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Commercial Banking Developments

The Second World War had a tremendous impact on the Indian banking system. There was a phenomenal growth of banking, in terms of resources as well as number of offices, under the stimulus of monetary expansion and the large-scale war effort. The Indian banking system as a whole withstood the strains of the war period very well and displayed remarkable resilience and vigour in several directions. There is no doubt that there was also growth of the banking habit in the country. However, the war-time banking structure presented several disquieting features too, which were particularly marked in the case of the newly established units. While the needs of the economy during the war warranted a rapid expansion of banking and there was certainly room for some new institutions, there was a pronounced tendency for opening banks with little intrinsic strength in the form of a sound capital structure and liquidity of assets; more serious was the rather indiscriminate opening of branches and the employment of unsound methods to attract deposits. The motives behind several of the new banking ventures were not altogether legitimate or worthy. There was evidently a desire to get control over public funds for speculative investments and trading activities and also for pecuniary gains in many ways through excessive salaries, bonus, commission, etc. There was again, in some cases, a desire on the part of industrial houses to have under their control sizeable banking and insurance establishments; this interlocking of interests between banks, insurance companies and industrial concerns was generally detrimental to the interests of bank depositors. There was moreover, in some cases, the dressing up of accounts to give a misleading impression of the financial position of the bank. A number of banks also engaged in dubious devices to become eligible for inclusion in the Second Schedule.

These developments lent urgency to the passing of comprehensive banking legislation. Unfortunately, this did not materialise during the war period. In the early years of the war, the Bank itself desired postponement of such legislation; in the later war years, the new Governor made every possible effort to get the measure enacted but this did not prove possible owing to circumstances beyond the Bank's control. However, some ad hoc enactments were made to deal with some specific abuses and shortcomings of the banking system. The Reserve Bank spared no pains to have an adequate statutory base for the regulation of the banks on sound yet progressive lines. The Bank's contacts with the commercial banks, both scheduled and non-scheduled, became much closer during the war; these would in any case have taken place, but the war developments made it all the more imperative on the part of the Bank to be in a position to keep a close watch on the banking system.

During the war years banks did not have to seek much accommodation from the Reserve Bank, since there was a very marked expansion of deposits and there were no corresponding avenues for lending; in the result, the bulk of the funds came to be invested in Government securities. The Bank's assistance was sought mainly on occasions when, because of war developments, there was a temporary run on some banks. Nevertheless, the Bank tried to enlarge to some extent the availability of funds to the banks through loans and discounts. While the principal forms of assistance were by way of purchase of and loans against Government securities, arrangements were also made to provide accommodation under Section 17(2) (a) or 17(4) (c) of the Reserve Bank Act against usance promissory notes supported by bills in respect of Government supply contracts. But, as already mentioned, the Bank's actual lending to the scheduled banks was negligible, the largest outstanding accommodation being in the neighbourhood of just Rs. 1crore. Another direction in which the Reserve Bank tried to assist the banks and indirectly the balanced development of the national money market was the liberalisation of remittance facilities. These facilities were also extended to approved non-scheduled banks and indigenous bankers. A further promotional measure, which was largely the result of the Bank's efforts, was the reduction, in 1940, in the stamp duty on commercial bills and promissory notes, to a nominal level of two annas per Rs. 1,000 or part thereof.

Towards the close of the war, the Bank started taking interest in the subject of industrial finance. In a statement which the Government of India issued on April 21, 1945, outlining among other things, their plan for the future industrial development of the country, it was stated that the question of the promotion of an Industrial Investment Corporation or a similar institution, for providing long-term funds for industry, was being examined by Government. In the General Purposes Sub-Committee appointed by the Department of Planning and Development, it was generally agreed that the question was one of urgency and should be examined by the Finance Department in consultation with the Reserve Bank. In implementation of this decision the Bank prepared a comprehensive study on the subject in the middle of 1945; its conclusion was that the most suitable financial institution would be one owned jointly by Government, Reserve Bank and institutional and other investors, with the power not only to lend but also to underwrite issues of share and debenture capital. The Bank's proposals were generally accepted by Government and the Bank was entrusted with the task of the formulation of a detailed plan, including a draft bill. These efforts culminated in the establishment of the Industrial Finance Corporation of India in 1948. The developments in this regard will be discussed in detail in the section relating to the period 1945-51

War- time Banking Growth

The growth of commercial banking, which was most marked in the latter part of the war period, is indicated in the table below, relating to the scheduled banks.

(Rs. crores)

Last Friday of		No of Reporting Schedules Banks*	Liabilities			Cash and Balances with in Reserve Bank	Advances and Bills Discounted
			Demand	Time	Total		
August	1939	55	135	103	238	34	105
December	1939	56	139	101	240	26	143
“	1940	57	166	97	263	57	100
“	1941	58	213	108	321	42	125
“	1942	62	334	111	445	60	99
“	1943	74	501	158	659	117	168
“	1944	84	617	203	820	109	250
“	1945	91	673	280	953	122	327

* Excluding Burma scheduled banks; figures in other columns exclude those in respect of the Burma branches of Indian scheduled banks.

† Figures include those relating to Burma banks up to the end of 1941; the amounts in respect of Burma banks are, however, negligible.

With the extension of the war to Burma in December 1941, scheduled banks in India with branches in Burma found it increasingly difficult to submit returns prescribed by Section 42 of the Reserve Bank Act in respect of their business in that country. To relieve their difficulties, the Reserve Bank of India (Temporary Amendment) Ordinance was issued in February 1942, amending temporarily Sections 42(1) and (2) and 43 of the Act, so as to omit all references to Burma. The effect of the Ordinance was that scheduled banks in India were not required to include their liabilities in Burma for the purpose of computing the statutory cash reserves with the Bank; their returns would reflect their position in India only. The provisions in the Burma Monetary Arrangements Order stipulating compliance by Burma scheduled banks with the conditions regarding maintenance of minimum cash balances with the Reserve Bank or submission of the weekly (or monthly) returns remained in abeyance, for all practical purposes, until June 1946 when they were deleted. Thus, after 1942, there was practically no statutory relationship between the Reserve Bank and banks in Burma.

The increase of thirty-five in the number of scheduled banks in the six years between 1939 and 1945, as against the increase of under ten in the pre-war years, was about equally divided between newly established units and existing units which acquired the scheduled status. The liabilities (mostly deposits) of scheduled banks rose by almost 300 per cent, demand liabilities recording a much larger rise than time liabilities. On the assets side, the principal changes were a decline in the share of advances and bills and an increase in investments mostly in Government securities. The advances-deposits ratio, which on the eve of the war was about 44 per cent rose sharply to 60 per cent by the end of 1939; over the subsequent three years, there was a significant contraction of credit and so the ratio declined. From 1943, scheduled bank credit rose rather sharply; even so, the ratio at the end of 1945 was only around 35 per cent owing to the steeper rise in deposits. Investments of Indian scheduled banks, mostly in Government securities, showed a nearly 500 per cent increase during the period from Rs. 75 crores to Rs. 433 crores, representing roughly three-fifths of the increase in deposits *. Apart from the war-time necessity to have a large portfolio of Government securities, banks found it quite profitable to do so, since these securities carried a yield of 3 per cent or more, whereas banks paid either no interest or negligible interest on demand deposits, which constituted the major portion of their total deposits, and the rates prevailing on time deposits too were comparatively low at ½ to 1 ¾ per cent. The above phenomenon also, to some extent, contributed to the spurt in the starting of new banks and the tendency to open a large number of branches.

* Figures relating to investments of scheduled banks have not been shown in the table on p. 438 as they were not available from the returns under Section 42(2) of the Reserve Bank Act, on which it is based. The data are available in respect of Indian scheduled banks from their balance sheets. However, as the balance sheets of exchange banks relate to their global position, consolidated figures for all scheduled banks cannot be given.

Non-scheduled banks also shared in the deposit growth during the period although there was a decline in their number, as may be seen from the following table.

(Rs. crorcs)

Last Friday of	*No. of Banks Submitting Returns*	*Demand and Time Liabilities*	*Cash Balances*
1939	609	16	1
1940	604	17	1
1941	601	20	2
1942	534	25	3
1943	530	35	5
1944	613	53	6
1945	632	74	9

The substantial rise in the number of branches, especially in the latter half of the war period, may be seen from the table below.

Year	Imperial Banks of India	Exchange Banks	Other Schedules Banks	Total Scheduled Banks	Non Scheduled Banks with Paid-up Capital and Reserves of Rs. 5 lakhs and over	Non Scheduled Banks with Paid –up Capital and Reserves of Rs.50,000 to Rs.5 lakhs	All Banks
1940	383	87	844	1,314	105	545	1,964
1941	393	84	937	1,414	204	678	2,296
1942	392	84	971	1,447	263	869	2,579
1943	399	84	1,395	1,878	400	996	3,274
1944	421	79	1,944	2,444	@	@	@
1945	428	77	2,451	2,956	811	1,434	5,201

@ Not available.

It will be seen that the tendency for expansion was particularly noticeable among the smaller banks. New offices were opened without careful preliminary prospecting. This resulted in the opening of too many branches in places which already had banking facilities. For instance, between 1942 and 1945, of the increase of over 1,500 in the number of offices of scheduled banks, only 217 offices were opened at places which were not previously served by either a scheduled bank or a non-scheduled bank having capital and reserves above Rs. 50,000.

EXTENSION OF FACILITIES TO BANKS AND INDIGENOUS BANKERS

The establishment of a sound banking system called for close surveillance by the Reserve Bank and legislation was necessary to clothe the Bank with the requisite powers in this behalf. Simultaneously, action was necessary to integrate the money market further and narrow the variations in interest rates arising from regional as well as seasonal imbalances in the supply of and demand for funds. A brief account may first be given of the action taken in this area, namely, arrangements for an adequate system of remittances and the promotion, to an extent, of the bill market habit through reduction of the stamp duty on usance bills and promissory notes. The Bank also extended to non-scheduled banks the facility of opening of accounts with it (i.e., the Reserve Bank).

Scheme for Remittance Facilities, 1940

Provision of adequate remittance facilities constitutes one of the important means of narrowing seasonal and regional stringency in the money market and of unifying the national monetary and credit system. From 1935 onwards, the scheduled banks were enjoying certain facilities for effecting remittances (free of charge or at lower rates than those charged to other banks and the general public) between the accounts kept by them with the Reserve Bank and its agency, viz., the Imperial Bank*. The available facilities suffered from certain shortcomings. For instance, even the scheduled banks had no special facilities for transfers to and from places at which there. were no offices of the Bank or branches of the Imperial Bank. For transfers to and from such places, they had to pay the same rates as the general public, viz., 1/16 per cent for Rs. 10,000 and over; ⅛ per cent for Rs. 1,000 up to Rs. 10,000; and ¼ per cent for less than Rs. 1,000. Secondly, the existing facilities were not available to even the relatively larger and well managed non-scheduled banks or indigenous bankers; nor did the co-operative banks and societies enjoy these facilities except for certain limited types of remittances. Further, the remittances were effected in obsolete forms such as Currency Telegraphic Transfers, Supply Bills, Remittance Transfer Receipts, etc.

With the object of liberalising the facilities and altering the forms of remittance in a manner more consonant with ordinary banking practice, the Bank introduced in October 1940 a new scheme of remittance facilities. The principal features of the scheme were as follows:

* The facilities covered the remittances of money as follows:

(a) an amount of Rs. 10,000 or a multiple thereof, between the scheduled bank's accounts at the offices and branches of the Reserve Bank, free of charge;
(b) once a week an amount of Rs. 5,000 or a multiple thereof, to the account which the scheduled bank maintained with the principal office of the Reserve Bank from any place at which it had an office, branch, sub-office, or pay-office, and at which there was an agency of the Reserve Bank, free of charge;
(c) other remittances to its account at the principal office of the Reserve Bank, subject to a charge of 1/64 per cent, and
(d) other remittances through the Reserve Bank or its agency, subject to a charge of 1/16 per cent for amounts less than Rs. 5,000 and 1/32 per cent for amounts of Rs. 5,000 and above.

(i) The old forms of remittance were discontinued and were substituted by telegraphic transfers, mail transfers and Government and bank drafts.

(ii) For scheduled banks, the existing facilities were continued and, in addition, telegraphic transfers, mail transfers and drafts in favour of third parties were allowed, subject to certain limits on drawings on Treasury agencies, at the following rates; 1/16 per cent for amounts up to Rs. 5,000 and l/32 per cent over Rs. 5,000. These rates were considerably lower (generally 50 per cent) than the earlier rates, already referred to. All the Treasuries and sub-Treasuries with currency chest facilities were designated as Treasury Agencies of the Reserve Bank for the issue and payment of telegraphic transfers and drafts.

(iii) The scheme was, for the first time, made applicable to such non-scheduled banks and indigenous bankers as were included in an approved list to be compiled by the Bank. These were to be charged the same rates as those charged to the scheduled banks for remittances in favour of third parties, viz., 1/16 per cent up to Rs. 5,000 and l/32 per cent over Rs. 5,000.

For inclusion in the approved list, non-scheduled banks and indigenous bankers were to have a minimum owned capital of Rs. 50,000. Only those indigenous bankers who accepted deposits and/or discounted hundies with joint-stock or other banks primarily with a view to making loans were eligible to apply for inclusion. Besides, an approved non-scheduled bank or indigenous banker had to conform to any banking or moneylending regulation that might be in force in the respective Province. At the end of December 1945, there were seventy-nine non-scheduled banks and four indigenous bankers on the approved list for remittance facilities.

(iv) The scheme was also extended to co-operative banks and societies (see Chapter 16). These institutions were to be charged the same rates as those charged to scheduled banks for remittances in favour of third parties, i.e., l/is per cent up to Rs. 5,000 and l/32 per cent over Rs. 5,000, except that the minimum commission per remittance was fixed at four annas for co-operative banks and societies as against Re. 1 for eligible commercial banks and indigenous bankers.

Thus, the remittance facilities were simplified and extended to cover the entire banking system in a uniform measure, except that the scheduled banks were allowed certain additional facilities for effecting remittances between the accounts maintained by them with the offices of the Reserve Bank or the Imperial Bank.

Reduction of Stamp Duty on Promissory Notes

Mention has been made in Chapter 6 of the keen interest shown by the Bank's Board to get the stamp duty on bills reduced by the Government with a view to popularising the use of bills for commercial transactions. The duty payable up to 1940 was on an ad valorem basis according to the schedule of rates prescribed by the Indian Stamp Act as far back as 1912. For instance, the duty payable on a bill of exchange or time promissory note of Rs.1,000 was fifteen annas. In January 1940, the Central Government reduced the stamp duty on inland bills of exchange of not more than one year's usance to two annas per Rs.1,000 or part thereof. The relative modification, however, omitted promissory notes from its scope; inasmuch as the vast majority of inland bills in India were drawn in the form of promissory notes, the higher rates of duty on them caused considerable inconvenience to the business community who were forced to draw their usance bills in the form of bills of exchange in order to obtain the benefit of reduction of the duty. This anomalous position was pointed out to the Central Government by the Bank in April and October 1940, with the request that the reduction be made applicable to promissory notes as well. The Central Government agreed to the Bank's suggestion and by a notification issued in November 1940 reduced the stamp duty on inland promissory notes payable otherwise than on demand and of not more than a year's usance to two annas per Rs. 1,000 or part thereof, with retrospective effect from the date of the original modification.

Opening of Accounts by Non-Scheduled Banks

On a representation received from certain non-scheduled banks, the Bank agreed to allow non-scheduled banks to open accounts with it with effect from February 1945. The opening of accounts was to be at the absolute discretion of the Bank and be subject to the following terms and conditions:

(i) the bank should maintain a minimum balance commensurate with the volume of business transacted and in no case less than Rs. 10,000;
(ii) the account should not be treated as an ordinary current ac-count by issuing cheques in favour of third parties, but could be used for remittance purposes and inter-bank transactions;
(iii) no interest would be allowed on balances maintained in the account;
(iv) a bank would be allowed to open an account only at the office of the Reserve Bank within the Province in which the bank's principal office was situated; and

(v) the Reserve Bank could refuse to open an account or could close an account without assigning any reason.

At the end of 1945, eleven non-scheduled banks had been approved for opening accounts with the Bank.

BANKING REGULATION

As already explained, even in the pre-war years, the Bank gave considerable attention to the problem of regulating the banking system so as to eliminate the prevailing unhealthy features and unsound practices. These features assumed rather serious dimensions in the war period necessitating immediate action, albeit on an ad hoc basis. The various developments in the sphere of banking regulation may now be discussed.

Regulation of 'Scheduled ' Status

The position at the commencement of the war period was that banks having paid-up capital and reserves of Rs. 5 lakhs and over were included or retained in the Second Schedule, more or less as a routine, irrespective of their financial position, as the returns submitted by them were not adequate for such an assessment and the Bank had no statutory power of inspection of their affairs. The Bank felt the necessity of knowing more of the methods of operation of such banks as approached it for assistance. This contingency arose when, with the intensification of the hostilities in May 1940, some scheduled banks experienced withdrawal of deposits due to a certain degree of nervousness among depositors. The scheduled banks, on the whole, had no difficulty in meeting the withdrawals; nevertheless, the Reserve Bank issued a circular letter in June 1940, advising scheduled banks that if they needed assistance from the Bank by way of rediscounting of bills, they would have to provide continuous information about their position and working. The circular also mentioned that it might be necessary for an officer of the Bank to pay a visit to the scheduled bank desiring accommodation in order to have a clearer idea of its financial position. It was made clear that the Bank would be prepared to give assistance to scheduled banks only if it was satisfied that their business was run on sound lines and on condition that any advances granted by the Bank would be utilised by them solely for the purpose of tiding over their difficulties and not for increasing their lending or investments.

Some important modifications were also made in the manner of implementing the statutory requirement that a bank must have paid-up capital and reserves of an aggregate value of not less than Rs.5

lakhs to qualify for the scheduled status. Hitherto, the general practice was for the Bank to be satisfied about this condition on the basis of the book value shown in the balance-sheet. Since this was found to lend itself easily to abuses on the part of non-scheduled banks aspiring for inclusion in the Second Schedule, the Central Government, in consultation with the Bank, decided that the words 'aggregate value of paid-up capital and reserves' occurring in Section 42 (6) of the Reserve Bank Act should be interpreted to mean the real or exchangeable value of paid-up capital and reserves and not merely the book value as shown in the balance-sheet. In pursuance of this decision, a new procedure for inclusion of banks in the Schedule was drawn up under which the Bank agreed to co-operate with the Government in evaluating the value of capital and reserves. Under this procedure, on receipt of an application from a bank, the Reserve Bank would, in the first instance, scrutinise the balance-sheets of the applying bank and if, as a result of the scrutiny, the Bank found the affairs of the bank were above board, it would recommend the bank for inclusion in the Second Schedule forthwith. If, however, the Bank considered that further details were required before an opinion could be expressed on the applicant bank's position, the Bank would request the Government to require the bank concerned to fill in the usual 'inspection' forms, which could give a fairly accurate picture of the bank's position. In cases where the balance-sheets revealed an unsound position, the Reserve Bank would inform the Government that an inspection of the applicant bank's books was necessary before it could be recommended for inclusion. Such inspection would take a week or less and be carried out by an officer of the Bank on behalf of the Government and with the consent of the applying bank. The report of the inspection, with the Bank's recommendations, would then be submitted to the Government for decision on the question of admission to the Schedule.

In terms of the new procedure, several banks were inspected by the Bank and many among them were considered ineligible for inclusion in the Schedule on the score of the real or exchangeable value of the paid-up capital and reserves being less than Rs. 5 lakhs. In 1941, as desired by the Government, the Bank submitted a list of banks already included in the Schedule but whose capital and reserves were suspected to have fallen below the prescribed minimum. Government thereupon issued notices to some of the banks stating that they desired to be satisfied whether the banks continued to fulfil the conditions requisite for retention in the Schedule and seeking their willingness to permit the Bank to inspect their books and accounts for the purpose. Most of the banks signified their assent for inspection; but before the programme of inspection could be completed, war developments and the consequent disturbance of rices made it temporarily difficult to evaluate the banks' assets accurately and necessitated partial postponement of the programme. With the return of relatively stable conditions in 1942, the work was resumed. On the basis of the inspection, one bank was excluded from the Schedule in June 1943.

Although the inspections were undertaken by the Bank for a limited purpose and, that too, with the consent of the banks concerned, they did give the Bank an insight into the general financial position and working of the banks and afforded the basis for many of the clauses to be incorporated in subsequent banking legislation. From 1939 through February 1944, the Bank inspected about thirty banks.

Statutory Reserves -Reserve Bank (Amendment) Act, 1940

Ever since the closing of the doors of the Travancore National and Quilon Bank in 1938, the Bank's management was greatly concerned over the difficulty in the administration of Section 42 (1) of the Reserve Bank Act, which stipulated the maintenance with the Bank of a daily balance of not less than five per cent of demand liabilities and two per cent of time liabilities by each scheduled bank. The TNQ Bank had been in persistent default for over two months before it suspended payment. The Reserve Bank had asked it to rectify the position; and on its expressing its inability to do so, the matter had been referred to the Central Government whose sanction was necessary under Section 42(5) for any legal action under the Section. The Government had replied after taking legal opinion that the Bank had no statutory power to compel a scheduled bank to raise its deposits to the required minimum inasmuch as sub-section (4) of the Section provided a penalty for non-compliance and that the ordinary legal principle was that where a Section in an Act laid down that something should be done and in the same Section provided a penalty for not doing it, no other remedy was legally enforceable.

The Bank then enquired from Government whether it could refuse to allow a scheduled bank to draw on its account when the balance was below the minimum. Government again replied after taking legal advice that for the same reason the Bank had no power to do so. A third possibility, viz., the issue of a communique to the public, drawing attention to the non-compliance regarding maintenance of the prescribed minimum balance, was also explored, but the Bank was advised by its solicitors that such publication would be ultra vires, since the necessary power could be conferred upon the Bank only by an amendment of the Act and not by a mere amendment of the regulations made there under. Further, it was pointed out that publication of such information would immediately cause a run on the concerned bank and almost certainly force it to close its doors.

The position was thus unsatisfactory, especially because it left the public in ignorance of the fact that a bank had been persistently in default. Of course, the original intention in prescribing a minimum deposit was primarily to provide a credit pool which would be at the disposal of the Bank and not to give security to the depositors of the scheduled banks. Even so, the Bank felt that steps should be taken to rectify the anomalous position of defaults by banks. However, in view of the prevailing scare in Southern India after the TNQ Bank crash, the Bank contented itself with writing to each bank, which seemed to it to require correction after examination of its balance-sheet, pointing out the tendency among scheduled banks to overtrade and impressing on the bank concerned the necessity to restrict its advances to a maximum of 60 per cent of its total deposits and keep the balance in liquid form, that is, cash, Government securities, etc. Scheduled banks were also advised that they should, as a measure of prudence, augment their reserve fund until it equalled the paid-up capital, notwithstanding the fact that the provisions of Section 277K of the Indian Companies Act, 1936, compelling banks to build up their reserve fund, had not been made applicable to scheduled banks. The Legislature had felt that in the case of scheduled banks less rigidity was necessary and that the matter could be left to the general supervision and advice of the Reserve Bank.

The Central Board of the Bank had decided in July 1938 that consideration of the action to be taken in case of defaults by banks should be deferred until the liquidation proceedings pending with the courts were over. The matter, however, came up again for consideration in connection with the defaults committed by a bank in the Calcutta area. Thereupon a reference was again made to the Central Government in May 1939 requesting them to bring forthwith to the notice of the public that it was a misapprehension to think that Section 42 was meant to afford real protection to the depositors and that there was no legal impediment in the Act to the withdrawal of those deposits on payments of penal interest by the defaulting bank. The letter was subsequently published by the Government.

In view of further persistent defaults by some of the scheduled banks, the Central Board desired in August 1940 that early action should be taken to tighten up the effectiveness of Section 42 of the Reserve Bank Act in advance of the consideration of general banking legislation. The Board desired, in particular, that the Governor should consider whether the penal provisions of Section 277L of the Companies Act (i.e., imposition of fine on every director or other officer of the bank knowingly and willfully a party to the default) could not be made applicable to recalcitrant cases.

The Governor accordingly examined the question in all its ramifications and considered certain alternatives, such as: (i) vesting of authority in the Bank to examine the affairs of the bank committing default persistently and to ascertain whether it was due to temporary difficulties or mismanagement, (ii) prohibition of the bank from taking fresh deposits or granting advances or declaring dividend, (iii) removal of the bank from the Second Schedule, and (iv) publication of the name of the defaulting bank. On careful study, all the above alternatives were found unsuitable.

Suggestion (i) was considered undesirable as it would have involved a fundamental change in the scope of Section 42. The criterion for inclusion in the Schedule was the size of the bank and not its soundness. Secondly, the solvency or otherwise of a bank could not possibly be judged by the small percentage of cash reserve held, without regard to its other assets. Suggestions (ii) and (iii) were also likewise considered by the Bank as too far-reaching. The last suggestion had already been discounted as causing unnecessary publicity and possibly scare. Ultimately, the Governor recommended to the Board the imposition of a penalty (i.e., fine) analogous to that provided in Section 277L of the Indian Companies Act, for non-scheduled banks. The Board approved the above proposal in October 1940 and suggested that an additional clause be provided for in the proposed amendment of Section 42 of the Reserve Bank Act to the effect that the Bank might at its discretion cause a notice to be served on the defaulting bank prohibiting it from receiving any fresh deposits and imposing a suitable punishment for any breach committed against such prohibition.

Legislation was introduced by the Central Government on the lines suggested by the Bank's Board and the Reserve Bank of India (Third Amendment) Act, 1940, became effective November 1940. Under this Act, every Director and officer of a scheduled bank who was knowingly and willfully a party to the default -the period being specified in the Section -was punishable with fine which could extend up to Rs. 500 per day; besides, the Bank could prohibit a scheduled bank from receiving fresh deposits. Similar penalty was to be levied if the bank accepted fresh deposits in contravention of the embargo laid by the Reserve Bank.

Control of Capital Issues

Alarmed at the rate of growth of mushroom companies, generally as well as in banking and insurance sectors, and with the object of preventing undesirable capital reconstruction practices as well as the diversion of funds from the defence effort, the Central Government published in May 1943 an amendment to the Defence of India Rules, inserting a new Rule, 94-A, to control capital issues. This Rule prohibited the floatation of new companies or raising of any fresh capital by the sale

Fifth Annual Meeting of the Boards of Governors of the I.M.F. and the I.B.R.D.
(Left to right) : Mr. Eugene R. Black, President, I.B.R.D., Sir Chintaman D. Deshmukh, Chairman of the Boards of Governors, Mr. Vincent Auriol, President of French Republic and Mr. Maurice Petsche, French Finance Minister.

Sir Chintaman Deshmukh (centre) with .\lr. .. Sundaresan (to his IeJt) and Mr.* 3. *V. Joshi (to his right), at annual meeting of* **Boa&** **0f** *Governors* **0f** *the I.,M.F. and the I'.B.R.D.*

of shares, stocks, bonds and debentures without the consent of the Central Government. Applications for capital issues by banks (and insurance companies) were referred to the Reserve Bank for its comments. The Bank had to keep in view, while judging the applications on their individual merits, the overriding consideration of promotion of healthy banking development in the country as also the need for strengthening the capital structure of the existing banks, which in the case of the vast majority of the Indian banks was weak. For instance, on December 31, 1943, in British India, there were 585 banking companies, of which only 82 (apart from the exchange banks) had paid-up capital and reserves of over Rs. 5 lakhs each, while 135 had between Rs. 1 lakh and Rs. 5 lakhs each and the remaining below Rs. 1 lakh each.

The disposal of applications from banks for capital issues by the Reserve Bank in the period between May 1943 and November 1944 is indicated in the table below.

	Total No.of Banks applying	Total No.of Applications	Recommended	
			For Acceptance	For Rejection
New floatations (proposed banks)	60	67	34	33
Existing				
Scheduled banks	46	72	49	23
Non-scheduled banks	206	265	117	148
	312	404	200	204

The largest number of applications came from Bengal (153)) followed by Madras (76), Bombay (45) and the Punjab (37).

At a Conference of joint-stock banks of South India held in Madras in November 1944, one of the complaints ventilated was to the effect that the Department of Examiner of Capital Issues in conjunction with the authorities of the Reserve Bank was standing in the way of the smaller banks strengthening their capital structure. This, on examination by the Bank, was found to be baseless. In fact, out of 76 applications from the Madras Province received up to November 1944, as many as 45 had been recommended for acceptance.

In a memorandum on the subject submitted to the Central Board in December 1944, the Governor explained that the applications were sanctioned on the basis of criteria such as the promotion of the company having reached an advanced stage, conversion of indigenous banking concerns into joint-stock companies, helping backward communities, serving places with inadequate banking facilities and good standing of the promoters. The rejection of applications in the case of new floatations was mainly on the score of unsatisfactory reports on the standing of the promoters and the proposed areas of operation being already over banked. In the case of existing banks, unsound financial position and methods of operation formed the main reason for rejection; in a few cases, there was over-capitalisation. The Governor elucidated that 1:10 was usually regarded by the Bank as the normal ratio which should roughly exist between owned resources (paid-up capital and reserves) and deposits. This ratio, he added, was not, however, a rigid one nor was it the sole criterion adopted by the Bank. Each proposal was regarded on its merits, the underlying idea being whether the sanction would be in the best interests of the bank's shareholders and depositors and whether it would assist banking development.

The President of the Madras Local Board was rather critical of the Bank's policy with regard to capital issues control. An important point he made was that for its proper administration, control over the establishment of branches by banks was necessary. The Governor expressed the opinion that regulation and control over branch banking by the Bank was impracticable; any such regulation and control had to be based on a commercial survey, which was not there. Further, he said, the regulation to be effective had to be continuous. Later, however, the indiscriminate branch expansion during the years 1943-45 moved the Governor to sponsor legislation to regulate the opening of branches.

Proposals for a Bank Act

The Reserve Bank's proposals for a Bank Act, which were, as stated in Chapter 6, sent to the Government of India in November 1939, were circulated by the Government in January 1940 among banks, banking and commercial associations, prominent members of the public and the press, with the request that the replies be sent to the Reserve Bank (with a copy to Government) within a period of six months. The replies received indicated that, by and large, the draft Bill was welcomed by the business community and their associations. In fact, some of them, particularly the Federation of Indian Chambers of Commerce and Industry, felt that the proposed Bill was too limited in scope as it did not tackle questions such as regulation of foreign banking and the linking up of the indigenous bankers with the Bank. The exchange banks and non-scheduled banks, which were likely to be adversely affected by the Bill, opposed it. Among scheduled banks (other than the exchange banks), the proposal had a mixed reception and controversy generally centred on the clauses of the Bill relating to definition of 'banking', minimum capital and minimum liquid assets. There were also a number of suggestions which, on the whole, aimed at increasing the control of Government over banking institutions.

Those who opposed the proposals could be divided into two groups. The first consisted of some critics (including the Bengal Chamber of Commerce) who, while not opposed to banking legislation as such, felt that there was no need then for a separate Bank Bill in view of the fact that the Indian Companies Act, as amended in 1936, contained some provisions in respect of banking companies and that sufficient time had not elapsed to see how they worked. The other group of critics consisted of institutions such as the Imperial Bank of India and the Calcutta Exchange Banks' Association, to whom the whole idea of further restrictive legislation appeared anathema. Their views were based on the usual counts of opposition to any regulative measure, namely, that (i) inexperience, lack of business acumen and failure to appreciate the accepted canons of sound finance could never be remedied by legislation; (ii) State control might instil in certain sections of the public a false sense of security in banks; and (iii) it was unfair that sound banking institutions should be regulated in order to check the undesirable practices of a few small or dishonest banks.

Coming to the opinions expressed on the various clauses of the Bill, the draft definition of banking proposed by the Bank may first be dealt with. It may be recalled that the Indian Companies (Amendment) Act had defined a banking company as a company which carried on as its principal business the accepting of money on current account or otherwise subject to withdrawal by cheque, draft or order. The Bank's proposed definition in the draft Bill differed from the above definition in two essential respects, viz., it omitted the words 'principal business' and 'draft or order'. This definition was generally criticised as being too narrow and restricted and that it would leave out of account a good many institutions which were not issuing cheques, but which were carrying on the primary functions of banking, viz., the collection of savings of the community and placing them at the disposal of trade and industry. On a review of the opinions, the Bank's management felt that the expression ' withdrawal by cheque ' in the draft Bill was inappropriate and that it would be better to define banking as ' accepting of deposits repayable on demand ' which would emphasise the most essential function of banking, i.e., to receive the public's money on current account.

The proposal for minimum paid-up capital and reserves necessary for starting or running a banking company made by the Bank came in for severe criticism, especially from the smaller banks and their associations. They contended that the proposed provision would result in the virtual annihilation of the smaller units and that it would retard the development of branch banking. The Bank was clear in its mind that proposals that were in view such as compulsory reserves, Reserve Bank being the statutory liquidator and the inspection of banks were not designed to work and would not work with petty institutions; the banks which might go under if its proposals were brought into force represented less than 5 per cent of the total ban-k deposits of the country. The Bank, nevertheless, was willing to reduce the minimum capital for all banks opening branches outside the Province or State of their origin, from Rs. 20 lakhs to Rs. 10 lakhs.

No clause came in for more severe or more uniform criticism than the one on liquidity requirement, laying down that every banking company should maintain at least 30 per cent of its demand and time liabilities in the form of cash or unencumbered approved securities. It was argued that the clause would make it difficult for banks to make reasonable profits; there was also risk of depreciation of Government securities as also difficulties of marketing the securities. The Bank's management was unable to accept the main objections to its proposal. It was, however, willing to consider the suggestion by some scheduled banks for enlarging the list of approved securities so as to include gold and balances held with scheduled banks on current account.

Quite a few Indian trade associations and Chambers of Commerce advocated measures to check the activities of the non-Indian banks in regard to their financing of internal trade and industry in India. A small scheduled bank suggested that certain business and banking experience should be among the minimum qualifications for directors of banks and that managers or managing directors should be persons holding some technical certificates or university degrees or persons who, from a statement of their qualifications, might be certified as fit and proper to be directors of a bank by either the Registrar of Companies or the Reserve Bank.

All points of view considered, it could be said that the draft Bill was received favourably. Indeed, there was some comment that the legislation could go much further. Thus, the Times of India* suggested that the Bill could be refashioned so as to extend its scope not merely to the protection of the depositors but to the improvement of banking conditions as a whole, for instance, by improved facilities in rural credit and for industry generally---a precursor of the later thinking on social control of banks !

There were certain proposals which were not provided for in the draft Bill, but which nevertheless were referred to in the explanatory memorandom on the Bill. One of these was that the Reserve Bank should be appointed as the statutory liquidator of banking companies. Opinion among the banks and the public was sharply divided on this issue. Some argued that no authority in the country was better fitted to be the statutory liquidator than the Reserve Bank. This opinion was not shared by many others who stated that the Bank might get involved in

*January 23, 1940

litigation on account of suits by disgruntled creditors and that the appointment should be left to the discretion of the court. Another matter dealt with was the question of link up of the indigenous bankers with the Reserve Bank by legislation. The position of these bankers remained, in the opinion of the Bank's management, as nebulous as before because of certain practical difficulties. These seemed 'insuperable', unless provision could be made for the bankers to organise their business on the lines prescribed for banking companies and to keep their accounts in such a manner that their banking assets were properly segregated from their other forms of business. The Governor was, therefore, of the opinion that they should be left outside the scope of the proposals. A third question dealt with in the explanatory memorandum was about periodic inspections of banks. In general, it seemed that the larger banks were against such a power while the smaller ones were in its favour. The Governor was still doubtful whether inspection would prove more than an illusory safeguard, unless the size of the member banks was very substantially increased. The utmost he was prepared to concede was that, if the Legislature considered that inspection was required, a separate authority such as a Superintendent of Banking could be created with such powers of inspection as the Legislature might deem it desirable to confer on him.

A synopsis of the replies received and the Governor's revised proposals were submitted to the Central Board in October 1940. The Board, however, resolved that the consideration of the Bill be postponed for a period of six months and that, in the meantime, the synopsis of the replies be sent to the Local Boards for their comments.

The reactions of the Local Boards revealed the same sort of mixed reception as was noticed among the banking and business community. The Rangoon Board supported the revised proposals in toto; the Calcutta and Delhi Boards, while endorsing, by and large, the Governor's proposals made some suggestions for incorporation in the Bill. The Calcutta Board suggested that the minimum capital and reserves for a bank having offices outside its Province or State could be lower at Rs. 15 lakhs instead of Rs. 20 lakhs. The Delhi Board was strongly of the opinion that provision should be made in the proposed Act for the annual or biannual inspection of banks' accounts by the Reserve Bank and for the issue of a certificate of the true state of affairs. The Delhi Board also suggested a reduction in minimum liquidity requirement from 30 to 20 per cent. The Bombay Board had no comments to offer, though one of its members, Sir R. P. Masani, was opposed to some of the important provisions. The Madras Board stuck to its former view that a Bill for a limited purpose would hardly be of any avail and might possibly prejudice fair consideration of the larger issues awaiting solution. It did not, in general, support the stand taken by the Bank on the controversial clauses, except in backing the suggestion that a post of a Superintendent of Banking could be created.

Reviewing the mass of comments as a whole, the Governor wrote to the Central Government in March 1941 that opinion in the country was still not ripe for undertaking an elaborate new banking legislation. The field of controversy, he said, was so wide and the then existing conditions so abnormal that he doubted if in the distractions and preoccupations of the war it would be possible for the Government or the Legislature to devote the necessary attention to a technical matter of such complexity. Therefore, he was inclined to the view that the question of undertaking comprehensive new legislation should be held over for the duration of the war. However, he called for the passing of some interim legislation in order to reinforce the administration of the provisions of the Indian Companies Act relating to banking companies. The measure he had in view was designed mainly to remove the ambiguities in the definition of banking.

Interim Banking Legislation, 1941-42

The Governor suggested to the Central Government that Section 277G of the Indian Companies Act should be amended so as to restrict the use of the word ‘ bank ’ or its derivatives only to those companies which carried on banking and ancillary business as defined in Section 277F irrespective of when such companies were formed. He recognised that this would still leave a residuum of companies not calling themselves banks but, nevertheless, carrying on banking business and attracting deposits, and throw the onus on the depositors to deal with such a company at their own risk; it would be open to the Registrar to hold, in suitable cases, that any company of this type was a banking company, unless his decision was challenged successfully in a court of law. In June 1941, the Central Government conveyed their concurrence with the Governor’s views regarding both the inadvisability of comprehensive banking legislation and the urgency of the interim measure, but made no formal announcement in the Legislature or in the press regarding this decision. It should be mentioned here that the Governor had not considered it necessary to obtain the prior approval of the Central Board on such an important matter as postponing sine die his own Bank Act proposals, before addressing the Government and obtaining their concurrence, although the Board had, as earlier stated, resolved in October 1940 to postpone the consideration of the proposals for six months and wished, in the interim period, to ascertain the comments of the Local Boards. The developments were subsequently (i.e., in July 1941) reported to the Board, which, however, only recorded them without any protest!

On the proposal made by the Governor for interim legislation regarding amendment of Section 277G of the Companies Act, the Government, after further examination, proposed in August I 94 I that the object in view would be achieved by the insertion in Section 277F of an explanation to the effect that any company which used the term ' bank ' or its derivatives in its name should be deemed to be a banking company irrespective of whether the business of accepting deposits of money on current account or otherwise subject to withdrawal by cheque, draft or order was its principal business or not. The Governor had no serious objection to the alternative proposed by the Government. The Government had also meanwhile addressed a communication to the Provincial Governments and recognised Chambers of Commerce in October 1941 on the proposed amendment of Section 277F. The replies received by the Government showed that there was overwhelming support for the amendment. A Bill was consequently introduced in the Legislative Assembly in August 1942, adding a proviso to Section 277F, in substantially the same form as it originated from the Government and emerged as the Indian Companies (Second Amendment) Act, 1942, in October 1942. The Government, however, did not keep their promise made to the Bank in November 1941 that, in the Statement of Objects and Reasons of the Bill, mention would be made of the fact that the recommendation for the proposed amendment came from the Central Board of the Reserve Bank. The Bank had suggested this earlier not only to let the public know that it had not allowed the matter of banking legislation to drop out of sight, but also that such a reference to the Bank's role might carry weight with the Legislative Assembly and thus help passage of the Bill. The omission was probably due to the fact that the actual legislation was handled by the Commerce Department of the Government while the Reserve Bank's channel of communication was the Finance Department. In fact, the Commerce Department had earlier issued a letter to the Provincial Governments and Chambers of Commerce to elicit their views without the knowledge of the Finance Department!

Interim Banking Legislation and Control, 1943

In December 1942, the Bank undertook a review of floatations of banks in the country after the commencement of war and its findings were as follows. Since September 1939, 38 new banks had come into existence. The regional distribution showed that 12 of these banks had registered offices in Calcutta and 6 in Bombay; most of the others were also in other important commercial and industrial cities. The banks opened in Calcutta were small institutions, 6 out of the 12 banks having paid-up capital of less than Rs. 1 lakh. Three of the scheduled banks, viz., the Bharat Bank, the Exchange Bank of India and Africa and the Associated Banking Corporation, had ambitious programmes of starting branches in the Indian States where banking facilities were inadequate; but it transpired that schemes of expansion of branches without ensuring proper supervision and control by the Head Office were themselves one of the main reasons for the undoing of these banks in later years. The review brought out several unhealthy features of expansion of banks as indicated below, and so further piecemeal measures of regulation followed in 1943, on the initiative of the Bank:

(a) While a few of the new banks started with large and even grandiose amounts of authorised capital, the majority of the new institutions commenced business with paid-up capital which could generally be regarded as inadequate.

(b) There was, in many cases, a distribution of the capital structure into preference, ordinary and deferred shares, to ensure, it would appear, a controlling voice in the management to an individual or a small group. The devices adopted in this regard were that (i) a portion of the capital was raised through preference shares without any voting rights; (ii) the nominal value of deferred shares, which could be easily distributed among the promoters and their adherents, was kept very low and the holder of one share was given the same voting right as was enjoyed by a person holding an ordinary share many times the value of the deferred; and (iii) only a small amount of the nominally large value of an ordinary share was called up.

(c) Some of the banks adopted devices to get round the principle underlying Section 277H of the Indian Companies Act, which prohibited a bank being managed by a managing agent other than another banking company. These banks owed their origin to the efforts of one or two enterprising individuals who had got themselves appointed as the managing directors; and it was not uncommon for a managing director to enter into an agreement with the Bank for a long term of office, varying from 15 to 20 years, entitling him to a fairly high salary and allowances and, in certain cases, a percentage of profits after the bank was able to declare a specified rate of dividend, which was generally fixed at a low figure. The managing director was thus in a position to employ the funds of the bank to promote the interests of industrial concerns owned by him or his friends and still might not be removable for such action if he had a long-term contract of service, either explicit or implicit, in the articles of association or agreement with the bank.

The Bank conveyed its findings to the Government in December 1942, adding that it was of the utmost importance that the capital structure and the system of management of banks should be such as to minimise the temptation for an over-ambitious and get-rich-quick policy and to encourage, in its stead, cautious and steady banking on well-tried orthodox lines. It, therefore, suggested that Government might take action quickly, after consulting the Provincial Governments and commercial opinion, to add to Section 277I of the Indian Companies Act provisos to the effect that the subscribed capital should not be less than half of the authorised capital and the paid-up capital not less than half of the subscribed capital, and that no banking company should have other than ordinary shares. It may be recalled that the first of the provisos mentioned above had already been included in the proposals for an Indian Bank Act made by the Bank in November 1939. As regards management of banks, the Bank suggested to the Government in February 1943 legislation, in due course, for buttressing Section 277H with other provisions, namely, (i) prohibiting loans to a manager or a managing director or to a company in which he was avowedly interested otherwise than as a shareholder, (ii) setting, say, a ten-year time limit for his tenure of office and (iii) prohibiting participation in profits by a person entrusted with the management of a bank since such participation might provide a temptation for methods of management directed towards increasing profits in disregard of the ultimate safety and solvency of the bank.

In March 1943, the Government followed the usual procedure of circulation of the Bank's letter of December 1942 regarding the proposed amendments to the Companies Act, among Provincial Governments, scheduled banks and commercial associations. The Government also circulated an alternative proposal relating to the capital structure of banks, namely, allowing ordinary, preference or any other kind of shares provided the capital structure was such as to permit voting rights in proportion to the capital contributed by each class of shares. While the proposals were naturally opposed by many commercial organisations and banks, especially the Bharat Bank Ltd. (which initially had authorised and subscribed capital of Rs. 20 crores and Rs. 15 crores, respectively, and a paid-up capital of Rs. 15.60 lakhs only), there was general public support to the amending Bill. The Bombay Shareholders' Association, for instance, was wholly on the side of the Reserve Bank. It also counselled the Government to curb, at an early date, the undesirable tendencies in the managerial appointments of banks, pointing out that the arrangements or agreements entered into by many banks for the appointment of managing directors and managers were nothing but so many modified versions of managing agency agreements.

The executives of the Bank reviewed the various opinions and proposed to the Committee of the Central Board in September 1943 that legislation be recommended to amend the two sub-sections of the

Companies Act on the lines suggested by the Government, thus revising the Bank's own earlier opinion that amendment of Section 277H (management) was not of a relatively urgent nature. The Committee approved the proposals subject to the modifications that (i) neither preference nor deferred shares be allowed in the case of banks established after the coming into force of the proposed legislation and no unissued preference shares be allowed to be issued in the case of banks already incorporated and (ii) the permissible term of employment of a manager, etc., be reduced to five years, renewal being allowed. The necessary legislation was soon initiated; the Indian Companies (Amendment) Bill, 1944, received the assent of the Governor General in March 1944.

To recapitulate the provisions as were finally enacted: a bank was precluded from employing or being managed by a managing agent or any person whose remuneration or part of whose remuneration took the form of commission or share in the profits of the company or any person having a contract for its management for a period exceeding five years at a time (new Section 277HH). The following restrictions were also imposed on a bank incorporated after January 15, 1937:(a) the subscribed capital should not be less than half the authorized capital and the paid-up capital not less than half the subscribed capital; (b) the capital of the bank should consist of ordinary shares only or ordinary and such preference shares as were issued before the commencement of the Indian Companies (Amendment) Act, 1944; and (c) the voting rights of every shareholder should be strictly in proportion to the contribution made by him to the paid-up capital (Section 277I as amended).

The amending Act was generally well received by the press. Thus, the Indian Express* commented that the vices sought to be corrected were serious and it went to the credit of the authorities of the Reserve Bank that they were able to negotiate and direct legislation in such a short time.

Renewal of Efforts for a Bank Act

Some of the replies received in the middle of 1943 in connection with the amendments to the Indian Companies Act and some of the comments in the press revealed a renewed demand for comprehensive banking legislation at an early date as it was felt that piecemeal legislation would fail to achieve the desired object. As an illustration, the remarks of the Eastern Economist, in its issue of June 25, 1943, may be given:

* February 25, 1944.

> We have still to evolve a banking system which really answers to the special needs and circumstances of our country and can stand up to the strenuous demands of our post-war economy. Some of the salient defects of our banking system as at present organised are under-capitalisation, over-trading and wasteful competitive branch banking. . . . . The proposals for interim banking reform by the Board of the Reserve Bank do not touch the basic maladies and needs of our banking system. . . . . . .The crying need is for a comprehensive legislation, and piecemeal efforts may do more harm than good. The war has, indeed, created many difficult situations which demand control, but in the peculiar circumstances and, at any rate, for the duration of the war, executive supervision, as for example, through a Superintendent of Banking, may prove more effective than over-all control through hasty controversial constitutional changes such as are proposed.

In view of this demand and the extent of support that the Bank's proposals had received, in June 1943 Mr. Deshmukh, who was in charge of the Governor's duties, considered that it was desirable to review the whole question of proceeding with separate banking legislation. According to him the arguments in favour of such action were the following:

(i) the war appeared likely to continue for at least a couple of years more and it was undesirable to postpone action for so long a period;

(ii) a large number of new banks had been started during the war period -a development not anticipated when Government decided to suspend action on banking legislation;

(iii) there was a possibility of a severe post-war reaction to the war time monetary developments and inflationary growth factors -a reaction which had to be guarded against as early as possible; the introduction of banking legislation would be an important step in that direction inasmuch as it would ensure banking development on sound and healthy lines;

(iv) there was a likelihood of the public favouring regulation to a greater extent through a realisation of the possible repercussions during the post-war period and the proposals consequently proving less controversial;

(v) on account of the improved war situation Government themselves might find their pre-occupation with the war not so heavy as to preclude comprehensive banking legislation; and

(vi) there was example of other countries, e.g., South Africa, which had introduced commercial banking legislation even in war time.

In September-October 1943, the Central Board and the Government concurred with the Governor's (Mr. Deshmukh had by then become Governor) views and set the pace for the renewal of the Bank's efforts .for a more comprehensive Bank Act.

Banking Companies Bill, 1944

Early in 1944, the Bank proceeded to consider what modifications and additions were necessary to its original proposals in view of the criticisms and suggestions received from time to time and the experience gained during the war period. The Bank was still not convinced that in the conditions then prevailing in India it would be appropriate to attempt detailed legislation covering the various activities of banking as had been enacted in some countries abroad such as the United States of America. Further, even if such legislation were attempted, the Bank had no machinery to administer it and it would be some years before a suitably trained staff would become available. The Bank, consequently, felt that its original proposals were conceived on sound lines and that it should attempt to lay down only the foundation covering general principles, leaving the super-structure of detailed regulation to be built up later as might be necessary with growing experience. In the light of these general considerations and the criticisms and Suggestions received, the proposals were reviewed and a revised draft Bank Bill was submitted to the Committee of the Central Board in April 1944. The main changes and additions suggested to the original proposals made by the Bank, apart from those covered by the interim legislation, provided for the prohibition of a banking company engaging directly or indirectly in trading activities; disposal of non-banking assets acquired in satisfaction of claims within a period of seven years; inclusion of gold in the category of liquid assets; submission by banking companies of monthly returns of assets and liabilities to the Reserve Bank; restrictions on loans and advances on the security of own shares or to directors and firms or companies in which they were interested as partners or directors; inspection of a banking company by the Reserve Bank on being directed to do so by the Central Government; submission of a report by the Reserve Bank to Government in cases of temporary suspension of business or voluntary winding up; and appointment of the Reserve Bank as the Official Liquidator of a banking company on its being wound up by court.

Of the above provisions suggested by the Bank, the most significant was perhaps the one recommending inspection by the Bank, albeit for a limited purpose, in the background of the Bank's (in particular, Sir James Taylor's) earlier strong views against the vesting of such a power. In his memorandum on the subject submitted to the Central Board in April 1944, the Governor explained the shift in the Bank's position thus:

> Although originally we were doubtful of the value of inspections, in the light of later developments and in view of possible post-war reactions, we have after careful consideration, altered our opinion, and I consider

> that the power to inspect the books of a bank will be a valuable adjunct to the other statutory provisions. I do not, however, consider that it will be practicable to provide for a regular system of inspection of banks as has been suggested by the Local Board, Northern Area, for the requisite trained personnel is not available for the purpose. Nor do I think it will be conducive to the healthy growth of Indian banking if banks have to carry on their business under the atmosphere of continuous surveillance which such inspections will necessarily tend to create.
>
> This question is closely linked with the question of the most appropriate authority for administering the Act and it has been suggested that this duty should be entrusted to the Reserve Bank. I consider that this function is primarily one for the Government to discharge but that with the experience we have gained of scheduled banks, the work of investigation or calling for information and returns should be carried out by the Reserve Bank who will report their findings to Government. . . . . . This will not in any way militate against the establishment of harmonious relations with the commercial banks for we will be merely the reporting authority and the final decisions will be those of Government.

This statement, however, did not go far enough to meet the demand of one of the Directors, Mr. Kasturbhai Lalbhai, to institute a compulsory inspection of all banks irrespective of the size of their capital and reserves.

The proposals made by the Governor were approved in principle by the Central Board in April 1944, with the instruction that they should be finalised by the Committee of the Board after obtaining the urgent comments of the Local Boards. The Local Boards made some suggestions, the important ones being that a foreign bank opening a new branch in India should be required to obtain a licence from the Reserve Bank and that the percentage of approved liquid assets to be maintained could be reduced from 30 per cent to 25 per cent. These suggestions were incorporated in the draft Bill, with some modifications. There were also some suggestions by the Local Boards and their members which were not immediately acceptable to the Bank's management. Notable among these was a suggestion by the Calcutta Local Board that there ought to be a provision empowering inspection of banks by the Bank without the red-tape of prior consent of Central Government, consultation with the Government being restricted to cases of exclusion of banks from the Second Schedule. A very surprising suggestion was that put forward by the Madras Local Board (which had undertaken all along to plead for generous assistance by the Bank to the smaller scheduled banks), proposing that the minimum capital requirement for inclusion in the Schedule be raised from Rs. 5 lakhs to Rs. 20 lakhs. The acceptance of this suggestion would have meant exclusion of most of the South Indian banks from the Schedule!

The revised proposals of the Bank were forwarded to the Central Government in June 1944. The Bank also sent to the Government in October a separate pro forma balance-sheet for banks, which gave most of the details given in the prescribed form under the Indian Companies Act (Form F) as also certain additional ones which were of particular importance in the case of banks. A separate form of balance-sheet for banks was considered necessary because:

(i) Form F under the Companies Act, being meant for companies in general, was not suited to meet the special requirements of banks and
(ii) for better understanding of the affairs of banks, a standard form was necessary, since it was observed that many banks, especially the smaller ones, were publishing their balance-sheets in different forms, for window-dressing, among other reasons.

A Bill 'to consolidate and amend the law relating to banking companies' on the lines recommended by the Central Board was introduced in the Legislative Assembly on November 16, 1944 and a motion for circulation of the Bill for eliciting public opinion was adopted by the Legislative Assembly on November 20. Among the interesting points made in the brief debate were that the Imperial Bank Act should be repealed and that the bank be brought under the scope of the proposed Bill (Mr. T. T. Krishnamachari, who went to the length of referring to the bank as 'a tumour in the body politic of this country') and that banking should be nationalised or socialised (Mr. Sami Venkatachalam Chetty and Prof. N. G. Ranga). Prof. Ranga complained that no action had been taken on the suggestion of the Industrial Commission for the establishment of Investment Boards to offer credit to industrial concerns. This matter was, however, beginning to engage the attention of the authorities.

The Legislative Department of the Government forwarded the Bill to the Provincial Governments and the Chief Commissioners of centrally administered areas with a request to circulate it among the banks and the general public. Most of the opinions called for were received by the end of March 1945. The Bank's management considered these opinions exhaustively in a memorandum submitted to the Central Board for consideration at its meeting held on April 2, 1945; the Governor suggested certain modifications to the original Bill, for consideration and appropriate amendments at the Select Committee stage. The Board generally endorsed the Governor's recommendations, the principal ones being reduction in minimum capital requirement for banks having an office outside the Province or State of registration from Rs. 20 lakhs to Rs. 10 lakhs and lowering of the proportion of minimum liquid assets from 25 per cent to 20 per cent. The Bank's proposals were conveyed to Government in May.

The Problem of the Exchange Banks

At this stage, it is necessary to refer briefly to two matters which engaged the attention of the Legislature and the press, namely, the position of the exchange banks and of the Imperial Bank, in the scheme of banking regulation.

The exchange banks were not required to furnish the Bank any detailed information regarding their assets and liabilities. The only statements they were periodically submitting were (a) the weekly return under Section 42 of the Reserve Bank Act and (b) copies of consolidated balance-sheets (which did not give separate figures in respect of their Indian business) under Section 277(3) of the Indian Companies Act. These banks were not subject to the various provisions of the Indian Companies Act relating to Indian banking companies, except as regards proceedings in regard to the winding up of their affairs in this country.

The meagre information about them available with the Bank prompted the Central Board to ask the Governor (Taylor) in October 1941 to find out how the statistics regarding their business in India could be made as complete as those of Indian joint-stock banks. The Governor examined the question and intimated to the Board his view that it would seem somewhat futile to ask the Government to legislate calling for special returns from the foreign banks providing additional information without at the same time taking action on the proposals of the Bank Act. According to him, the exchange banks, being authorised dealers, were providing the Bank with detailed information under the provisions of the Defence of India Act regarding their daily exchange operations. He said that the collection of information about the assets and liabilities of such banks, in advance of general legislation, would only be of statistical interest.

The Governor’s views did not satisfy the Board. It decided, in December 1941, that he should collate the information relating to the investments and foreign exchange business of these banks from the material available with the Bank. After studying the data, the Governor reported to the Board in February 1942 that the exchange banks were maintaining assets in India appreciably in excess of the limit of 75 per cent sought to be prescribed in the Bank’s proposals for a Bank Act. About 33 per cent of their resources in India seemed to be employed in financing internal trade; around 16 per cent was maintained in cash and, perhaps, about 20 per cent in the form of Government securities. The bulk of the balance, about 23 per cent, appeared to have been utilised in the finance of foreign trade. In view of the Governor’s findings, the Central Board decided to drop the matter for the time being.

The exchange banks which were thus in a privileged position in the matter of statutory provisions were naturally opposed to the proposed banking legislation. Public opinion was increasingly critical of the preferential treatment given to foreign banks and the Calcutta Local Board was also strongly advocating their being brought under stricter control by a system of licensing, but what the Bank's management suggested was the addition of a clause in the 1944-45 Bill, prescribing that banks incorporated outside British India or the United Kingdom should obtain licences from the Bank for carrying on business in British India! The British banks were thus placed on a footing superior to even banks incorporated in the Indian States or neighbouring countries like Ceylon and Burma. The Eastern Economist, in its issue of January 12, 1945, called this 'politically obnoxious and economically vicious' and added that 'this will not only foster uneconomic competition prejudicial to the growth of national banking institutions, but give rise to the presumption, wholly without justification, that U.K. banks do not need to be regulated in respect of their capital, liquidity and other standards of healthy banking'. The Select Committee, in its February 1947 Report, recognised the validity of the criticisms made against the clause as it stood and recommended extension of the provisions of licensing to all banks incorporated in or outside India.

The Position of the Imperial Bank

Like the exchange banks, the Imperial Bank was not governed by the provisions of the Indian Companies Act relating to banking business, being incorporated under a separate Act. Since the proposals for a Bank Act made in 1939 were applicable only to companies as defined by the Indian Companies Act, the Imperial was not covered. The criticisms made during the Legislative Assembly debates in November 1944 on the Banking Companies Bill made the Reserve Bank take up in right earnest the question of extension of the proposed banking legislation to the Imperial, which held nearly 30 per cent of the deposits of scheduled banks. The Bank recommended to the Government in the same month that the whole of the banking legislation excepting the clause relating to the business of banking companies should be made applicable to the Imperial also without affecting fundamentally any of the provisions of the Imperial Bank of India Act or the Regulations made under it. But, two months later, i.e., in January 1945, after consulting the Managing Director of the Imperial Bank, the Bank advised the Government differently, thus:

> We have examined further the question of bringing the Imperial Bank of India within the purview of the Banking Companies Bill. The restrictions imposed on the business of the Imperial Bank by its own Act and

> Bye-laws are in some respects considerably more onerous than those contemplated in the Bill, while under Regulation 59 (Schedule II) of the Imperial Bank of India Act, the Central Government have already power to appoint such auditors as they think fit to examine and report on their accounts. As regards the furnishing of returns and statistics, the bank has undertaken to co-operate with us in supplying the necessary information. In view of these considerations and the historical reason that the Imperial Bank formerly acted as bankers to Government and are now acting as our Agents for the transaction of Government business at centres where we are not represented, we do not consider it necessary to press for an amendment to bring that Bank within the purview of the Banking Companies Bill.

However, as in the case of the exchange banks, the Select Committee, in 1947, recommended that most of the important provisions of the Bill be made applicable to the Imperial Bank.

Select Committee on the Banking Companies Bill

On April 6, 1945, the Finance Member moved in the Legislative Assembly a motion for reference of the Bill to a Select Committee. After a four-day debate, the Assembly adopted the motion on April 11. Mr. Ram Nath, Secretary of the Bank, participated in the proceedings, as a nominated Member; it fell to his lot to reply to the debate, on behalf of the Government.

At this stage it is not necessary to go into the details of the interesting debate concerning the individual clauses of the Bill. More than the Bill, it would seem that the working of the Reserve Bank came in for considerable discussion, since the administration of the proposed Act was to be entrusted to the Reserve Bank. There was much criticism of the Bank's functioning, especially concerning what the members regarded as unsatisfactory progress in the sphere of rural credit. Mr. Manu Subedar went so far as to remark:

> The Reserve Bank has failed entirely as an instrument of national policy. It is not a national institution as it stands. The Reserve Bank has failed to develop the mechanism for the advancement of agriculture, of exchange banking and of the financing of industries.

Mr. Akhil Chandra Dutta made the interesting suggestion that there should be a Bankers' Advisory Council, elected by the members of the Legislature or the banks themselves, for advising the Government with regard to the control of banks and particularly in regard to the exercise of powers conferred by Section 28 (Inspection) of the Bill and Section 42 of the Reserve Bank of India Act. The Council was to examine periodically the working of the whole banking system including the Reserve Bank and make reports, to be placed before the Legislature.

Prof. N. G. Ranga also made two proposals, one for the setting up of an Advisory Council, comprising representatives of the banking world, to study the inspection reports on banks and tender advice to the Reserve Bank. The other proposal was the replacement of the Reserve Bank's Board of Directors by an Advisory Board consisting of representatives of scheduled banks including exchange banks, the Legislative Assembly, Government and of agriculture, industry and commerce. The Governor and the Deputy Governors of the Bank were to supply information to the Board and initiate discussions. The Board was to make periodic reports to Government. The role of the Board was to be purely recommendatory. (In these suggestions we seem to have the germ of the idea of the National Credit Council, which was established on December 22, 1967.)

The meetings of the Select Committee were scheduled for October 1945 and the Bill was to be taken up for final consideration in the autumn session of the Legislature. Owing, however, to the decision of the Governor General to hold fresh elections and the consequent dissolution of the Assembly, effective October 1, 1945, the proposed meetings of the Select Committee were cancelled and the Bill lapsed. The Bill was reintroduced in March 1946 and again in March 1948, but the legislation was passed only in February 1949.

Meanwhile, as the Bank expected that there would be further delay in the passage of the Bill, it recommended the enactment of some urgent measures, which were brought into force in 1946. The interim legislation passed during the years 1946-48 and the developments eventually leading up to the enactment of the Banking Companies Act, 1949 are discussed in the section of the History relating to the period 1945-51.

Although a full-fledged Bank Act was not passed before 1949, there is no doubt that the interim measures of legislation, undertaken largely on the initiative of the Bank, had a salutary effect on the functioning of banks. The benefits of these measures were both direct and indirect. They helped achieve an improved standard in the working of banks and also restrained the overgrowth of banks. Bank failures recorded an almost continuous decline from 119 in 1939 to 27 in 1945. In the previous four years 1935 through 1938, the number of failures had ranged from 51 to 88. It could be argued that the war-time plethora of funds and rise in values of assets helped conceal trouble spots. However, the post-war performance of the Indian banking system bears some testimony to the useful contribution of the war-time regulatory measures.