasing their shares without any regard to the price and yield and effects of the transactions on their own financial position. (closely connected to this practice is that of interlocking of interests between banks and business concerns and holding of large parcels of shares of companies in which the directors or management are interested and even the floatation of investment trusts for such purposes. All this clearly amounts to the utilization of the depositors’ money for the benefit of the management against the traditional canons of safety, yield and liquidity.)

b) Some banks had resorted to indiscriminate branch banking in places which were already well banked with a view to attract deposits at high rates of interest.

c) Excessive ‘window dressing’ at the time of balance sheet publication practised by a few banks gives an altogether erroneous picture of their financial position.

It should be noted that these undesirable developments in our Banking could take place only because of the absence of comprehensive banking legislation. Its need was greatly felt and the public made a strong
With the independence of India in 1947 came the greatest catastrophe in its history: the Partition of the country. It completely upset the economic structure of the country and created many economic, political and social problems of great magnitude. This had a tremendous impact on the banking concerns in the East Punjab and West Bengal. During such critical periods the Reserve Bank rose to the occasion and undertook many measures and as such many bank failures were averted. The banking crisis brought about by the partition had a brighter aspect also. It threw greater responsibilities on the Reserve Bank which undertook many steps for the development and improvement of commercial banking. Moreover this in no uncertain terms stressed the necessity of a comprehensive piece of banking legislation.

The Draft Bank Bill of 1939 which was postponed due to the Second World War was again introduced in 1944 in the Central Legislative Assembly for consolidating and amending the law relating to banking

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74 a) Section 17 of the RBI was amended and scheduled banks were granted advances against securities which were not ordinarily granted.

b) An ordinance was promulgated which prohibited any action against banks having their Head Offices in Delhi or East Punjab for three months.

c) Govt. granted a sum of Rs. 1 crore for the reestablishment of the uprooted banks.
companies. Ultimately a fresh Bill was introduced incorporating the amendments and entitled 'The Banking Companies Bill 1948'. This Bill was passed and came into force in March 1949 and is known as the 'Banking Companies Act 1949'. Thus a long felt need was fulfilled and a lacuna was removed by incorporating certain important requirements in the Act.

The Banking Regulation act represents the first comprehensive and systematic attempt to bring commercial banking within the sphere of central banking management. It empowered the Reserve Bank to regulate the appointment and remuneration of bank executives occupying senior posts and

75 A few undesirable features had developed in wartime banking and the Reserve Bank was of the opinion that a banking crisis might lie ahead. D.N.Ghose, Banking Policy in India - An Evaluation (1979) p.10.

76 The Bill was referred to a select Committee. The Committee could not meet and the Bill lapsed. A Bill (The Banking Companies Bill 1945) modeled on the proposals of the Reserve Bank was adopted by the Assembly on 11th April 1945. But it lapsed owing to the dissolution of the Assembly and had to be reintroduced in the newly elected Assembly on 15th March 1946. See Sethi's, Commentary on Banking Regulation Act and Banking in India (1992), p.XXV.

77 The main features of this Bill were a) Simple definition of banking with the object of limiting the scope of legislation to institutions in which funds are deposited primarily to ensure their safety and ready withdrawal b) fixing of minimum capital standards c) prohibition of trading to eliminate non banking risks. d) to include in the scope of legislation banks incorporated or registered outside India e) introduction of a comprehensive system of licensing of banks. f) provision for an expeditious procedure for liquidation of banks. g) Inspection of the books and accounts of a bank when necessary h) empowering the Central Govt. to take action against banks conducting their affairs in a manner detrimental to the interest of the depositors i) prescription of a special form of balance sheet and conferring of powers on Reserve Bank to call for periodical returns.
could appoint observers to attend board meeting. The earlier Act such as the Indian Companies (Amendment) Act of 1936 did not provide for preventing those banks which used unsound methods from attracting deposits. There was a keen desire to get control over public funds for monetary gains through excessive salaries, bonus, commission, etc. Many industrial houses had under their control reliable banking and insurance establishments. The piecemeal measures by subsequent amendments in 1942, 1944 and the Banking Companies (Inspection) Ordinance in 1946 also were of no avail and the banking system continued to show the earlier undesirable features till the B.R.Act 1949 came into force. The object of the Act was to consolidate and amend the law relating to banking companies\textsuperscript{78}.

Under this Act the RBI was given very wide powers of control and supervision\textsuperscript{79}. A new dynamism was generated for financing economic growth of the country. The Act gives a precise definition of a Bank and has prohibited it from taking part in trading and speculative activities\textsuperscript{80}. In order to

\textsuperscript{78} The provisions of this Act are mainly on the lines of the Banking Bill sponsored in the Central Assembly in 1945. An Act to consolidate and amend the law relating to banking.

\textsuperscript{79} See Section 35 of the B.R.Act, 1949. See Appendix VIII.

\textsuperscript{80} See Section 5(b) of the B.R.Act, 1949.
do away with malpractices of managing agents and directors, restrictions have been put on their appointment and remuneration. Minimum standards of capital and reserves of the banks have been laid down on the basis of the places of their operation. To avoid the concentration of capital and management of banking companies in few hands, limits have been put on the number of shares an individual can hold and the votes he can cast. Section 17 provides that every banking company incorporated in India must maintain a Reserve Fund. Non scheduled banks are also now required to maintain cash reserves either with itself or with the Reserve Bank or with the State Bank of India or with any notified bank. Banks have now been prohibited from granting loans on the security of its own shares or without security advancing to its own directors or firms and companies in which directors are interested in any way. Another important provision is regarding the licensing of Banking Companies. Every banking company is now required to obtain a licence from the RBI. It is issued subject to the conditions laid down by the RBI. It also has

81 See Section 5(gg) and 10BB of the B.R.Act, 1949.
84 See Section 20 of the B.R.Act, 1949.
the right to cancel such licence in certain cases. Restrictions also have been
put on opening of new branches and transfer of existing place of business. This
can be done only with prior permission of the RBI. Another effective
measure given to the RBI under the Act is that of inspection of banks. Prohibition of common directors and Schemes of arrangement and amalgamation. Under the patient and able guidance of the Reserve Bank, a
new spirit of development and service permeated the banking systems.

Consequently the banks not only recorded uninterrupted growth, they also shouldered increasingly heavier responsibilities and widened their
horizons by undertaking new and diversified banking functions. This shows
that though the RBI was constituted in 1935, much could not be done in
respect of bank failures till the banking companies Act was put on the statute
book in 1949. Also the independence of the country in 1947 changed the whole
approach towards commercial banking.

89 See Section 45 of the B.R. Act, 1949.
Performance of Commercial Banking as in 1950

Though there was a remarkable growth of Indian Banking during and immediately after the Second World War it was not sufficient to meet the requirements of such a vast country like India with a large population and untapped resources. There was a small number of big banks whose financial position was very sound but there was a large number of small banks with meagre financial resources. The problem therefore was of merging these small banks with big banks so that the possibility of bank failures might be minimized and better service could be rendered to the community. There was also a great urgency of providing banking facilities in semi urban and rural areas.  

The part played by Indian Banks in financing industries was extremely inadequate. Banks generally followed the traditional theory of commercial banking by confining their advances to short term loans only. In view of the rapid industrial growth that was to take place in India during the planned period, Indian banks were expected to play a greater and more positive

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A peculiar feature of branch banking in India is that most of the banks are concentrated in urban areas neglecting the rural areas totally. K.N.Kabra, R.R.Suresh, *Public Sector Banking* (1970), pp.33,35.
role in the financing of industries\(^9\). People were apprehensive whether the banks under private sector would be able to do so.

Indian agriculture was also starving on account of paucity of capital resources. Indian banks were of the opinion that agriculture finance was not within their purview and hence they had no responsibility in this regard. To improve upon the situation the Rural Banking Enquiry Committee made certain recommendations\(^9\). In view of the emphasis on agricultural development in the first Five Year Plan, Indian banks had to contribute adequately in this venture during this period.

There were also complaints against the management of Indian Banks. Favouritism and high interest rates, red tapism, interlocking of funds, faulty loans and advance policies have been the common charges against the management of Indian banks. Since untrained and incompetent men were indiscriminately appointed to fill the highest offices, the management of many

\(^9\) The role of banks in Germany and Japan in bringing about industrial growth at a remarkable rate is noteworthy. Like establishment of warehouses, provision for facilities for grading and standardization of Indian produce etc. RBI was also extending credit facilities to the scheduled banks by rediscounting of bills drawn for financing agriculture. Charles Kindleberger, Economic Response – Comparative Studies in Trade, Finance and Growth (1978), p.73.

\(^9\) Rural Banking Committee Report (1956), p.35.
banks were neither strong nor independent. The Central Banking Enquiry Committee Report of 1931 had also pointed out these defects\(^9\) and their recommendations were incorporated in the Indian Companies (Amendment) Act, 1936\(^9\).

Bank failures have been a chronic disease with Indian Banking and occurred more or less in a cyclic order. This was the result of unplanned and unrestricted expansion of bank offices during and immediately after the Second World War\(^9\). Many banks with inadequate capital resources and inexperienced and inefficient managements had come into existence\(^9\).

The recruitment policy was also defective. Persons were recruited not on the basis of their efficiency and capability but on the recommendations that they could bring forth. Moreover Indian Banks paid the lowest

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\(^9\) Prohibiting activities other than banking activities, restriction on grant of loans to directors, managers and members of the staff, a bank qualifications for appointment, retirement and voting powers of directors and officers of the banks.


\(^9\) Ibid. at p.66.

remuneration to their employees\textsuperscript{97}. There were certain glaring defects in the structure, working and management of Indian banks. State had given wide powers to the RBI for removing those shortcomings and developing commercial banking on sound lines under the Banking Companies Act and the RBI Act\textsuperscript{98}. Economic plans evidently had a great impact on our banking which tried its best to meet the requirements of our developing economy. During this period our banking was put to great stress and a few serious shortcomings in its operations came to light which needed immediate removal. The State was therefore looked upon to remove the weaknesses and to control and regulate banking in such a way as could bring its development on sound lines.

**Impact of Banking Regulation Act\textsuperscript{99}**

The Banking Companies Act 1949 was passed to consolidate and amend the law relating to banking companies. The Act was necessary partly due to the abuse of powers by persons controlling some banks and absence of

\textsuperscript{97} All India Banks Employees Association was formed to safeguard their interests. The relation between the managements and the staff were not as cordial as they ought to have been. Staff who are the real backbone of a banking concern were not given sufficient attention. The Award of the All India Industrial Tribunal (Bank disputes) published in 1950 is noteworthy in this aspect. See *Ram Kishan Tandon v. Central Bank of India, AIR 1958 All.413*.

\textsuperscript{98} This is in brief an account of the working of our commercial banks during the First Five Year Plan period.

\textsuperscript{99} From 1950 to 1969.
measures for safeguarding the interest of the depositors of banking companies in particular and partly to the economic interests of the country in general\textsuperscript{100}. The nationalization of the RBI and the passing of the Indian Banking Companies Act in 1949 gave rise to two schools of thought\textsuperscript{101} regarding the problem of control and supervision over banks. There were a good number who opined that the commercial banks must be nationalized in order to play their role properly in the planned economic development of the country\textsuperscript{102}. Hence they persistently and consistently insisted on nationalization as a sort of panacea.

The other groups were of the view that wide and effective powers of control and supervision had already been given to the RBI and these should be able to remove the defects of the Indian banking structure and there was no need for nationalization. But India was passing through a very critical\textsuperscript{103} period after independence and banking activities were to be extended to rural areas also. And so nationalized banks were expected to give priority to the

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\textsuperscript{100} M.L. Tannan's, \textit{Banking Law and Practice} (1997) p.65.


\textsuperscript{102} \textit{Ibid}.

\textsuperscript{103} Unlawful activities were financed by undesirable elements with the help of banks. \textit{Ibid}.
schemes of the neglected sectors. During this period, the SBI, the biggest commercial bank, which stands as a class by itself was formed with the passing of SBI\textsuperscript{104} Act, 1955. It took over the entire assets and liabilities of the Imperial Bank of India\textsuperscript{105}. The establishment of the SBI is a landmark in the history of the commercial banking in India and represents an active participation of the State in commercial banking activities. SBI and its associate\textsuperscript{106} banks had a large coverage of several areas and also carried great scope for extension to rural areas. Thus the nationalization of the Imperial Bank and the establishment of the SBI was an important milestone on the road to the establishment of an integrated commercial banking unit with branches all over

\textsuperscript{104} Management of State Bank, according to the R.B.I. under the S.B.I.Act, 1955 is vested with a Central Board consisting of a chairman and vice-chairman appointed by the Central Government in consultation with the R.B.I. (S.19) and two Managing Directors appointed by Central Board approved by the Central Government, 6 Directors to be elected by the shareholders, other than the R.B.I., 8 Directors to be nominated by the Central Government in consultation with the R.B.I., one Director nominated by the Central Government and one nominated by the Reserve Bank. The Chairman, Vice-Chairman and Managing Director hold office for such term not exceeding 5 years fixed by the Central Government (S.20).

\textsuperscript{105} SBI was established by the nationalization of the Imperial Bank of India.

\textsuperscript{106} In 1959, by the Amendment of the SBI Act, 1955, it associated with major state owned banks, namely, Bank of Saurashtra, Bank of Bikaner, Bank of Patiala, Bank of Jaipur, Bank of Indore, Bank of Mysore, Hyderabad State Bank and State Bank of Travancore were made its subsidiaries.
the country under effective state control\textsuperscript{107}. The bank has made great strides and has played a pioneering role not only mopping up the country’s savings but also in the financing of industries and in rural credit\textsuperscript{108}.

The agreement between the former Imperial Bank of India and the RBI was replaced by another agreement between the SBI and the RBI for the performance of agency functions\textsuperscript{109}. The SBI (Amendment) Act 1959 simplified the procedure in regard to taking over of business of any banking institution which the State Bank may acquire through negotiations under Section 35 of the SBI Act 1955. The Act also simplified the orderly winding up of the banking institutions whose business is so acquired by the State Bank\textsuperscript{110}. The main object of this Act was to provide for the formation of certain Government associated banks as subsidiaries of the SBI\textsuperscript{111} and for the

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\item \textsuperscript{108} \textit{Supra.} n.100.
\item \textsuperscript{109} The earlier amendment allowed the state bank and its subsidiaries to have 5% of the total voting rights. The object was to restrain control exercised by particular group of persons over the affairs of the bank. D.Bhattacharjee, \textit{Practical Banking} (1973), p.9.
\item \textsuperscript{110} Section 58 of the State Bank of India (Subsidiary Banks) Act, 1959 (Also known as the Banking Laws (Amendment) Act, 1968.
\item \textsuperscript{111} \textit{Supra}, n.106.
\end{itemize}
constitution, management and control of the banks so formed on matters connected therein.

The banking institutions are custodians of private savings and serve as powerful instruments to provide credit. They mobilize the resources of the country by accepting deposits and channelise them for industrial and national development by granting advances. As regards scheduled banks there were complaints that Indian commercial banks were directing their advances to the large and medium scale industries and big business houses and that the sectors demanding priority such as the Agriculture, Small scale industries and Exports were not receiving their due share. This was one of the chief reasons for the imposition of social control by amending the Banking Regulation Act and thereby Social Control Act 1968 was enacted.

Some of the provisions were amended relating to the management of the Bank for the purpose of widening the scope of the RBI. Banks are required to reconstitute their Board of Directors and not less than 51% of the

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113 This Act was struck down by the S.C. in *R.C. Cooper v. Union of India, A.I.R 1970 SC 564*.

114 Sections 21, 35A and 36AB – relating to directions by RBI to Banks on loans and advances and in the appointment of additional directors. See, Report on Banking Commission (1972), pp.34, 35.
total number of members are persons, who have special knowledge or practical experience in certain fields and they should not have any substantial personal interest in their respective field. The object was to clearly distinguish between the majority of non-industrialist directors and other non-industrialists and businessmen on the board of banks and to ensure that the majority are not closely connected with any business for their personal aggrandizement.

The Social Control Act amended the Banking Regulation Act 1949 so as to provide for the extension of social control over banks and for matters connected therewith. It also gave powers to amend the RBI Act 1934 and the SBI Act 1955 accordingly. The Social Control Act could not achieve its purpose. The expression “Social Control” in relation to banks and banking came into vogue since 1967. There was an allegation that the directors of banks who were mostly industrialists influenced many banks in granting indiscriminate advances to such companies, firms or institutions in which the directors were substantially interested. These and other alleged mismanagement of the banks justified their demand for nationalization of banks.

\[115\] The social control was imposed through amending Act No 58 of 1968.
In 1967 itself the Government had declared its policy to impose the social control\(^{117}\). Two main steps were taken. One, setting up a National Credit Council\(^{118}\) and two introducing legislative controls by amending the Banking Regulation Act\(^{119}\). This policy is in line with the recommendation\(^{120}\) of conferring wider powers of control and regulation to the RBI.

In this way the Govt. of India declined to nationalize commercial banks but at the same time tried to do away with the shortcomings of our commercial banks and to make them play a greater and more effective role in meeting the financial and banking requirements of our developing economy—by imposing greater social control over these banks. This satisfied the

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\(^{117}\) The then Dy.Prime Minister and Finance Minister Shri. Morarji Desai made a statement in the Lok Sabha declaring the views of the Govt. and how it proposed to impose the social control.

\(^{118}\) National Credit Council was set up under a resolution of the Govt. passed in 1967. Its functions are,- (a) to assess the demand for bank credit from various sectors of the economy, (b) to determine priorities for grant of loans and advances, (c) to co-ordinate lending and investment policies to ensure optimum and efficient use of the overall resources. The council now stands dissolved since the nationalization of commercial banks.

\(^{119}\) Passing of Act 58 of 1968 introducing radical amendments in certain provisions of Banking Regulation Act stating in the preamble that the amendments are intended to provide for the extension of social control over banks.

\(^{120}\) Recommendations made by the Banking Commission under R.G.Saraiya in 1963, who made the first comprehensive review of the banking systems since the Central Banking Enquiry Committee of 1931.
advocates of nationalization of banks and also did not create problems had there been nationalization.

But the imposition of social control did not change the position as expected. Commercial banks continued to direct their advances to large and medium scale industries. Sectors demanding priority such as Agriculture, Small scale Industries and Export-Imports were not receiving attention due to them from banks.¹²¹

**Nationalisation of Banks**

The nationalization of the commercial banks¹²² was a "revolution" in the Indian banking system. It was a "historic" and momentous event in the history of India. This revolution did not merely signify a change of the

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¹²¹ B.P. Sharma, *Role of commercial banks in India's developing economy* (1978), p.27.

¹²² In 1969, 14 major banks with deposits of Rs.50 crores or more were nationalized, namely viz, The Central Bank of India, Bank of India, Punjab National Bank, Bank of Baroda, United Commercial Bank, Canara Bank, United Bank of India, Dena Bank, Syndicate Bank, Union Bank of India, Allahabad Bank, Indian Bank, Bank of Maharashtra, and Indian Overseas Banks have deposits of more than fifty crores and forty three thousand one hundred and thirty branches were nationalized and taken over.
ownership\textsuperscript{123} of these banks but it was the beginning of a coordinated endeavour to use an important part of the financial mechanism for the country’s economic development. The then PM Mrs. Gandhi made the policy in the following words, “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 be not only socially controlled but publicly owned\textsuperscript{124}.”

In nationalizing the banks, Government was only putting into effect its programme for achieving socialistic pattern of society and it was hoped that nationalization would effectively decentralize credit with the result that the priority sectors such as agriculture, small scale industries, exports, self employment etc, would be provided with liberal banking facilities and that banking units could be extended to rural areas\textsuperscript{125}.

\textsuperscript{123} Govt of India promulgated an ordinance called “The Banking Companies (Acquisition and transfer of Undertakings) Ordinance 1969 in terms of which the Central Government acquired the undertaking of 14 major banks.


Views against Nationalisation

One criticism was that the scheme of social control over banks has not been given a fair trial\textsuperscript{126}. Because within 6 months\textsuperscript{127} of imposition of social control, the Central Government thought it fit not to continue the experiment to rectify the basic weakness of the banking systems and that is too short a period to judge the results of social control and there was no reason to conclude it had failed. Secondly foreign banks and smaller banks were left out of the purview of nationalization\textsuperscript{128}. It was criticized on the theory that public ownership would lead to inefficiency in the working of banks\textsuperscript{129}. The weakness of social control was that in many banks people who had been controlling their policies in the past continued to exercise their influence over them.


\textsuperscript{127} 168 days (from 1/2/1969 to 19/7/1969) the day of nationalisation – the day on which social control was imposed.

\textsuperscript{128} \textit{Ibid.}

\textsuperscript{129} The broad aims of nationalization of banks are “to control the heights of economy and to meet progressively and serve better the needs of the development of the economy in conformity with national policy and objectives.” More specifically the important objectives of nationalization are the removal of control by a few, provision of adequate credit for agriculture and small industry and exports, the giving of a professional bent to bank management, the encouragement of new classes of entrepreneurs and the provision of adequate training as well as reasonable terms of service for bank staff. Prof. Amul Desai, \textit{Nationalisation at the Crossroads} (1968), p. 10.
The criticism that nationalization will lead to inefficient functioning of banks can best be answered by pointing out the example of the SBI. S.N.Supa\textsuperscript{130} in the survey on banking in India pointed out the working of SBI to repudiate this statement. The enormous growth in the deposits of the SBI since its inception and its performance in the priority sectors of credit as compared to other commercial banks stand to prove that the efficiency of an organization need not necessarily depend on its ownership. It has also been made clear that there will be autonomy for each bank and the Boards of Directors will have well defined powers. Directions will be issued only on policy and general issues and not on specific loans or specific parties: thus public ownership does not mean the elimination of healthy competition or initiative.

There is often a misconception that nationalization is a peculiarly socialistic measure. The peculiar nature of banking industry which distinguishes it from other industries has been the main consideration for many countries\textsuperscript{131} to bring their system under public ownership. Another argument


\textsuperscript{131} France, Sweden, Sri Lanka etc. are such examples. The opponents argued that Banking Industry is not nationalized in all socialistic countries. Commercial banks in Norway, Sweden, Finland and Denmark are in private hands and every Russian Banker talks like Bankers. See Karl Lanz, \textit{Bank of World} (1963), p.62.
was that the commercial banks were operating mostly with other peoples’ money. The financial stake of the shareholders was almost negligible. This aspect of banking has led even predominantly capitalist countries to nationalize their banks or keep an eagle eye on them. Hope and enthusiasm were liberally expressed that the nationalization would effectively channelise the credits to priority fields of Agriculture, Small Scale Industries and Exports and that banking units now would expand in rural areas and the public confidence will be greatly enhanced. The employees’ welcome to the step indicated that the efficiency and service will not suffer.

**First Phase of Nationalisation**

Nationalization of banks was affected by the Banking Companies’ (Acquisition and Transfer of Undertakings) Act 1970. The constitutional validity of this Act was challenged in the Supreme Court.

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132 France has nationalized four of its six large banks and Italy four out of its five.


134 Referred as the “Nationalisation Act”. It received the President’s assent on March 31st 1970 and came into force retrospectively with effect from July 19th 1969.

135 The ordinance was promulgated by the Vice-President (acting as the President) in exercise of his power under Article 123 (1) of the Constitution. Article 123(1) provides for the ordinance making power of the President when both houses are not in session.
After a careful hearing the Supreme Court struck down the Act and declared it as ‘unconstitutional’. It held that the impugned Act was discriminatory and the action taken or deemed to be taken in exercise of the powers under the Act was unauthorized\textsuperscript{136}. The Act was held to be within the legislative competence of the Parliament but it made hostile discrimination against the named banks in that it prohibited them from carrying on banking business whereas other banks were permitted to carry on banking business\textsuperscript{137}. The Act also violated the guarantee of compensation under Article 31 (2) in that it provide for giving certain amounts determined according to the principles which were not relevant in the determination of compensation of the undertaking of the named banks and by the method prescribed the amount so determined could be regarded as compensation\textsuperscript{138}. Compensation was inadequate and method of valuation, illusory\textsuperscript{139}.

\textsuperscript{136} The undertakings of the fourteen banking companies each with a deposit of Rs.50 crores or more were purported to be transferred to fourteen new body corporates called “corresponding new banks”. The ordinance provided for the management of the fourteen new banks and payment of compensation to the shareholders of the corresponding banking companies which were taken over.

\textsuperscript{137} Petitions challenging the competence of the Ordinance were filed in the Supreme Court. Before they were heard, the Parliament passed and enacted on 9\textsuperscript{th} August 1969 the “Banking Companies(Acquisition and Transfer of Undertaking) Act 1969.

\textsuperscript{138} Supra. n.113.

\textsuperscript{139} The compensation was expected to be more generous and in cash rather than primarily in bonds.
It was natural for the Govt. to protect the earlier nationalization. Therefore another ordinance was promulgated by the President re-nationalising fourteen Indian ‘majors’\textsuperscript{140}. The ordinance was replaced by the ‘Banking Companies (Acquisition and Transfer of Undertakings) Act 1970’\textsuperscript{141}. The new Act attempted to plug the constitutional loopholes pointed out by the Supreme Court\textsuperscript{142}. The Act deals mainly with the mode and mechanics of transfer of the undertakings of the fourteen existing banking companies, payment of compensation to the fourteen banking companies, and the management of the fourteen new banks nationalized\textsuperscript{143}. This brought an end to the long drawn out debate on bank nationalization.

Under section 9 of the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970 each nationalised bank will have on its board directors not exceeding 15. And every Board so constructed shall include representatives of the employees and depositors and persons

\textsuperscript{140} Ibid.

\textsuperscript{141} Section 8 the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970.

\textsuperscript{142} Ibid.

\textsuperscript{143} A scheme called “the Nationalised Banks (Management and Miscellaneous Provision) Scheme 1970 was framed by the Central Government under section 9 of the 1970 Act.
representing farmers, workers and artisans, ensuring professionalism of the banking management being the main object. It was made clear that there will be authority for each bank and the board of directors will have well defined powers. It was also made clear that public ownership does not mean the elimination of healthy competition or initiative.

Second Phase of Nationalisation

As a further step in the Government's action when it wanted the large banks to fall in line with its goal of obtaining national objectives six more banks\(^{144}\) were nationalized in 1980. With the latest move, 91% of the entire banking system has been brought under the public sector. The nationalization of six more commercial banks is said to help the weaker sections of society in that it is a step in the direction of gearing the economy towards socio-economic objectives\(^{145}\). The public sector banks have to assume the role of pace setters in the herculean effort for economic development and minimization of economic disparities in the socio-economic structure of the country. Thus bank

\(^{144}\) These banks are the Andhra Bank, New Bank of India, Corporation Bank, Punjab and Sind Bank, Oriental Bank of Commerce and Vijaya Bank.

nationalization meant shifting of the emphasis in granting bank loans from creditworthiness of the person to creditworthiness of the purpose\textsuperscript{146}.

Since nationalization there has been a sea change in the banking scene. The scale and scope of banking operations have registered a massive upward trend\textsuperscript{147}. These consisted of larger allocation of credit to priority sectors, mobilizing deposits, bridging the gap between banker and borrower, transition from class banking to mass banking and greater alignment of credit policy with the overall objectives of the state\textsuperscript{148}.

Though India witnessed a phenomenal expansion in the geographical coverage and functional spread of our banking and financial system since nationalization in 1969, several distortions had over the years crept into it\textsuperscript{149}. There are complaints of deterioration in diversion of rural funds to metropolitan cities, kite flying operations, irregularities and corruption in lending operations, mounting cases of misappropriation, cheating.

\textsuperscript{146} A study conducted by National Credit Council headed by Dr. D.R. Gadgil and four other economists (1981).


\textsuperscript{149} Kanhaiya Singha, \textit{24 years of Bank Nationalisation}, Indian Express (Bombay), Oct.12 (1993).
embezzlement and fraud, rising operating costs, indiscriminate opening of branches in certain areas, lip sympathy to small scale sectors, slackening discipline among employees and all such evils of public sector undertakings. As a result productivity of the systems had suffered, its portfolio quality had badly deteriorated and profitability had been eroded.

Several public sector banks and financial institutions had become weak financially and some public sector banks had been incurring losses year after year. Their customer service was poor, their work technology outmoded and they were unable to meet the challenges of a competitive environment. As regards SBI and its Associate banks there has been a steady

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\text{150} \quad \text{Ibid.}
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\text{151} \quad \text{Nepotism and favouritism have crept in and the banking system has become erratic. Petty squabbles are settled through general strikes regardless of huge national losses and inconvenience to customers. N.Sugayya, \textit{Performance of Scheduled Commercial Banks – An Evaluation}, \textit{Prajnam}, Vol.III, No.2 (April/June 1979).}
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\text{152} \quad \text{The quantum of bad and doubtful debts of PSB’s has also risen sharply. (NPA). Efficiency, dispatch and integrity which used to be the hallmarks of Indian commercial banking have degenerated. There has been a high degree of social orientation and in this process commercial considerations have been forsaken. \textit{Ibid.}}
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rise in net profits\textsuperscript{153}. But in the case of other nationalized banks profitability has always been quite low\textsuperscript{154}.

These losses were due to the securities scam and also the result of dictates of non commercial orientation, direct lending, loan waivers and rising trend in non performing assets\textsuperscript{155}. But in the case of Indian private sector banks and foreign banks the profitability has always been excellent\textsuperscript{156}. Some of the public sector banks are deeply in the red. It is possible to defend the low profitability and poor financial condition of public sector banks by referring to their deep commitment to social obligations imposed by the Government\textsuperscript{157}.

When the banks were nationalised and brought into public sector, the ownership was acquired by Government. Along with ownership, the Government also took up certain functions which involved direct intervention

\begin{footnotesize}

\textsuperscript{154} Report on Trend and Progress of Banking in India (1985).


\textsuperscript{157} Example opening rural banking, setting up and subsidizing Regional Rural Banks, financing IRDP and other poverty alleviation programmes at concessional rates of interest.
\end{footnotesize}
in the management of the banks. This has in effect killed initiative and narrowed down the options available to both borrower and depositor. Worse still, politicians and bureaucrats are known to misuse their powers and exert influence on day to day decisions on loans and credit granted to clients.\(^{158}\)

The hope that the nationalized banks will act as the leader and pace setter in evolving an integrated and efficient functioning banking system for promoting growth with stability and social justice has not materialized so far.\(^{159}\) It is in this context that the Narasimham Committee\(^{160}\) which was constituted in 1991 assumes importance.

*Narasimham Committee on Financial Sector Reforms*

The Committee calls for legislative amendment in certain areas such as amendment in the Nationalisation Act to enable grant of greater managerial


\(^{159}\) The Stock exchange scam of 1992 proves the fragile functioning of the nationalized banking system.

\(^{160}\) The Government of India set up a high level committee with Mr. Narasimham as the Chairman to examine all aspects related to the structure, organization, functions and procedures of the financial system. Narasimham was the former Governor of the RBI. They submitted its report in November, 1991. Primarily they were interested in improving the financial health of PSB's and development financial institutions. (DFI's) so as to make them viable and efficient and meet fully the emerging needs of the real economy.
autonomy to public sector banks and as regards the constitution of the Board of Directors and Management Committees. Another aspect which requires review is the structure of the Banking Systems as per the B.R.Act. It is structured on the basis that banking supervision is a Government function and Reserve Bank is an agent of Central Government. The Act provides appellate powers to Government over decisions by RBI. in several matters and provides original power to Government in certain other aspects. The Committee was of the view that the Indian banking system is over regulated and over-administered. It viewed the irksome duality of control over the banking systems between the RBI. and Finance Ministry and stated that as the Government has proprietary interest in banks and financial institutions, it would be appropriate for the finance ministry to deal with other Government Departments and Parliament and discharge its other statutory obligations but not to engage in direct regulatory functions.

The basic approach of the Committee was that greater market orientation would strengthen the financial system and thus improve its efficiency. The major recommendations of the Narainham Committee center round the banking system, the development financial institutions and the money and the capital markets. The Committee made several recommendations relating to the capital adequacy of banking institutions,
establishment of private sector banks, structural reorganisation, abolition of
dual control, freedom to open or close or swap branches, depoliticisation of
Chief Executives’ appointments, progressive reduction of SLR\textsuperscript{161} and CRR\textsuperscript{162},
phasing out concessional interest rates, income recognition and provisioning
norms, transparent balance sheets, special tribunal for recovery of dues,
directed credit programmes etc.\textsuperscript{163} The Committee’s approach thus seeks to
consolidate the gains made in the Indian financial sector while improving
quality of the portfolio providing greater operational flexibility and most
importantly greater autonomy in the internal operations of the banks and
financial institutions so as to nurture a healthy competitive and vibrant
financial sector\textsuperscript{164}.

The proposed de-regulation of the financial sector and the measures
aimed at improving its health and competitive vitality would in the
committee’s view be consistent with the steps being taken to open up the
Indian economy, enable the Indian financial sector to forge close links with the
global financial markets and enhance India’s ability to take competitive

\textsuperscript{161} Statutory Liquid Ratio.
\textsuperscript{162} Cash Reserve Ratio.
\textsuperscript{164} Ibid.
advantage of the increasing international opportunities for Indian trade, industry and finance.

The Narasimham Committee's recommendations were based on the fundamental assumption that the resources of the bank come from the general public and were held by the banks in trust and that they were to be deployed for the maximum benefit of the depositors. This assumption automatically implied that even the Govt. had no business to endanger the solvency, health and efficiency of the nationalized banks under the pretext of using the bank's resources for the economic planning, social banking, poverty eradication etc.\(^{165}\)

The Government of India managed to appropriate the Bank's funds under the SLR scheme at low rates of interest for its own use. The committee pointed out that this was clearly based on the misconception that socially oriented credit should also be low cost credit. They also emphasized that timely and adequate access to credit was far more important than its cost. The policy makers in this country had clearly ignored the fact that institutional finance was much cheaper than the alternative of informal sector finance (from

\(^{165}\) Under the guise of social banking the Govt. of India has used the PSB's to finance many of its pet programmes of poverty reduction and alleviation. Despite many adverse criticisms and even clear recommendations against such schemes being financed through banks the Govt. of India has persisted in using bank funds to finance various social sector schemes for employment generation and poverty alleviation. P.C.P.Nambari, *Social Banking and its challenges*, State Bank of India Monthly Review, Vol.XIX, No.5 May (1980), pp.163-171
money lenders and indigenous bankers). According to the committee there was actually no need for interest subsidy which only reduced the ability of the banking system to build its strength and to extend the coverage of bank credit even by them\textsuperscript{166}.

Besides there was the question of basic morality or logic in forcing banks to make available their funds to Govt. at low rates of interest or for the finance ministry of the Govt. of India to use banks’ funds for IRDP at concessional rates of interest\textsuperscript{167}. The public who keep their hard earned savings with banks for safe custody have a right to expect a decent rate of interest on their savings. The Finance Ministry has no moral right to use or rather waste the funds of public sector banks. In fact this has been an essential feature of this country’s development strategy and a major cause for low profitability of public sector banks. Besides the Govt. has no right to get hold of the funds of the banks at low rates of interest and use them for financing its consumption expenditure and thus defraud the depositors\textsuperscript{168}.

\textsuperscript{166} Ibid at p.126.


\textsuperscript{168} D.N.Ghose, \textit{Banking Policy in India – An Evaluation} (1979), p.68.
According to the Narasimham Committee the most serious damage to the public sector banks was the political and administrative interference in decision making. Commenting on the ‘loan melas’ the committee stated that the intended socially oriented credit in the process degenerated into irresponsible lending.

The recommendations were aimed at ensuring a degree of operational flexibility, internal autonomy for public sector banks in the decision making process and a greater degree of professionalism in banking operations. The committee wanted the Govt. to make a positive declaration that there would be no more nationalization of banks. The committee also recommended that the present system of dual control over the banking system between the banking industry and the banking division of the Ministry of Finance should end immediately and that the RBI should be the primary agency for the regulation of the banking system.

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169 ‘Loan Melas’ organized by the Congress party leaders to direct bank credit to their supporters in rural and urban areas were contrary to the principles of sound banking. Dr.N.L.Mitra, Legal Dimensions of Economic Reforms (1997), p.37.

170 This was also the case in the distribution of IRDP loans among economically weak in rural areas. In many cases banks have virtually abdicated the responsibility in undertaking need based credit assessment and appraisal of potential viability and instead have tended to rely on lists of identified borrowers prepared by the Govt. authorities. Ibid at p.30

171 The appointment of the Chief Executive of a bank (Chairman cum Managing Director) should not be based on political considerations but on professionalism and integrity and should be made by an independent channel of experts and not by the Government as at present.
The Committee stated that the PSB’s should be free and autonomous. Every bank should go in for a radical change in both technology and culture, so as to become competitive internally and to be in step with wide ranging innovations taking place abroad. RBI should examine all the guidelines and directions issued to the banking system in the context of the independence and autonomy of banks. The committee directly blamed the Govt. of India and the finance ministry for the sad state of affairs of the public sector banks. These banks were used and abused by the Govt. of India, the officials and the bank employees and the trade unions. The recommendations of the committee were revolutionary in many respects and were opposed by the bank unions and certain political parties. The Govt. of India however accepted all the major recommendations of the Narasimham Committee and started implementing them immediately. Banking reforms since 1992 based on the recommendations aimed at transforming the highly regulated and directed public sector banking system into one characterized by transparency, competition, prudential and supervisory discipline.

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172 See speech by Dr.C.Rangarajan on the occasion of the silver jubilee of the NIBM (1996), RBI bulletin, p.73.


The Finance Minister of the Govt. of India appointed Mr. Narasimham again as Chairman of the second committee\textsuperscript{175}, i.e., "Committee on Banking Sector Reforms". The committee was asked to review the progress of banking sector reforms today and chart a programme on financial sector reforms necessary to strengthen India's financial system and make it internationally competitive. This committee which submitted its report to the Govt. in 1998 covers the entire gamut of issues ranging from Capital Adequacy, Bank Mergers, the creation of global sized banks, recasting Banking Boards and revamping banking legislation\textsuperscript{176}.

The financial sector reforms\textsuperscript{177} initiated during the recent past can rightly be considered as the second banking revolution paving the way for the

\textsuperscript{175} Report of Narasimham Committee II in 1998 on Banking Sector Reforms.

\textsuperscript{176} N.A. Majumdar, \textit{Banking Sector Reforms: Second Coming}, EPW Nov. 21\textsuperscript{st} (1998).

\textsuperscript{177} Narasimham Committee Report 1991 on Financial Sector Reforms. Reference may also be made to the International Finance Corporation background paper circulated in 1996. Some of the observations made here are already covered by the Narasimham Committee Report. According to the paper political and social objectives have weakened India's state owned banks financially and operationally. While appreciating the PSB's for mobilizing savings from the people, making them familiar with banking and helping develop small and rural business, the paper says that these banks have operated in a non competitive and highly regulated environment as instruments for achieving political and social objectives. Consequently they have been weakened financially and operationally and are unable to respond fully to the changing needs of India's corporate sector. The paper continues to state that India's banking system has been adversely affected due to pursuit of non commercial objectives and because of inadequate accounting and capital adequacy of loan standards. Because of directed credit, political influence in granting of loans and inappropriate appointments to the board of nationalized
development of superior foundations and positioning the banking system strategically to meet the challenges and embrace the opportunities of the future. Of course one is acutely aware that given the intensity of the tasks and problems before the banking system there is still much to be done but it would be less than charitable not to pay tribute to the progress achieved so far.

To conclude the history of development of banking in India after 1969 can be divided into three phases. In the first phase there was active state intervention with a view to building up of the institutional infrastructure. The second phase could be characterized by deregulation, rationalization and simplification of controls. The third phase has been a phase of more liberalization and restructuring.

banks the banking system was over time greatly weakened. The paper points out that in 1991 India's commercial banks made a collective loss of Rs. 41 billion. It says that as the Govt. continues its liberalization programme the traditional dominance of the public sector financial institutions and banks is expected to continue to decline. Although the situation may not be as alarming as depicted in the paper the above observation should act as an eye opener for the PSB's and financial sector reforms should be seen by all concerned both as a challenge and opportunity. It is a challenge since it calls for a process of adjustment that is new methods, new approaches and new strategies. It is an opportunity in that institutions, which measure up to international standards can certainly emerge as global players.

179 Division based on landmark changes in the banking system.
CHAPTER III