6

Emerging Role as a Bankers' Bank

The basic purpose of the establishment of the Reserve Bank of India was the unification of the authority for the regulation of currency and of credit. In regard to the banking system of the country, the primary role of the Reserve Bank was conceived as that of the lender of last resort for the purpose of ensuring the liquidity of the short-term assets of banks. Hence, the provision of credit facilities to banks through discounts and advances was to constitute the centre of relationship between the central banking authority and the scheduled banks. The custody of the cash reserves of banks vested in the Bank was primarily meant to serve as a central pool to be available for use in times of emergency for supporting scheduled banks, rather than constitute an instrument of credit control.

The Bank's Statute did not provide for any detailed regulation by it of commercial banking operations towards ensuring sound banking practices. The submission of weekly returns by scheduled banks under Section 42(2) of the Act was mainly intended to keep a watch over their compliance with the requirements regarding maintenance of cash reserves with the Bank. Inspection of banks by the Reserve Bank was also visualised for the limited purpose of determining the eligibility of banks for inclusion or retention in the Second Schedule to the Act. Thus, apart from the limited scope of the Bank's powers of supervision and control over scheduled banks, the large number of small banking institutions, which came to be known as non-scheduled banks, lay entirely outside the purview of its control. Besides, but for the few relatively minor provisions in the Indian Companies Act, 1913 governing companies engaged in the business of banking, there was a virtual absence of specific laws or regulations for controlling the operations of commercial banks. Soon after the Bank commenced operations, it became clear enough that the lacuna in regard to banking legislation

was bound to prove a serious handicap in the sphere of its regulatory functions over the banking system. The urgency of such a measure was also highlighted by the South Indian banking crisis of 1938 which brought to the fore several of the undesirable features in the working of banking institutions. Accordingly, the Bank's attention, as bankers' bank, was mainly occupied during this period with the problems of banking regulation, rather than with discounts and advances for which, as mentioned in Chapter 5, there was also not much demand on account of the prevalence, of easy money conditions.

First Move Towards Banking Legislation

The first attempt at banking legislation in India was the passing of the Indian Companies (Amendment) Act, 1936, incorporating a separate chapter on provisions relating to banking companies. Prior to its enactment, banks were governed in all important matters such as incorporation, organisation, management, etc., by the Indian Companies Act, 1913, which applied commonly to banking as well as non-banking companies. There were only certain relatively innocuous provisions in the Companies Act which made a distinction between banks and other companies. These were: Section 4, which prohibited a partnership exceeding ten from carrying on the business of banking unless it was registered as a company; Section 136, which required every limited company doing banking business to display a statement regarding its assets and liabilities in the prescribed form (Form G in the Third Schedule to the Act) every half year; Section 138, which empowered the local Government to appoint inspectors to investigate the affairs of a banking company on the application of members holding not less than 1/5th of the shares issued (as against 1/10th of the shares in the case of other companies) ; and, Section 145, which provided that if a banking company had branches beyond the limits of India, it was sufficient if the auditor was allowed access to such copies and extracts from the accounts of the branches as had been transmitted to the head office of the company.

These provisions touched only the fringe of the problem of banking regulation. The Report of the Central Banking Enquiry Committee, as mentioned in Chapter 2, emphasised the need for enacting a special Bank Act, covering the organisation, management, audit and liquidation of banks. The Committee cited the instances of the United States of America, Canada and other countries, where there were special banking laws, the objects and scope of which varied. according to individual circumstances and requirements. In a number of European countries too, after the economic depression of 1930-33, legislative restrictions on banking were introduced with the object of preventing

malpractices in the working of banks. In the U.K., however, apart from the Companies Act, there was no special enactment for the regulation of commercial banks.

There were two important features of the new legislation which embodied some of the recommendations of the Central Banking Enquiry Committee. For the first time, a determined effort was made to evolve a working definition of 'banking' and to segregate banking from other commercial operations. Secondly, the special status of scheduled banks was recognised inasmuch as certain provisions of the amended Act, such as building up reserves, were made applicable only to non-scheduled banks, on the ground that the scheduled banks could be left to the general supervision and control of the Reserve Bank. The principal banking provisions of the amended Companies Act, which came into force on January 15, 1937, were:

(i) the definition of a banking company as 'a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order', notwithstanding that it engaged in any one or more of the forms of business specified in the Section (Section 277F);
(ii) prohibition of banking companies from engaging in business other than that specified in Section 277F [Section 277G(2)];
(ii;) restriction on the managing agency system in respect of a banking company by providing that it should not employ or be managed by a managing agent other than a banking company (Section, 277H);
(iv) prescription of minimum paid-up capital of Rs. 50,000 for banking companies incorporated after the commencement of the Act (Section 277I);
(v) prohibition of creation of charge on unpaid capital (Section 277J);
(vi) transfer by non-scheduled banking companies, before any dividend was declared, of not less than 20 per cent of the annual profits to the reserve fund until such fund equalled the paid-up capital, and for the investment of the reserve fund in Government or trustee securities or in a special account with a scheduled bank (Section 277K) ;
(vii) maintenance by non-scheduled banking companies of, a cash reserve of at least 1½ per cent against their time liabilities and 5 per cent against demand liabilities (Section 277L) ;
(viii) restriction on formation of a subsidiary company or holding of shares in any subsidiary company except a subsidiary company formed for the purpose of undertaking the administration of estates as executor trustee or otherwise and for other purposes set forth in Section 277F as were incidental to the business of accepting deposits on current account or otherwise (Section 277M); and

(ix) the grant of a moratorium by the court to a banking company in temporary difficulties (Section 277N).

Reserve Bank and Banking Legislation

While the initiative for the amendment of the Indian Companies Act came from the Central Government, the Reserve Bank was actively consulted on the portions of the measure pertaining to banking companies. The vexed question of definition of 'banking' appears to have given rise to a cleavage of views at the highest executive level inside the Bank. The definition, incorporated in the Amendment Bill, was welcomed by the Governor, Sir Osborne Smith, whose personal view, recorded in November 1935, was that the activities constituting banking had never been defined in this country and it was high time that the permissible duties and limitations were defined by Statute. However, Sir James Taylor, the 'senior' Deputy Governor, was more concerned with the difficulty of framing such a definition; a difficulty which, he said, had been emphasised by every authority which had examined the subject both in this and other countries, e.g., in England the Macmillan Committee, and in India the Hilton Young Commission and the Central Banking Enquiry Committee. In his opinion, the enumeration of the various lines of business which a banking company could undertake would involve Government in expensive litigation on difficult border-line cases, hamper legitimate current activities and impede future development. There could also be evasion by some banks, claiming that banking was not their 'principal' business, which would 'drive a coach and four' through the Bill's whole object, namely, to effect a clear separation between banking and other companies. In July 1936, the Reserve Bank conveyed to the Government its opinion that the attempt to frame a comprehensive definition should be abandoned and a banking company should be merely described as a company which carried on the business of banking. The Bank, however, suggested that, if it was thought desirable, there could be a statutory 'objects' clause in the memorandum of association for banking companies, to prevent the growth of mushroom institutions. The views of the Bank did not have much practical effect and the Select Committee appointed to consider the amendments (under the chairmanship of Sir N. N. Sircar, the Law Member of the Viceroy's Executive Council) adopted a definition of 'banking company' almost in the same form as was originally proposed and incorporated a more detailed list of activities in which a banking company might engage. The stand taken by Sir James was, however, vindicated later, when the difficulties envisaged by him in determining whether a company was a banking company or not posed knotty problems for the Registrars of Companies.

Apart from the question of definition, the Bank was also averse to the clauses regarding (a) maintenance of a cash reserve by non-scheduled banks, in the absence of a provision for statutory returns necessary for its enforcement and (b) grant of moratorium to an individual institution, since, in any case, a sound bank in difficulties could count on the Reserve Bank for assistance and the sooner that an unsound bank closed its doors the better, so as to make the winding-up process fair to all concerned. About the other clauses, the Bank was of the view that the minimum paid-up capital for a banking company suggested in the Amendment Bill was too low at Rs. 50,000 and should be raised to Rs.1 lakh and that the annual transfer by non-scheduled banks to the reserve fund before any dividend was declared, should be not less than 2½ per cent of the paid-up capital till the former equalled the latter. The other suggestions made by the Bank related to (i) the examination of the question of extending the clause regarding prohibition of loans to directors of companies (Section 86D, which was inapplicable to banking companies) to the directors of a banking company and (ii) the prohibition of loans to auditors.

None of these suggestions found a place in the Amendment Act of 1936 in the manner the Bank wanted. Perhaps, the Central Government was in a hurry to see the Amendment Act through, recognising that some legislation for banks was better than no legislation.* In his minute of dissent to the Select Committee's Report, a member, Mr. Mathuradas Vissanji, emphasised the desirability of a separate comprehensive legislation to regulate and govern banking business in the country and asked for a public undertaking from Government, as had already been given with regard to insurance companies, to bring forward the necessary legislation for banking business also.

Reserve Bank and Non-Scheduled Banks

The amended Indian Companies Act, no doubt, placed some restrictions on the business of non-scheduled banks, but they were still outside the purview of the central banking authority, which practically had no information on their working. In view of the fact that over 200 out of 1,421 banking and loan companies had paid-up capital and reserves of over Rs. 50,000 and several of them could be regarded as potential scheduled banks, the Bank considered that it should establish closer

* Sir N. N. Sircar was so worked up with the number of amendments suggested that he wrote in August 1936 to Sir James Taylor thus: 'I said casually that the bill will take 10 full days in the House, upon which Pandit Pant observed "It will take more than 12 days"! If I do not last till the end, I hope you will find time to attend my funeral. I shall leave instructions for a copy of the Company Law to be burnt at my cremation'. Sir James replied: 'I do not think that the alterations you have made will lead to any difficulty and hope that you will be able to maintain them in the discussions with the Legislature, so that all the trouble which you have taken will not end on a combined burning ghat '!

contacts with them. Accordingly, at the instance of the Bank, the Central Government passed, in February 1938, an amendment to the Indian Companies -Act, under which non-scheduled banks were required to submit an additional copy of their returns (such as cash reserve returns, balance sheets, etc.) to the Registrars of Joint-Stock Companies for being transmitted to the Reserve Bank for information. The Reserve Bank, however, had no statutory power to call for any further information even though it might feel the need for it for enabling it to assess the soundness of individual banks. In November 1938, a circular letter was, therefore, addressed to non-scheduled banks with paid-up capital and reserves of Rs. 50,000 and over, enquiring whether they would be willing to place the Reserve Bank in possession of information regarding their operations so that the Bank could, if necessary, help them with advice and guidance. The response from non-scheduled banks to this informal approach was quite encouraging. The Bank also recommended to the Government of India a standard form for submission of the cash reserve return under Section 277L of the Indian Companies (Amendment) Act, 1936.

The information on non-scheduled banks which the Bank obtained in pursuance of its efforts merely served to substantiate the general impression about deficiencies of small banks. The following extract from the Governor's speech at the annual general meeting of shareholders of the Bank in February 1939 portrays the Bank's concern for them:

> Small banks have doubtless a useful place in society provided that they circumscribe their activities to a small area and serve the needs of small scale industries and agriculturists. When, however, they extend their ramifications too far, they must inevitably labour under the difficulties attendant on small scale institutions, such as the competition of the larger banks, their inability to employ an equally well-qualified staff conversant with modern methods of banking, or to spread their risks. They are the most vulnerable points in our banking system which become exposed when there is the slightest shock to our credit structure. . . . . It remains to be seen whether the provisions in the Indian Companies Amendment Act will be sufficient to ensure the orderly development of banking in this country or whether it will be necessary for the Central Legislature to consider a more comprehensive and detailed measure dealing with banks alone.

Later in the year, proposals for such a measure were submitted by the Bank to the Central Government; these proposals are set out in some detail later in this chapter.

Growth of Joint-Stock Banking: 1935-38

A brief survey of the growth of joint-stock banking in the years immediately following the Bank's inception may be introduced at this stage

so that subsequent banking developments may be viewed in proper perspective. The first three years of the Bank's functioning synchronised with a fairly steady growth of commercial banking. The scheduled banks (inclusive of four banks incorporated in the Burma region*): 48 in number at the time of the establishment of the Bank, rose to 57 by the end of 1938. Their demand and time liabilities increased from Rs. 208 crores in July 1935 to Rs. 239 crores in December 1938. The Central Government, at that time, had no option under Section 42(6) of the Reserve Bank Act but to direct the Bank to include in the Second Schedule to the Act any bank which had paid-up capital and reserves of an aggregate value of Rs. 5 lakhs or more irrespective of its financial position and methods of operation. This made it convenient for some of the non-scheduled banks on the border line to acquire the status and privileges of scheduled banks by making relatively small increases in their paid-up capital and reserves. A scrutiny of the balance-sheets and other returns of some of the banks seeking inclusion in the Second Schedule to the Act revealed resort to certain undesirable practices in raising the paid-up capital and reserves.

There was also a substantial increase in the number of offices of scheduled banks from 723 to 1,125 during the period, though this was in part due to the inclusion of new banks in the Second Schedule. The branch expansion, both among the scheduled and non-scheduled banks, was particularly noticeable in South India. This growth in branch banking did not fail to attract the attention of the Bank, which attributed the trend to the desire of banks to develop the potentialities of the up-country markets on account of cheap money conditions. The Bank also welcomed the expansion of branches by the larger banks as one of the main solutions to the problem of building up rural credit and spreading the banking habit. However, the Bank was soon to be made aware of the lurking dangers of unhealthy expansion and the urgent need on its part for exercising greater vigilance over the operations of banking institutions, by the rude shock administered by the failure of a leading bank in the Southern region.

South Indian Banking Crisis

Since the banking crisis of 1913-14 which brought disaster to many a joint-stock bank, bank failures in the decades following constituted, by and large, individual failures resulting from endemic weakness and deficiencies to which several banking companies were prone in the days

* Consequent on the separation of Burma from India in April 1937, these four banks were, under the India and Burma (Burma Monetary Arrangements) Order, excluded from the Second Schedule to the Reserve Bank Act and redesignated as ' Burma scheduled banks'. They were, however, obliged, till February 1942, to maintain minimum cash balances with the Reserve Bank and submit weekly (or in difficult circumstances, monthly) statements of position.

of unregulated banking. The failure of the Travancore National and Quilon Bank (TNQ Bank) in the middle of 1938 created a public scare of which the Government and the Bank had to take notice. It drew attention to the urgent need for comprehensive banking reform and legislation to avert the dangers of policies of unbridled expansion of branches, frittering away of profits by distributing high dividends, speculation in investments, granting of advances without security or on inadequate security, incompetence or dishonesty of management and so on. The size and standing of the TNQ Bank were such that its failure sparked off a banking crisis in Southern India in the form of heavy withdrawals of deposits. Luckily, the crisis in a severe form lasted only for a short period; but an underlying feeling of nervousness persisted in the region until the close of the year. The Reserve Bank, on receiving news of the crisis, sanctioned increased borrowing limits to banks in that region up to their statutory deposits; the limits were doubled subsequently. Additional assistance was extended by the Bank to some of the banks which approached it for help during the closing months of the year. Yet, there was much adverse criticism of the Reserve Bank's policy in relation to the banking crisis in- general and the TNQ Bank in particular. To appreciate the grounds of criticism and the Bank's stand, it is necessary to narrate in some detail the proximate events surrounding the closing of doors by the TNQ Bank.

The TNQ Bank was constituted in September 1937 by the amalgamation of two separate banks, the Travancore National Bank and the Quilon Bank, which were established in the then Travancore State in 1912 and 1919, respectively. The merger was acclaimed in the local press as the 'greatest banking amalgamation in South Indian history '. The Reserve Bank also felt that an amalgamation, if soundly conducted, might be of material assistance in improving the banking situation. The Governor, while welcoming the step, advised the bank to devote its profits towards building up reserves rather than paying higher dividends. To facilitate the amalgamation, the Reserve Bank also sanctioned a line of credit to cover the actual period of the change-over extending up to the end of December 1937. As on December 31, 1937, the amalgamated bank had paid-up capital and reserves of Rs. 28 lakhs, deposits of Rs.3 ½ crores, investments of Rs.56 lakhs and advances of Rs. 2⅔ crores. It had 75 branches spread over the country with the Central Office at Madras and the Registered Office in Travancore State. In April 1938, barely six months after the amalgamation came into effect, there was an unprecedented run on the bank and it with drew the bulk of its statutory deposit with the Reserve Bank. It was subsequently rumoured'-and this was given publicity by a section of the South Indian press-that the initial panic was artificially created

and sustained by the highest authorities in the Travancore State, on political and communal grounds. As the run continued to grow in intensity, the TNQ Bank was constrained to suspend payment on June 21, 1938.

A fortnight before this event, the Managing Director of the bank (Mr. Mathen) had approached the Reserve Bank for financial help. The Deputy Governor (Mr. Nanavati) informed Mr. Mathen that 'he would always be glad to help the bank if there was possibility of doing so on business consideration' and asked him to submit as soon as possible a statement of loans, advances and investments and, in particular, setting out clearly the secured and unsecured loans to employees, directors and their families as well as loans that were overdue or under litigation. The Deputy Governor also indicated that if the statement showed prima facie a solvent position, a thorough investigation into the position of the bank would be conducted so that the Reserve Bank might make advances against specifically segregated assets of the bank. The bank agreed to the investigation, whereupon the Reserve Bank issued instructions to the TNQ Bank's auditors on the lines the investigation had to be carried out by them. The investigation was commenced on June 20, 1938, but on the same day the TNQ Bank instructed the auditors not to continue the investigation as the Reserve Bank was not giving any immediate help. The next day, June 21, the bank suspended payment. Proceedings for winding up commenced in Quilon where the Registered Office of the bank was situated and also in Bombay on June 22. Another petition for winding up was presented at the Madras High Court on June 23.

The bank, meanwhile, had requested the Reserve Bank to take charge of its property and assets and conserve them, pending further investigation. The Governor replied that under the Reserve Bank Act such functions could not be undertaken. At the same time, the Governor deputed Mr. Nanavati, the Deputy Governor, to Madras on June 27 because of the continued uneasiness of the situation. Discussions took place between the Deputy Governor and the Madras Government on June 27 and 29 regarding the affairs of the TNQ Bank. On June 30, the Government of Madras issued a press communique stating that the Government had anxiously considered all possible steps that could be taken to-meet the situation, and that in consultation with the Reserve Bank they had to suggest the following course of action. The TNQ Bank should apply to the Reserve Bank to take up an immediate and thorough investigation of its affairs through competent auditors and agree to act according to the advice tendered by .the Reserve Bank as a result of the investigation, for the continuation, reorganisation or liquidation of the bank, whichever course was finally suggested. The TNQ Bank informed the Reserve Bank of its acceptance

of the proposal for investigation and requested the latter to make suitable arrangements for carrying it out.

The Reserve Bank provisionally estimated that the expenses of the investigation would amount to Rs. 10,000 and intimated its willingness to undertake the investigation on payment of this sum. The TNQ Bank moved the Madras High Court, on July 2, 1938, to appoint provisional liquidators and to sanction the payment of Rs.10,000 out of the assets of the bank. The Court appointed the provisional liquidators and adjourned the hearing of the winding up proceedings to July 28 pending investigation by the Reserve Bank; the provisional liquidators were directed to give every assistance in their power for making the investigation possible. The Court, however, refused to sanction the costs of investigation on the ground that it had no power for authorising the expenditure. The Madras Government and the TNQ Bank thereupon requested the Reserve Bank to take up the investigation, assuring that the costs would be borne by a third party. On July 8, the Reserve Bank expressed its willingness to depute a Special Officer at its expense to keep it in touch with the liquidators, assist them generally and apprise it of further developments. In the beginning, the Special Officer could not secure the necessary co-operation from the bank officials, but he examined some books and statements with the help of the provisional liquidators and submitted a preliminary report to the Bank during the third week of July 1938. The findings of the report were: nearly all the easily realisable securities had been realised during the run in April and May 1938; the balance-sheet as on December 31, 1937 was an incorrect one; the bank was buying its own shares presumably with a view to keeping up their market value; it was indulging in speculation in stocks and shares; the directors and other interested parties had borrowed to the tune of Rs. 26 ½ lakhs on inadequate security or on a clean basis, etc.

In order to have a first hand knowledge of the situation, the Governor visited Madras between July 18 and 20. He had an interview with the Prime Minister of Madras and received a deputation from the Committee of Creditors of the TNQ Bank. After perusing the Special Officer's report and getting all the information from the local sources, the Governor wrote to the Prime Minister on July 28, 1938, that the only conclusion to be drawn from the material available was that the interests of the depositors would best be served by allowing the liquidation proceedings to take their course without further postponement. The letter was published in the local press on August 9, 1938. In the meantime, a scheme for reconstruction of the bank had been presented before the Madras High Court and the Quilon District Court by certain depositors. The Madras High Court was inclined to consider the merits of the scheme; but difficulties were encountered due to the

Official Liquidator of Travancore not being prepared to recognise the claims of 'foreign' creditors in the distribution of the Travancore assets. The District Court of Quilon, relying on the report of the Official Liquidator of Travancore, considered the scheme to be unworkable and ordered the winding up of the bank in August 1938. An appeal was made by the bank against this order in the High Court of Travancore, but the High Court confirmed the order of winding up passed by the lower court stating that the bank was commercially insolvent and that it was satisfied that the bank would not be able to pay the claims of the creditors as they accrued. The Agent of the Imperial Bank at Trivandrum was appointed as Official Liquidator. As it was unable to pursue with the consideration of the scheme on account of the decision taken by the courts in Travancore, the Madras High Court also ordered, on September 5, the winding up of the British Indian offices of the bank and appointed the provisional liquidators as Official Liquidators. Thus, there was a jurisdictional tangle, which later affected the smooth progress of liquidation proceedings of the bank as the bulk of the money was borrowed in British India while the greater part of the assets were in Indian States. The liquidation proceedings went on for about seventeen years, till the bank's dissolution on March 21, 1955, during which time a total dividend of 12 annas 3½ pies in the rupee was paid to creditors.

The Reserve Bank's role in this episode came in for vehement criticism in the press as also by the Chambers of Commerce in the Southern region and by some of the South Indian scheduled banks. The Bank was attacked, in the first place, for what was considered to be the negative attitude it took while the TNQ Bank was sinking, and secondly, for not offering adequate aid to the other South Indian banks which were affected during the crisis. It was contended that the Bank had pointlessly insisted on an examination of affairs at a time when the TNQ Bank was gasping for breath and that such investigation, if at all, should, have been carried out at the time of amalgamation or in the course of the preceding three years. It was also argued that the Reserve Bank could have provided assistance subject to payment of a penalty. Wrote the Indian Finance:*

> A few days after the Travancore National and Quilon Bank suspended business, Mr. Nanavati visited the South Indian capital, where every bank of local domicile was, in the panic that followed, being subjected to severe raids. He went; he saw; and he conquered. The Reserve Bank was willing, he proclaimed, to help every sound bank. And a new definition of a sound bank was discovered. Any bank expressing its willingness to Mr. Manila1 Nanavati to have its accounts examined by the Reserve Bank was the new description of a sound bank. . . . . . Not

*July 23, 1938.

> to be left behind, even the half-dead, half-living Travancore National and Quilon Bank sought to buy the goodwill of Mr. Nanavati by offering to throw open all their books and by a promise to find Rs. 10,000 for the gracious look-over by the Reserve Bank. One wonders if this ransom of Rs.10, 000 was laid on each of the banks which applied for the Reserve Bank's inspection.

It may be mentioned in this context that all the further inspections of banks have been conducted by the Bank at its expense. Even in this case, although initially the Bank claimed reimbursement of the expenses of inspection, later it deputed, as stated earlier, its own Special Officer for a scrutiny.

The criticism that the Bank should have lent a helping hand to the TNQ Bank in the emergency failed to take note of the fact that such help would have meant investing good money after bad, even assuming that the fetters imposed by the Reserve Bank Act could have been relaxed. The position of the bank was, even from the preliminary and cursory evidence at the disposal of the Special Officer and the official liquidators, quite bad. The judgment of the courts in Travancore and Madras brought to light several disquieting features in the bank's operations. The position is well summed up in Governor Deshmukh's words*:

> In the light of the repayment made to the depositors by the liquidators it has been argued in some quarters that the intrinsic position of the bank was sound and that the failure could have been avoided had the Reserve Bank given timely assistance to the bank. The Board could be expected to take into account only the existing conditions and the information available to them. Although the depositors were paid 12 to 14 annas in a rupee, it may be mentioned that this was possible only by calling in from the shareholders their liability in respect of the unpaid amount of the shares; and another fortuitous circumstance was that, as a result of war, the liquidators were able to realise much larger prices for the estates and lands on which advances had been made by the bank.

The Southern India Chamber of Commerce, voicing the opinion of the joint-stock banks and indigenous bankers of Southern India, in a memorandum to the Governor, mentioned that the banks and the public had been disillusioned by the attitude adopted by the Bank towards the scheduled banks in the crisis. The Chamber wanted a definite pronouncement from the authorities of the Bank in regard to the attitude which the Bank would assume when similar crises arose in future. It suggested that if a scheduled bank was in liquidation, the Reserve Bank could give some relief to the commercial and other interests by making to the liquidator some advances against the sound

* Central Banking in India -A Retrospect.

assets of the bank to meet partially the demands of the creditors, the extent of the advances depending on the valuation of those assets. The Chamber deprecated the over technical and strained interpretation placed on the provisions of Section 17 of the Act by not accepting demand promissory notes of the constituents of banks and the latter's promissory notes supported by documents of title to goods in their pas-session, which were offered as security for advances. The ceiling on accommodation set by the Bank for rediscounting bills (i.e., twice the statutory deposit made under Section 42 of the Act) was, the Chamber said, too low to be of much practical help to the banks. To avoid the complications of independent jurisdictions, it also suggested that banks incorporated in Indian States or foreign settlements in India should not be allowed to open branches in British Indian Provinces, except under certain safeguards, such as fresh registration under the Indian Companies Act or obtaining a licence from the Reserve Bank.

The Governor's view, as conveyed to the Chamber, was that, if the Reserve Bank was to render effective help, the scheduled banks should also play their part and make proper provision for emergencies. He said that the Bank could not possibly help a bank experiencing a run by taking over its entire management, as this would mean that the Bank would be guaranteeing the solvency of each and every bank. There was also the problem of finding a new directorate for a bank, after its reconstruction, since the public would have come to the conclusion that the previous directorate was incompetent to handle its affairs. The Governor felt that making advances to liquidators also went beyond the Bank's statutory functions and would require legislation. He explained that there was no statutory limit setting out the extent to which the Bank could advance, but if advances were made by the Bank without proper investigation, there would be more harm than good to the unfortunate depositor in the event of liquidation becoming eventually necessary. In his general remarks, the Governor assured that the constructive suggestions made by the Chamber would be carefully considered, but he did not think it advisable' to rush into hasty legislation as all such provisions are double-edged '. He objected to too much control of the banking system on the ground that 'no control in the world will prevent recklessness or dishonesty while on the other hand it gives a false sense of security ', but recognised that 'conditions in India are different from those prevailing in England' and that 'there must be occasions here in which control is desirable even though it is proved unnecessary elsewhere'.

The failure of the TNQ Bank and the banking crisis in South India led to the view that, in the interests of the depositors, adequate powers of obtaining information and exercising control and supervision over the affairs of banks should be assumed by the Reserve Bank, so that it

could come to the rescue of sound banks in times of such emergency, prevent the gross abuses prevalent in the banking system and help build a sound banking tradition. The banking crisis of 1988 was thus the immediate cause of the proposals for a Bank Act made by the Reserve Bank in 1939, the whole of the draft of which was initially prepared by Sir James Taylor himself.

Bank's Policy Regarding Discounts and Advances

One of the results of the banking crisis was the elucidation of the Bank's policy regarding discounts and advances to scheduled banks. With a view to removing any misunderstanding about the nature and extent of the financial assistance which scheduled banks could expect from the Reserve Bank, a circular letter was issued by the Reserve Bank to all scheduled banks on September 1, 1938. The main purport of the letter was to explain that a central bank was, in essence, the lender of last resort and it could use the resources at its command only at times when the resources of the member banks had been exhausted. It would also assist individual member banks when in difficulty, so long as it was satisfied that they were strong. There was also 'the obvious difficulty that the Reserve Bank is being asked to help a bank in circumstances in which the credit bills of the country have not been exhausted, when other banks have funds but are not prepared to lend to it, in short, when the problem is as to the solvency of the member bank or group of banks, and not dearth of money in the credit system as a whole'.

The circular went on to say that the Reserve Bank did not have in its possession adequate data to enable it to judge the true financial position of the scheduled banks and that full information would be necessary if the Bank was to be in a position to extend assistance to deserving institutions without delay. There was, therefore, imperative need for scheduled banks to submit to the Bank periodical returns of their investments, bills and advances portfolios. The Bank also offered to depute an officer to establish informal contacts with banks. Later, speaking at the annual general meeting of the shareholders of the Bank, in February 1939, the Governor stated that the Bank had succeeded in establishing closer contacts with some of the South Indian banks in pursuance of the policy set out above. Such contacts, which were entirely voluntary on both sides, had afforded, he mentioned, an opportunity for frank and confidential discussions, enabling the Bank to give advice and guidance in suitable cases.

In December 1938, the Bank also circulated an Explanatory Memorandum to the scheduled banks, indicating the circumstances under which accommodation from the Bank might be sought by scheduled banks, the lending policy of the Bank and the ' eligible securities '

under the Reserve Bank Act which could be offered as collateral. It was mentioned that the Reserve Bank might be called upon to assist the scheduled banks (a) to meet some unexpected and temporary demands for which the scheduled banks concerned might not have been able to make provision in advance ; (b) to meet seasonal needs when there was stringency in the money market; and (c) in special circumstances affecting one bank or group of banks (e.g., a slump affecting the trade or industry with which certain banks were more particularly concerned or a scare imperiling banking habit in one particular part of the country). The very nature of the functions permitted under Sections 17 and 18 of the Reserve Bank Act required that business which the Reserve Bank undertook should be liquid, short-term and generally self-liquidating the securities eligible under Section 17 would consist of bills of exchange and time promissory notes, Government and trustee securities, bullion and documents of title to goods.

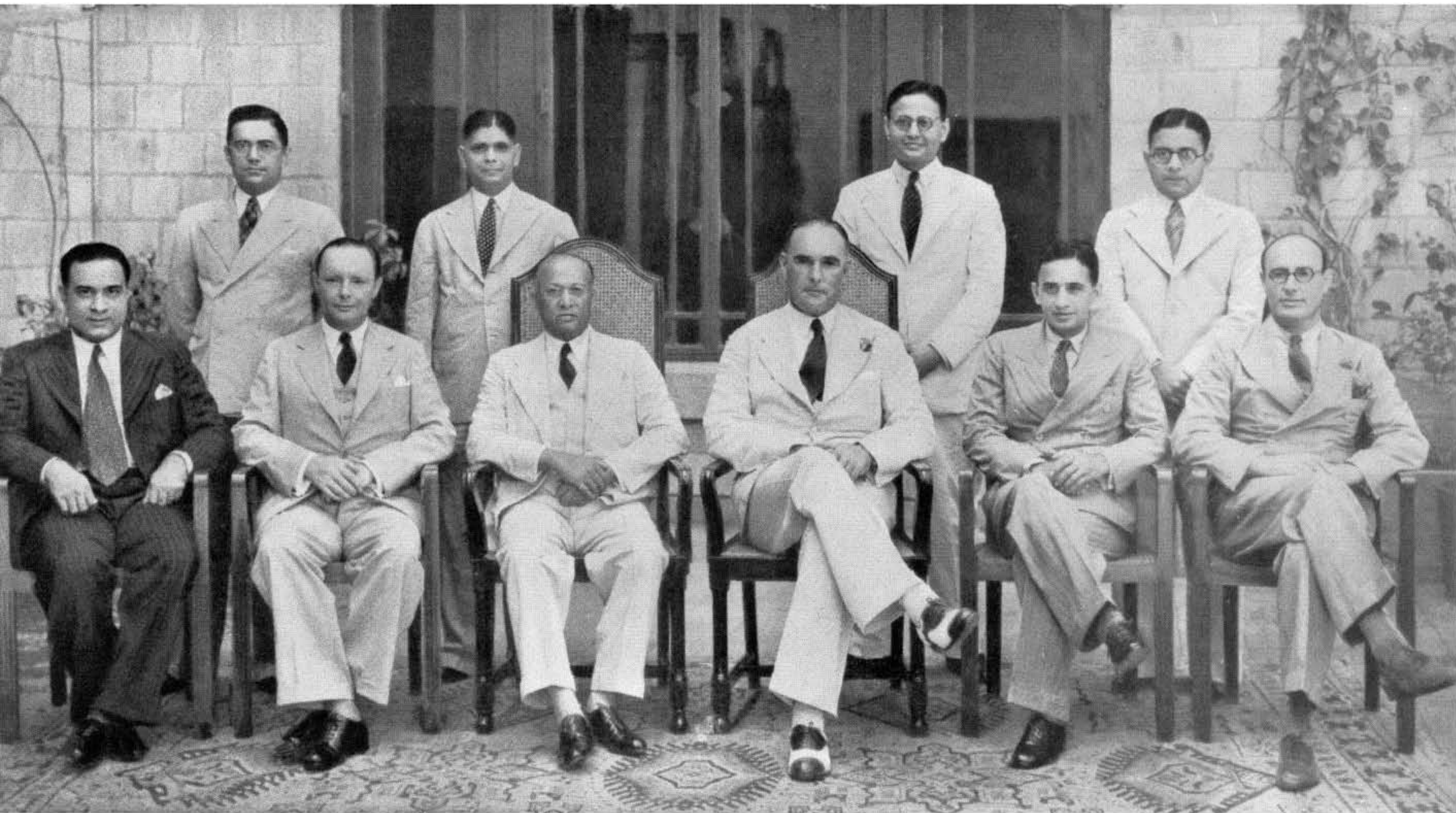
The adherence of the Bank to a strict interpretation of ' eligible securities ' for granting advances to scheduled banks under Section 17 of the Act had given rise to considerable criticism during the banking crisis. Consequently, the Explanatory Memorandum took pains to elucidate that the Reserve Bank was precluded from accepting, for purposes of purchase, discount or granting advances, demand promissory notes of constituents of banks which were not eligible paper under Sections 17(2) and 17(4) (c) of the Act, as these instruments had no fixed maturity. It also clarified that Sections 17(4) (b) and 17(4)(d) did not envisage advances against the security of gold or goods pledged to scheduled banks. This was because the scheduled bank could not transfer better title to the gold than it had itself, and had to release the gold on repayment of the original debt. On the other hand, delivery of gold was required which would need the development of an organisation for physical possession of gold by the Reserve Bank throughout the country. Likewise, Section 17(4) (d) re erred to 'documents of title to goods' and not to 'goods' because if the goods were transferred to a scheduled bank by its customer, the document of title would have to be created by the scheduled bank which had made the advance; it was not possible for the bank to create such a document in respect of the goods pledged to it since, despite possession of the goods of its customer, it was not his mercantile agent as defined in the Indian Sale of Goods Act. Further, the Reserve Bank Act did not contemplate the Bank's taking possession of the goods and looking after their warehousing. It followed, therefore, that the documents of title given by the customer to the scheduled bank and passed on to the Reserve Bank should be fully negotiable instruments, such as, warehousing receipts issued by an independent warehousing authority. The Bank's solicitors concurred with

the Bank's views-mentioned above. About Section 17(4) (d), they were also of the view that the security required could only be a transfer, assignment or pledge of the document already pledged, transferred or assigned to the scheduled bank by its customer and that such a document could be created only if the goods were not in the possession of either the scheduled bank or its constituent but in the possession of a mercantile agent or a warehouseman.

It must be mentioned that the draft of the Explanatory Memorandum had come in for criticism by some Directors of the Central Board at its November meeting. Sir Purshotamdas Thakurdas was of the view that unless the Reserve Bank could, on a scheduled bank approaching it, advance against pledged goods, assistance from the Bank, for practical purposes, would be very small. While he did not wish to contest the legal opinion, he felt that a practical solution to the difficulty might be found by way of taking off the stamp duty on time bills or hundies, which was the main handicap to the popularity of bills. Mr. C. R. Srinivasan was highly critical of the Bank's rigid posture. He said:

> Service with safety is the normal measure of value, of a Central Bank. All for safety and none for service cannot be the motto of a Central Bank alive to its larger responsibilities. In the literature that has so far issued from the Reserve Bank, it seems to me, there is far too much of doctrinnaire assertion and far-too little of practical grasp of the realities of the situation. . . . . .The method of approach strikes me as wrong. Organised credit in this country is yet of small dimensions and if the slender contact maintained with the scheduled banks is allowed to suffer by ultra cautious and conservative methods of dealing with their needs and requirements, the Reserve Bank can play no vital or vitalising part in the direction or diversion of credit in the country. That is a position few of us can view with equanimity.

Mr. Srinivasan felt that until the bill market developed and the warehouses came into existence, promissory notes endorsed/executed by the banks covering goods pledged could be treated as eligible paper. This suggestion regarding the acceptance of demand promissory notes was not found practicable by the Governor. His view was that such promissory notes were usually not drawn for any business transaction and accommodation was granted for an indefinite period according to the convenience of the bank or the drawer. The insistence on time bills was therefore based on genuine trade practice in India and foreign countries. Hence, the only immediate course open to the Reserve Bank was to try to work the Act as it stood. In the circumstances, the Board approved the issue to scheduled banks of the circular as proposed in the draft, also resolving that 'in accordance with the memorandum submitted by Sir Purshotamdas



The Governor and the Deputy Governor with some officers of the Bank (1941).
SITTING (LEFT TO RIGHT): *B. L. Punjabi, C. R. Trevor, Manilal B. Nanavati, James B. Taylor, C. D. Deshmukh, H. D. Cayley.*
STANDING: *N. D. Nangia, C. S. Divekar, B. K. Madan, D. N. Maluste.*

On becoming a Director of the Central Board of the Reserve Bank of India I do solemnly and sincerely declare that I will faithfully perform the duties of Director and that I will to the best of my ability uphold the interests of the Reserve Bank of India and that I will observe strict secrecy respecting all transactions of the Bank and all matters relating thereto and that I will not directly or indirectly communicate or divulge any of the matters or any information which may come to my knowledge in the discharge of my duties as such Director except when required or authorised to do so by the Central Board of the Bank or by law.

Bank's scroll *of* **oath** *of secrecy.*

Thakurdas the Board repeat * their recommendation to Government that the stamp duty on usance bills be reduced as early as possible, and point out that failing such reduction other methods of affording assistance will have to be considered which may involve amendments of the Act '.

It may be mentioned, incidentally, that Section 17(4) (d) was amended in 1951 by substituting after 'documents of title to goods' the words 'such documents having been transferred' instead of the words ' which have been transferred', thus making it clear beyond doubt, that only documents of title to goods were acceptable to the Bank for advances.

Banking Development in the Post-Crisis Period

The banking crisis of 1938 was largely a localised affair confined to South India; It had no serious repercussions on the banking system in the country as a whole. On the other hand, the number 'of scheduled banks increased from 57 in December 1938 to 61 in December 1939, despite the exclusion, from the Second Schedule, of the TNQ Bank on account of its liquidation, and of two other banks following a change in constitution and amalgamation with another bank, respectively. The increase was partly explained by the entry into scheduled status of some non-scheduled banks to secure the exemptions given to the scheduled banks from the operation of debt relief legislation and to acquire the status and publicity that scheduled banks enjoyed in the public mind. The demand and time liabilities of scheduled banks increased from Rs. 239 crores at the end of 1938 to Rs. 251 crores at the end of 1939. The number of their offices rose from 1,125 to 1,277 during 1939; the major part of the increase in offices was accounted for by the seven new banks scheduled during the year.

The character of the territorial distribution of banking offices in the period 1935-39 may also be commented upon briefly. According to a study made by the Bank, despite the rapid development of branch banking during the period 1935-39, there were 956 towns (about 57 per cent of the total number of towns) with a population between 20,000 and 50,000 which had not been served by an office of a joint-stock bank; towns with a population of 50,000 and more were, however, well catered for. The Bank's finding was that the small towns did not afford lucrative avenues to new banks. Besides, most of such towns were already being served by co-operative banks and societies. The distribution of banking offices was very uneven, some towns having a very large number of banks, while others, though important, had only a few.

* A similar recommendation had been made earlier in the Statutory Report made under Section 55 (1) of the RB1 Act.

There was also concentration of banking offices in certain Provinces like Madras, Bengal, the Punjab and Bombay.

As regards the state of banking confidence, the suspension of payment and application for moratorium in May 1939 by one of the scheduled banks-in the Calcutta Circle, had practically no adverse effect in that region, although one bank in the Delhi Circle was temporarily affected and the Reserve Bank had to grant it a limit for rediscounting of bills to help tide over the crisis. The decline in silver prices in the middle of 1939 gave rise to unfounded rumours of impending trouble in the case of a scheduled bank .based on its association with silver interests, but confidence soon returned. Again, in September 1939, on the outbreak of hostilities in Europe, certain scheduled banks experienced hurried withdrawals induced by fears of widespread escalation of the war, but the deposits soon began to return as the initial panic subsided and was followed by the emergence of boom conditions due to war.

Meanwhile, the Bank continued its efforts to get into closer touch with non-scheduled banks. A second circular was issued to them in August 1939 indicating that, if any of them required the Bank's advice or guidance, they should forward to it copies of their Memoranda and Articles of Association, balance-sheets for the previous three years, etc.; further, if they sought detailed advice, they would have to furnish detailed information about their operations. The Bank, however, found that, out of about, 42 concerns which could be considered to be non-scheduled banks, only 682 banks were submitting cash reserve returns. Most of the remaining banks contended that they were not banks inasmuch as they did not accept deposits withdrawable by cheque, draft or order. The Registrars of Companies instituted test cases against some of these concerns, but the proceedings resulted in their acquittal. There was also the anomalous position that companies which were registered before the coming into force of the Companies Amendment Act were allowed under that Act to call themselves as banks even if they were not carrying on banking business as defined in the Act; such companies could, despite having the words 'bank', 'banker' or 'banking' as part of their names, refuse to comply with the provisions of the Act relating to banking companies.

The Bank prepared and submitted to the Central Board, in October 1989, a report on the non-scheduled banks, with special reference to the distribution of their assets and liabilities. The report mentioned that several of these banks had poor cash reserves, a low investment ratio, overextension of the advances portfolio and a large proportion of bad and doubtful debts; especially in Bengal and Assam, there had been a mushroom growth of banks whose financial position was suspect; and all this information was given only on the basis of dressed-up

balance-sheets, which did not disclose many of the more unsatisfactory features.

Proposals for an Indian Bank Act

In June 1939, the Governor circulated to the Local Boards of the Bank a memorandum prepared by him containing proposals for an Indian Bank Act which was designed to bring within the orbit of the Bank's control the entire joint-stock banking sector. These proposals were formulated after a study of the banking laws of several foreign countries such as Canada, Australia, Denmark, U.S.A., Norway, Sweden, South Africa and Switzerland. The objective was limited to what was immediately necessary and practical, but at the same time the framework of the new measure possessed sufficient flexibility to provide room for further additions as experience accumulated.

The proposals, in the first instance, envisaged a clear-cut definition* of 'banking' as the accepting of deposits on current account or otherwise subject to withdrawal by cheque and of a 'banking company' as a company defined in the Indian Companies Act including a foreign company which did the business of banking in British India; co-operative banks were therefore excluded from the purview of the Act. It was also provided that a company which did banking business should include as part of its name the word ' bank', 'banker' or 'banking ' and no company which did not do banking business should use any of these words as part of its name. A list of the forms of business in which a banking company could engage, as enumerated in Section 277F of the Indian Companies Act, 1936, was also incorporated in the new proposals along with the provision that it should engage in no other business except such as the Government might notify in the Gazette of India.

A major objective of the measure was to safeguard the interests of the depositor. The case for affording adequate protection to the depositor was admirably and forthrightly set out by the Governor as follows:

> It never has been, and never will be, possible by legislation to prevent the rogue gulling the greedy fool, that is, the person who is open to be deceived by specious promises of high profit. A depositor, however, stands on a different footing when he places his money with a bank on current account at a very low rate of interest or without interest at all, because he thinks that it will be safe. If the Legislature wishes to protect him, and it is obviously in the interests of the development of the country that he should be protected, so as to encourage him to save and to deposit his money with banks as a preferable alternative to hoarding and as a preliminary to investing his money in Government securities or otherwise, we must take such measures as will ensure that any institution

* Apparently, Sir James Taylor had come round to the view that it was necessary and possible to give a clear definition of 'banking '.

> calling itself a bank which receives money on current account should firstly have sufficient resources to make it humanly possible that it can operate on a scale large enough to give it a working profit even if it has to confine itself to proper banking business; secondly, that certain minimum restrictions should be imposed on its investments to ensure that there are limits to the loss which the depositor can incur if it fails; thirdly, provision must be made to expedite liquidation proceedings so that if a bank does fail the depositor will get what is left with the minimum of delay and litigation expenses.

To achieve the desired objective, the proposals included, inter alia, (a) minimum capital standards, the amount of capital depending up on the area of a bank's operation and the population of the towns in which it operated, (b) a minimum proportion of assets to be held in British India and in liquid form and (c) certain provisions for expediting liquidation proceedings, besides incorporating some of the provisions of the Indian Companies Act relating to banking companies. The Governor was not inclined to provide for elaborate periodical inspections by the Bank or any separate Government Inspection Department which would ' merely tend to create a false sense of security in the minds of the public and throw all the onus of responsibility on those responsible for inspection in the event of a bank failing '. His view was that 'if the work is to be done properly, it must involve legal power to summon books for inspection which it would be somewhat invidious to give to the Reserve Bank, as this would tend to give the latter the role rather of a policeman than of a colleague and helper of other banks which is the obvious ideal '. He was also not in favour of extending the Act to private and indigenous bankers. The reasons given were that (a) these bankers rarely took deposits on current account and as such, no case had been made for protecting their depositors, (b) the regulation of usurious money lending practices was an item of Provincial legislation and would almost certainly be considered ultra vires of a Central Act, and (c) any assistance that such bankers might require from the Bank would be difficult to give, in the absence of their keeping proper accounts segregating their banking from other businesses.

The Local Boards of the Bank evinced a great deal of interest in the proposals. With the exception of the Madras Local Board, they welcomed the proposed Bill, but they were of the opinion that it was capable of expansion and modification and suggested certain amendments to individual clauses of the Bill. The Madras Local Board felt that the Bill per se concentrated on safety to the prejudice or neglect of service and some of the regulations imposed might lead to unforeseen results and unexpected developments. It gave vent to its concern for the protection of the borrowers and asked for sufficient safeguards to assist well conducted banks in panic. The Governor's reply was that

the general comments of the Madras Local Board seemed to put the matter in wrong focus. He did not wish, for the purpose of the proposals, to cover the whole range of lending and borrowing money which would be manifestly impossible; what he wanted to do was to ensure that, as far as possible, a person who wished to deposit his money in a bank, so that he could have the use of it at any time, did not find that the bank was using the money in such a way that it was not available when wanted. The proposals were, therefore, based on the general principle that the primary objective should be to safeguard the interests of the depositor, not the borrower or shareholder. It was not that the Local Boards merely indulged in criticism of the proposals; they did make several suggestions which were found useful and incorporated in banking legislation in subsequent years, such as, the quantum of liquid assets to be maintained, preferential treatment of smaller depositors in the event of liquidation, licensing and audit of banks, restrictions on directors' borrowing and prohibition of the chief executive of a bank being engaged in any other business or vocation.

The Governor submitted the proposals, along with the suggestions made by some of the Local Boards, to the Central Board in July 1939; the Board suggested further consultation with Local Boards. Meanwhile, the proposals had leaked out in the press Some of the newspapers commented that insistence on investment of 30 per cent of liabilities in Government securities was unwarranted ; the provisions were calculated to make liquidation peremptory, simpler and speedier and reconstruction possibilities more difficult; the proposals were inadequate and objectionable; and so on. It must, however, be mentioned that the press also gave useful suggestions in regard to such matters as inspection of banks by Reserve Bank officials, possession of knowledge of banking by bank directors and insurance of bank deposits -suggestions which found their way into banking legislation much later.

In October 1939, the Central Board approved the proposals. A list of the final proposals submitted to the Government of India, in November 1939, is given below:

(i) Definition of 'banking' and 'banking company', as stated earlier;

(ii) Stipulation as to minimum capital and reserves for each banking company as follows:

(a) Rs.1 lakh for any banking company not covered by clauses (b) to (d) below;

(b) Rs.5 lakhs for a banking company having its office at Bombay or Calcutta;

(c) Rs. 2 lakhs for a banking company having offices at other places with a population of over one lakh; and

(d) Rs.20 lakhs if a banking company operated outside the State or Province in which it had its principal office of business. (It was

also stipulated that the subscribed capital of a banking company should not be less than half of its authorised capital and its paid-up capital not less than half of its subscribed capital);

(iii) Maintenance by a banking company of at least 30 per cent of its demand and time liabilities in cash or in unencumbered approved securities ('approved securities' being defined as securities in which a trustee could invest under Section 20 of the Indian Trusts Act, 1882);

(iv) Holding of assets in British India by a banking company to the extent of at least 75 per cent of its liabilities;

(v) Prohibition of a banking company holding shares in any company whether as pledge, mortgagee or absolute owner of an amount exceeding 40 per cent of the issued capital of that company;

(vi) Provisions regarding compulsory winding up of a banking company if it was unable to pay its debts and preliminary distribution to depositors on winding up without the necessity of calling for a meeting of creditors or contributories and restriction on voluntary winding up unless approved by the Registrar;

(vii) Penalties for defaults in complying with the provisions of the Act; and

(viii) Central Government's powers to suspend a portion or any of the Sections of the Act for not exceeding two months at a time and to make regulations for enforcing the Act.

Besides the above provisions, the provisions in the Indian Companies Act, 1936, pertaining to banking companies were also incorporated in the proposals.

The Banking Companies Act took even longer time to be born than the Reserve Bank of India Act; it was only in 1949 that the measure was placed on the Statute-book, though there were odd bits of interim legislation.