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## Regulating Banks and Deposit Institutions

The first challenge the Bank faced following the passage of the Banking Companies Act was that of building a team of skilled inspectors. The Bank was not altogether a stranger to inspections: banks in the second schedule of the Reserve Bank of India Act already came under its gaze, while some others voluntarily subjected themselves to scrutiny by its inspectors. But frequent and regular inspections of a few hundred banks was another matter altogether, more so as it was decided quite soon after the passage of the Banking Companies Act that banks would generally not be issued or denied licences until their affairs had been inspected in detail. Besides, not only was it necessary to speed up inspections if they were to be effective, the Bank had also to set at the same time, enduring standards of inspection. Balancing these demands was not easy, and the Governor, B. Rama Rau, devoted a considerable amount of time and energy in the early months of his tenure to the organization of the Bank's inspection activities. The person overseeing these activities within the Bank, Rama Rau felt, should be senior and experienced enough to deserve a status equivalent to that of a Deputy Governor of the Bank. He was keen to engage K.G. Ambegaokar, who had earlier worked at the Bank and was currently Additional Secretary in the Ministry of Finance, to organize the Bank's inspection work and develop the new system. But this proposal foundered on the government's refusal to spare Ambegaokar, and the Bank re-employed Cecil Trevor (Deputy Governor till 1949) for three months 'on Special Duty', to set up its inspection arrangements. Trevor was soon succeeded by Ram Nath, who joined the Reserve Bank in 1935 from the Imperial Bank. Ram Nath went on to become a Deputy Governor of the Bank in 1951 at which post he remained until nearly the end of the decade. Ram Nath oversaw the country's commercial banking system on behalf of the Bank and was very largely instrumental in establishing its apparatus of banking regulation and supervision during this crucial period.

## INSPECTING BANKS

Since it suffered from shortages of trained staff in the early years, the Bank was forced to commence its inspection activities on a modest scale. When the Banking Companies Act was still in draft form, bankers had opposed giving the Bank, or any other agency, powers to inspect the working of their institutions on the ground that inspections were liable to trigger panic among depositors. Hence before initiating inspections under the Act, the Bank took care to inform banks and the public through a press note that until trained staff became available to inspect banks on an annual basis, it would only inspect as many banks as it found possible to do, but that inspections would not be confined merely to institutions whose working was believed to be unsatisfactory. Indeed, in an act that can only be seen as an effort to grab the bull (of presumed public mistrust of bank inspections) by its horns, the Bank issued a press note in March 1950 listing the names of banks it would inspect during the year in alphabetical order! With bank inspections becoming routine thereafter, this practice was dispensed with in later years. By the end of 1954, the first round of inspections of Indian commercial banks was practically complete. In addition five state-owned banks, which were not covered by the provisions of the Banking Companies Act, had also been inspected with their consent. In 1958 the Bank felt able to step up the frequency of inspections to one of each bank every year. From 1960, foreign branches of Indian commercial banks were also brought within the scope of the Bank's inspections.

Inspections by the Bank concerned themselves with virtually every aspect of the functioning of commercial banks. The efforts of the Bank to improve the capital funds ratio of banks and their liquidity position are discussed below. Inspections and scrutiny of banks' statements helped monitor banks' compliance with evolving conventions and statutory requirements in these respects. The Bank liked to keep a close watch on the trend of banks' earnings, frequently studying costs, intermediation margins, and global ways to regulate them, both in order to check profiteering at the expense of capital users and the erosion of banks' profitability to a point where they found it difficult to add to reserves or service their capital.

The Bank's moves towards regulating deposit and lending rates (discussed in chapter 4) originated partly in the close interest it took in banks' earnings. It also used the opportunity afforded by inspections to advise individual banks to reduce unnecessary expenditure, especially on unremunerative branches; and against offering high rates of interest to attract deposits, since it might predispose them to greater asset risk, lower earnings, and impair their ability to strengthen reserves. Likewise, while exploring general ways of

persuading or compelling banks to improve their reserves, the Bank utilized inspections to penetrate beyond the window and verify banks' balance sheet figures to satisfy itself that they gave a true picture of their financial condition. Where banks' provisions for bad debts were judged inadequate, they were advised to make the necessary provisions and appropriations, if need be by reducing or omitting dividends. In general too, inspectors tended to alert banks to the longer-term advantages of a prudent reserves and dividend policy, and although the Bank was averse to suggestions—mooted with some intensity in the mid-1950s—to regulate or restrict the dividends of banks and helped stiffen Finance Minister C.D. Deshmukh's resolve to resist them, from the late 1950s banks placed under observation were routinely asked to obtain Mint Road's approval before declaring dividends. In the 1960s the Bank began using its powers to regulate dividends more freely.

As discussed below, the Bank also took a keen interest in the managerial aspects of banking in India. However, advances and asset quality were by far the most important focus of the Bank's inspection exercises. Particularly in the early years, inspectors found many problems with banks' portfolios. These included, apart from a high advances-to-deposits ratio, illiquid assets; large investments in shares and debentures of joint-stock companies, and in unquoted scrips and scrips of companies owned or managed by the bank's directors; loans to the latter, their relatives and their concerns; concentration of a substantial proportion of loans in the hands of a relatively small number of borrowers; large unsecured advances or advances against real estate; and a high level of irregular and dormant advances and decreed and doubtful debts. In addition to routine inspections covering all aspects of a bank's functioning, the Bank sometimes undertook special inspections of its advances portfolio—the object usually being either to safeguard against a further decline in the quality of the bank's portfolio or to appraise its progress towards satisfying the Bank's conditions or directives relating to advances. Instances were also not unknown of the Bank ordering inspections of individual branches of banks on the basis of reliable information that came its way regarding a bank's advances to one or more borrowers. For example, the Bank launched a special investigation, assisted by inspections, of the exposure of selected Indian and exchange banks to the concerns owned or managed by Haridas Mundhra, and these investigations were among the first to lift the veil of secrecy and mystery hanging over the affairs of this entrepreneur.

Inspections completed, the Bank might deny a commercial bank a licence in extreme cases where the latter was judged to be 'beyond redemption'. In a few cases, banks also had their scheduled status and licences withdrawn. Other extreme measures included publishing the Bank's inspection report or

extracts from it in the official gazette of the Government of India and making an application to a court to wind up the affairs of a badly-run bank. In the case of a large number of banks, particularly in Kerala in the late 1950s, the Bank was forced to hold its hand even when some of them appeared to it to be beyond repair. In the early 1960s, on the other hand, inspections were used to facilitate schemes of arrangements or amalgamations involving relatively small and less viable banks.

Generally, however, the Bank preferred to adopt a calibrated response that sought to safeguard the interests of depositors of banks following unsound banking practices while the institutions themselves were allowed to function under closer supervision and made to undertake suitable corrective measures. Sometimes this response, as stated above, took the form of advice. At other times, banks with major defects were asked to submit reports to the Bank at regular intervals indicating the progress they had made in correcting them. Where such defects persisted, the Bank might impose 'conditions' requiring the bank concerned to take specific measures and submit periodic reports of compliance. Until January 1957, conditions could not be imposed on an affected bank until the latter formally accepted them. This sometimes led to an impossible situation as banks, while not formally rejecting the central bank's conditions, adopted obstructive tactics intended to deter or delay their imposition. Hence by an amendment to the Banking Companies Act passed in December 1956, the Reserve Bank acquired the powers to issue directions to banks, in their own interest, on matters of policy or administration. The same Amendment Act also empowered it to appoint observers on the boards of directors of banks to report on the conduct of their affairs. Until this amendment, the Bank's power to appoint an observer hinged on the consent of the board of directors of the concerned bank, and both in the case of the Punjab National Bank and the Palai Central Bank, such consent was not forthcoming. Observers, according to a memorandum submitted to the Central Board in 1965, played a positive role in the affairs of banks to which they had been deputed, not only preventing 'at source transactions of an undesirable nature', but also giving 'proper guidance' to them.

Besides appointing observers and issuing directions, the Bank could, under the 1956 Amendment Act, also refuse to approve the appointment of a chief executive officer and reduce the remuneration proposed for any bank official. However, in a significant check on its authority to regulate the functioning of the banking system, the Bank agreed not to use its new powers against medium- and large-sized banks (having deposits of Rs 10 crores or more) except in consultation with the government. H.V.R. Iengar, who took office days after this agreement with the government was formalized, chafed at this

restriction on the Bank's powers and attempted, within months of the Amendment Act coming into force, to review it. But the Bank's plea to the government to limit consultations to cases where a bank's deposits exceeded Rs 25 crores met with the response that the Government of India liked to 'have some idea of the working' of 'intermediate-sized banks' and that it hoped thereby to widen the range of its 'knowledge and awareness of current problems and questions generally'.

In August 1960, following the closure of the Palai Central Bank, Prime Minister Jawaharlal Nehru and Finance Minister Morarji Desai discussed with the Governor, H.V.R. Iengar, 'the more effective use of the powers of the Reserve Bank following inspections of banks'. Little came of these discussions directly. However, the new powers the Bank acquired in September 1960 to enforce amalgamations and the speedier 'de-licensing' of banks in the mid-1960s (on which more below) helped give more teeth to its inspections. On the other hand, the failure of the Palai Central Bank, and particularly of the Laxmi Bank where the management was reported to have misappropriated depositors' funds, alerted the Bank to the need to 'improve the inspection machinery' so that it could 'undertake surprise inspections of banks or even of some of their branches alone', and thereby 'detect frauds ... at the appropriate time'. In 1961 the Bank inducted D.R. Joshi, who until then was Secretary and Treasurer of the Bengal Circle of the State Bank of India, as an Executive Director, principally to reorganize and strengthen its inspection arrangements. Bank inspections now began to cover many more branches than in the past, and they were also widened to include elements of selective audit.

It is worth noting, in passing, that the Bank adopted certain other measures to help the banking system safeguard the quality of its assets. Following suggestions mooted by the Indian Banks' Association in 1950 and others subsequently, the Bank decided to set up an organization to collect information from member banks about the banking commitments of individual borrowers, and make it available to banks wishing to ascertain a large borrower's aggregate banking debts. Though there was some scepticism among banks about the utility of a scheme which would inevitably be prone to delays in securing and relaying the necessary information, the Bank decided to proceed with the legislative enactments which it was advised were needed for the proposed scheme to come into operation. These legislative changes, which took the form of a new chapter (IIIA) in the Reserve Bank of India Act, were carried out in September 1962. Following the enactment, the Bank decided to collect credit information about borrowers with sanctioned secured limits of Rs 5 lakhs or more and unsecured limits of Rs one lakh or more. Compiled on a borrower-wise basis, the information was made available to banks and

institutions seeking it. The names of the banks submitting the information were, however, withheld from its users. The credit information bureau, as this arrangement was sometimes referred to, proved a timely initiative, with the Bank receiving over 1,500 requests for information about individual borrowers in 1963—the first year the information became available. By 1967, the number of requests from banks and financial institutions for credit information had grown to over 2,700.

Towards the end of our period, the Bank also began to monitor scheduled banks' growing contingent liabilities (or 'off-balance sheet' items). In May 1967, it laid down guidelines for the conduct of guarantee business, and advised banks that besides asset portfolios, their soundness would be judged also by the size and nature of their contingent liability commitments.

### EVOLVING CAPITAL ADEQUACY NORMS

According to the Banking Companies Act (section 11) as originally enacted, a bank, having a single place of business, could be started with as little as Rs 50,000. This figure, incidentally, was fixed in 1936 when banks were governed by certain provisions of the Indian Companies Act. Minimum capital requirements for a bank were thereafter related to its area of operation, the number of offices it opened, and whether any of these were in Calcutta or Bombay. A bank with aggregate paid-up capital and reserves of Rs 10 lakhs could, in principle, open offices in all parts of the country including its two largest urban centres. Section 17 of the Act regulated banks' provisioning for reserves, and as framed originally, required banks to transfer a fifth of their annual profits to a reserve fund until the latter equalled the paid-up capital.

The paid-up capital and reserves of a banking concern together comprise a guarantee fund safeguarding to some extent the interests of its depositors, and enable a bank to undertake certain types of business which the short-term nature of its deposit liabilities might otherwise preclude. By almost any reckoning, the provisions of the Banking Companies Act relating to capital and reserves were extremely modest. Nor did they, except in the case of small banks willing to forego current dividends for rapid expansion and higher returns in the future, encourage banks to maintain their owned funds in some reasonable relation to their deposit liabilities. These limitations became apparent in the wake of the rapid growth of bank deposits in the 1950s. As a result of this growth and inadequate provisioning by banks, the ratio to deposits of paid-up capital and reserves of Indian banks fell from a respectable 9 per cent in 1951 to 7 per cent in 1956, and further to 4 per cent in 1961. The fall in this ratio was even sharper in the first period for scheduled banks, and by

1961 the ratio of owned capital to deposits of these institutions too had fallen to 4 per cent.

The question of capital adequacy was first raised within the Bank in 1954 at the instance, interestingly enough, of the Chairman of the Indian Banks' Association. The latter's memorandum to the Shroff Committee adverted to 'currency and deposit inflation since the war', and suggested that it had become necessary to quadruple the minimum capital and reserves of banks, from Rs 5 lakhs to Rs 20 lakhs in the case of scheduled banks, and from Rs 50,000 to Rs 2 lakhs in the case of non-scheduled banks.

The object of this suggestion was not far to seek, and the Bank too had little reason at the time to follow it up. A note of the Research and Statistics Department prepared in September 1954 examined the Indian Banks' Association's proposal in some detail. While acknowledging that the need for 'adequate capital for banks cannot be overemphasized' since it was in the nature of their business to maintain relatively low ratios of own to total resources, this note attempted to form some idea of the dimensions of the problem. Were the proposal outlined by the Chairman of the Indian Banks' Association to be implemented, it estimated, banks would have to find additional resources of Rs 5.26 crores. The bulk of the shortfall (Rs 3.07 crores) was accounted for by the scheduled banks, few among whom could be said to pay out excessive dividends. A policy of limiting dividends to boost reserves, on the other hand, would make it difficult for banks in general to raise fresh capital. The note also considered alternative measures of capital adequacy in vogue in other countries, including relating capital to deposits and 'risk assets' and concluded that there were few advantages in forcing banks to increase either ratio. Apart from the difficulty of raising the amounts required to meet the shortfall, relating capital to deposits or 'risk assets' might make the bigger banks 'less willing to accept fresh deposits' and deter the expansion of credit and banking facilities in the country. Rejecting as well the need for raising the minimum for capital and reserves, the note argued that the 'safety of depositors' money' depended largely on the

quality of bank management, the composition of assets and efficient control and supervision over banks. The Banking Companies Act has ... gone a long way in meeting these needs and the implementation of the scheme of deposit insurance outlined by the Shroff Committee will be an additional safeguard ....

Deposit insurance, in the event, was not instituted for several years after these lines were written. But similar views were voiced four years later in another note prepared in the Research Department. This note, however,

acknowledged the need to raise the minimum capital requirement as a means of 'ensuring that the activities of a bank do not go beyond what its resources warrant'. But it also warned against attaching 'too much importance to capital funds', since in the 'ultimate analysis', it was not 'so much the capital cushion but the liquidity position of a bank that makes for its survival and progress'. Warning against fixing 'arbitrary standards' of capital adequacy, this note too echoed the earlier one in suggesting that 'regulatory provisions ... in regard to banks' employment of funds ... and the close scrutiny in the conduct of banks' business' that inspections made possible reduced the 'emphasis on capital funds as a guarantee against loss of deposits'.

There is other evidence too, that the Bank was complacent about capital norms in the 1950s. For example, there was a sharp fall in the prices of government securities following the Bank rate increase in November 1951, and banks apprehended that they would be forced to declare lower dividends if they were required to provide for the depreciation of these assets according to the Banking Companies Act. Following representations from them, the Government of India decided, with the Bank's concurrence, to exempt banks from having to show the market value of their investments on the last day of 1951 in their balance sheets and profit and loss accounts as required by law, and to waive the application of sections 15 and 17 of the Banking Companies Act. The section 15 waiver enabled banks to pay dividends without writing off the depreciation in the value of their investments in approved securities so long as they did not capitalize the depreciation or account for it as a loss. Apart from helping banks out of a temporary difficulty, this waiver was justified on the ground that banks generally held government securities till maturity. Consequently, it was argued, any depreciation their values suffered in the meantime was 'notional' rather than real. The original section 17 of the Banking Companies Act was thought to prevent banks from making appropriations from reserves to write off losses on their investments until the former equalled or exceeded the paid-up capital. This provision too was relaxed through an executive order in the wake of the fall in security prices in 1951 to enable banks to write off the depreciation if they so chose.

Apart from being of some relief to banks in their embarrassment, an important object of these exemptions was to 'create a steady incentive for investment in government securities'. Although the need for them diminished as the maturity structure of banks' investments in government securities grew shorter, both exemptions were renewed from time to time thereafter. Finally in 1959, section 15 of the Banking Companies Act was amended to give statutory sanction to the dividend practices banks had adopted since 1951; while at the same time section 17 was amended to enlarge on recent practice



and allow banks to draw on reserves not only to cushion the impact of a fall in the value of their investments in approved securities, but also for all types of contingencies with little restriction on the nature of the losses they could set off against their reserves. In pushing for this amendment, the Bank argued that the 'reserve fund would have no meaning' if it could not be 'drawn upon for meeting unforeseen losses' and that 'what was important was not the reserve fund itself but the real or exchangeable value of the assets' of a bank. The Division of Banking Research, which appears not to have been consulted about these amendments, opposed both amendments after they were passed, and pressed for their 'reconsideration' and 'repeal'. As a note prepared in the division by D.G. Borkar and S.L.N. Simha remarked, even though the two amendments only acknowledged existing practice, they violated the sound banking principle of setting off losses on investments and advances against current earnings and would only help to lower the 'reserve standards' of the banking system. Barely two years after they came into force, the Division of Banking Research noted that the amendments, in particular the one to section 17, had 'had the effect of lowering the magnitude of transfers to reserves' of several banks.

The collapse of the Palai Central Bank in August 1960 affected several aspects of the Bank's policy towards commercial banks. Capital standards was one such aspect, with Governor Iengar himself taking direct personal interest in evolving capital adequacy norms for Indian banks. Unfortunately, unlike deposit insurance which was the other major reform he initiated to strengthen the Indian banking system after the Palai crisis, Iengar's achievement in the sphere of capital adequacy did not outlast his tenure at the Bank.

By an odd coincidence, a bill to amend the Banking Companies Act to protect banks from disclosing their secret reserves to labour tribunals was under discussion in Parliament when the Palai Central Bank collapsed. This bill, which in the event was passed in the middle of August 1960, might no doubt have been expected to boost banks' reserves indirectly. But more direct measures were called for in the wake of the Palai crisis, and the first suggestion thereafter to review capital adequacy norms for Indian banks came in a speech Iengar made to the Institute of Economic Growth in Delhi in September 1960. The Governor followed up this speech with a note to the Executive Director, B.K. Madan, which also suggested that the Bank should 'see that the increased income' accruing to commercial banks from the higher rates on advances announced for the 1960-61 busy season was not 'frittered away in additional declaration of dividends'. 'I think we should pursue this point actively now' the Governor reiterated early in November 1960, and suggested that 'one possible way of dealing with the matter' might be to issue a directive to banks asking them to take the Bank's approval before increasing their dividend rate.

There was little agreement within the Bank on the Governor's suggestion to regulate banks' dividends by a directive. Officials felt it was 'difficult' to devise a formal directive since rates of dividends were 'very disparate'. Besides, Madan remarked,

requiring formal approval of the R[eserve] B[ank] in every case assumes that we have cut-and-dried principles ... to fit all cases into a few well-defined categories; otherwise our judgement replaces the banks', which is not a very good thing in relation to the banking system as a whole.

Dividend restriction, he suggested instead, was a fit case to try out 'moral suasion', 'though psychological pressures are being built up against its use generally'.

In the event, little came of Iengar's suggestion to limit banks' dividends. Apart from the inherent difficulties of implementing it, dividend limitation held little appeal for officials who were more preoccupied with following up the Governor's other suggestion, viz. levering up the capital funds of banks. Apart from everything else, a policy of restricting dividends would throw the onus of increasing capital funds entirely onto reserves and this, as officials at the Bank soon realized, was not a practicable solution to the problem of capital inadequacy.

The Governor's speech to the Institute of Economic Growth led the Division of Banking Research to undertake a comprehensive study of the adequacy of capital funds of twenty-eight Indian scheduled banks. This study, which was conducted principally by D.G. Borkar and S.L.N. Simha and completed early in November 1960, recommended that rather than making banks approach the market for fresh capital, the Bank should concentrate on persuading them to strengthen their reserves. Not only was the latter easier than the former to accomplish for the banks themselves, strengthening reserves also meant 'inculcating prudence in management'. Besides, an increase in capital might actually reduce transfers to the reserve since banks were generally loath to reduce their dividend rates which tended to remain stable or increase slightly even in years of lower profits. The study also showed that though their gross profits margin had tended to be unsteady of late, banks deployed a smaller proportion of their profits than in the past to boost their reserves. Dividend payments had made 'heavy inroads into the transfer to reserves' in the case of a majority of the bigger banks, while some large banks, whose reserves equalled or exceeded their paid-up capital, had altogether stopped transferring any amount to their general reserves. Smaller banks tended to

retain a larger proportion of their profits than larger banks, but even here the share of retained profits was on the decline. Prevailing reserve policy, the note argued, was 'essentially of a minimal character' introduced at a time when there were a large number of 'submarginal units' following the abnormal wartime expansion of Indian banking.

Now that the greater part of the essential process of consolidation of the banking system has been completed and ... taking into account the changing character of the banking business towards greater assistance to industry, the reserves policy will have to be shifted towards the prescription of still better standards for even the strongest and largest units ....

Both Borkar and Simha, and a subsequent note by Madan, pointed out that linking reserves to paid-up capital was a major drawback since the latter was generally 'static' and bore 'no relation to the dynamic expansion of liabilities of banks as a sequel to the increase in economic activity'. Besides, if paid-up capital was low, reserves were likely to be low as well, and the existing provision may have had the effect of further discouraging banks from raising their paid-up capital. Borkar and Simha therefore favoured legislation to ensure that banks continued to set aside a fifth of their profits to reserve until the ratio of paid-up capital and reserves amounted to 5 per cent of their deposits. Subsequently, the Division of Banking Research also made a case for retaining, in addition, the clause requiring banks to add to reserves until they equalled their paid-up capital since the real value of capital funds of most of the small banks and some of the medium-sized banks was much lower than their nominal value, and their 'apparently high' capital funds ratio was 'illusory'.

The Departments of Banking Operations and Banking Development, for their part, favoured stiffer capital norms: and the higher figure of 7.5 per cent of deposit liabilities or 10 per cent of risk assets was suggested as a benchmark, with banks being allowed five to seven years to meet these standards. Relating capital to risk assets was thought, however, to be impractical since the latter were subject to seasonal fluctuations. After reviewing its earlier conclusions with the two banking departments, the Division of Banking Research too came to favour a 7.5 per cent norm. But the higher norm also meant banks could not be expected to achieve it within a reasonable period through more prudent management alone. Many banks, Banking Research acknowledged in a note written in January 1961, would be unable to meet the proposed higher norm for another ten years if they relied simply on augmenting reserves, or venture in the meantime into 'less orthodox forms of finance' such as term-

lending and underwriting of shares. Therefore, according to this note, banks should be made to increase their paid-up capital as well through an amendment to section 11 of the Banking Companies Act.

Recommending, besides, the repeal of the amendments made to sections 15 and 17 of the Banking Companies Act in 1959 since they had the effect of 'lowering reserve standards', the Borkar-Simha note also suggested that banks should be encouraged not to fritter away in dividend pay-outs, the higher profits likely to result from the increase in lending rates announced in September 1960, but use them instead to build reserves. Finally, it recommended persuading banks, if necessary through tax concessions, to make adequate provisions for secret reserves against bad debts and security depreciation, and to credit realized capital gains to security reserves. The latter proposals did not find much support elsewhere within the Bank.

Following these consultations, the Bank sent the Government of India a detailed sixteen-page note in April 1961 which made three proposals for Indian banks. The first was to increase the minimum capital for establishing a bank from Rs 50,000 to Rs 5 lakhs and to double the capital requirement to Rs 20 lakhs for banks having offices either in Bombay or Calcutta. The second proposal envisaged compelling Indian banks to transfer a fifth of their 'net profit before taxation' to reserves until the 'reserves and share premium account' equalled the paid-up capital, and the ratio to deposits from the public of both taken together reached 7.5 per cent. Thirdly, the Bank sought powers to compel banks to increase their paid-up capital. Finally, the Bank proposed that capital funds of foreign banks should equal or exceed 5 per cent of their deposit liabilities, subject to a minimum of Rs 15 lakhs, with the latter requirement rising to Rs 20 lakhs for foreign banks having offices in Bombay or Calcutta.

With only a few months left for the elections, the government's mind happened to be elsewhere. Iengar felt the Bank should nevertheless take the initiative to submit concrete proposals to the government and utilize the interval to consult Indian and exchange bankers about them. At the same time, the Bank also contemplated increasing banks' statutory cash and liquidity ratios, and its proposals in all these respects were communicated to the Indian Banks' Association and the exchange bankers in the summer of 1961. The Bank's views on the liquidity ratio are discussed below, and its evolving approach towards the question of capital adequacy of Indian and foreign banks forms the subject of the remainder of this section.

Not surprisingly, bankers were unenthusiastic about the Bank's proposals for augmenting capital. They felt the current trend of rising profits was a temporary one which would come to an end as wages increased, banks'

earnings dropped as a result of the new liquidity requirements that were on the anvil, and deposit rates increased. A 20 per cent transfer rate, banks felt, would mean smaller allocation to secret reserves and lower dividends. The latter, in turn, would make it difficult for banks to raise capital. A capital–deposits ratio of 7.5 per cent also did not receive much support. The proposal was thought to be unfair to banks which had built up secret reserves. Besides, banks argued, a higher ratio of capital funds was not a safeguard against bad management: a mere increase in paid-up capital was useful only if a bank failed and the object of policy should be to *prevent* bank failures. They also confessed to fears about maintaining and servicing even the existing capital base, let alone widening it in the future. The proposal to establish a parity between paid-up capital and reserves also ‘bothered’ some bankers. Finally, banks objected to the Bank acquiring powers through legislation to direct them to raise capital in the market either through new issues or calling up unpaid capital if their ‘own’ resources appeared inadequate. The exercise of such powers, they argued, was fraught with risks. Despite the best information available it was not possible to be certain about the response new issues would evoke in the market, and a failed stock issue would cause ‘incalculable harm’ to the bank concerned and affect banks of similar size. Rather than resorting to legislation, banks preferred the Reserve Bank adopting moral suasion whenever it felt the paid-up capital of a bank was too low in relation to its deposits.

The Bank’s proposals formed the basis of informal discussions between the Governor and representative commercial bankers in November 1961. At these discussions, the Chairman of the Indian Banks’ Association, Tulsidas Kilachand, pressed the case for reducing the capital adequacy ratio to 5 per cent and questioned the need for legislation to bring it about. Whereupon the Governor too pointed out that ‘he would much rather avoid going to the legislature’ if bankers agreed to implement the Reserve Bank’s proposals voluntarily. A fortnight later, early in December 1961, Kilachand wrote to the Governor reiterating his association’s reservations about the Bank’s proposals, but also suggesting ‘as a practicable proposition’ that banks might be allowed gradually to raise their owned funds to a ‘target’ of 6 per cent of deposits. This target, the banker insisted, should not be laid down by statute but achieved by all banks ‘by means of an understanding with the Reserve Bank’ which should also view with sympathy cases of banks having difficulties in meeting it.

The Governor thought this a ‘satisfactory response’ and responded three weeks later with a circular to all scheduled banks advising them to ‘aim to achieve a ratio of 6 per cent of capital funds to deposits’ by transferring a fifth of their declared profits to their published reserves and taking

'supplementary action' in the form of calling up unpaid capital or applying for fresh capital in the market. At the same time, with the Governor himself being of two minds regarding the advantages of prescribing capital adequacy norms for foreign banks operating in India, it was decided, willy nilly, to postpone imposing additional capital requirements on exchange banks until their position had been studied more closely.

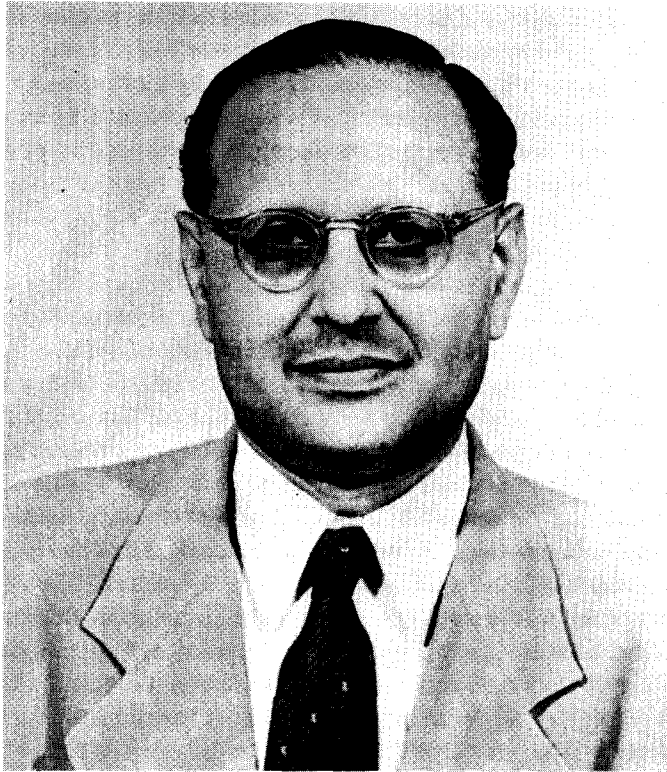
A review of banks' reserve practices in May 1962 revealed that the Governor's circular letter to scheduled banks had evoked an excellent response. Thirty-two of the sixty-four banks for whom data were available had a capital funds ratio below 6 per cent. Of these, all but two banks transferred 20 per cent or more of their profits to the reserve in the year ending December 1961. A large number of banks transferred a substantially higher proportion of their profits to the reserve, eight banks transferring over 50 per cent, four banks 40–50 per cent, ten banks 30–40 per cent, and another eight banks 20–30 per cent more than they had done the previous year. Sixteen banks, it also turned out, had obtained sanction for new issues totalling Rs 11 crores, while there were others whose applications were under consideration. Banks had also generally maintained their dividends at the 1960 level despite earning higher profits in 1961. These developments were all the more satisfactory, the study remarked, because the Governor's circular was issued at the fag end of the year and left banks little time to adjust to the new situation created by it. A note by A. Raman declared, banks had 'kept their faith ...'

But the convention came under pressure from the larger banks no sooner Iengar departed the Bank. At a meeting with his successor, P.C. Bhattacharyya in April 1962, representatives of three large banks wanted a 'review' of the '6 per cent ... requirement'. Bhattacharyya thought 'it was hardly appropriate to reopen an agreed formula', but agreed to consider allowing banks different periods of time within which to achieve the target. At almost the same time, the Department of Banking Operations too appears to have developed second thoughts about the capital adequacy ratio which it said was 'too high for the large banks and too low for the small ones' whom the department 'frequently advised ... to raise their reserves even if their capital funds had attained a ratio of 8 to 9 per cent'. At a meeting held to discuss these developments, both B.K. Madan and D.R. Joshi, Executive Directors, maintained that the ratio of capital and reserves to deposits represented an important 'guidepost' which should not be dispensed with. Whereupon Banking Operations suggested that small banks satisfying both the proposed criteria (of a 6 per cent capital funds ratio and parity between capital and reserves) should be asked to continue transferring a fifth of their declared profits to their reserves until the latter and paid-up capital amounted to Rs 5 lakhs.

Nothing much came directly out of this meeting since the overwhelming feeling at this stage was that the new convention should be allowed a year's time before it was amended in any way. But barely two months later different ideas had taken to the air, not it seems without many officials within the Bank expressing their reservations about them, and proposals to amend section 17 of the Banking Companies Act governing banks' reserve provisioning norms began to be openly discussed. And by September 1962, the Banking Companies Act had been amended to require Indian banks to transfer a fifth of their annual profits to a reserve fund, regardless of whether it was less or more than the paid-up capital, before declaring a dividend. Banks incorporated outside India were also required to deposit with the Bank a fifth of their profits from their business in India. At the same time, the minimum paid-up capital for an Indian banking company commencing banking business was raised from the prevailing level of Rs 50,000 to Rs 5 lakhs.

The reasons for abandoning the convention so soon after it was adopted are not clear. Despite noting that the capital funds ratio of scheduled banks was, at 4.2 per cent, 'on the low side', the memorandum to the Central Board on the proposals to amend the Banking Companies Act in 1962 (and the related notes) passed over the convention in silence, merely declaring the Bank's intention not to fix a 'rigid upper limit' on the capital and reserves of banks. The memorandum gave no reason for not prescribing a minimum *floor* ratio of capital and reserves to deposits, but almost certainly, the convention of December 1961 was abandoned because of growing recognition of the difficulties banks faced in meeting the 6 per cent norm at a time of rapid deposit growth and shrinking intermediation margins, and the apprehension that too rigid a norm might actually weaken banks' incentive to boost their deposits and impede the expansion of the banking system. The Bank too may not have been unmindful of the paradox that a rigid capital adequacy norm might actually help promote the growth of small, overcapitalized, and badly managed institutions to the detriment of bigger and sounder banks, and ultimately of the banking system.

Madan, who had played a major role in preparing the earlier proposals on capital adequacy, was far from happy at this turn of events. Feeling that the legislative amendments of September 1962 did not provide 'sufficient incentive to banks to build up their owned funds', he considered soon afterwards smuggling more stringent capital adequacy norms in through the back-door by relating banks' quotas for borrowing from the Reserve Bank under the recently introduced slab-rate system to their owned funds rather than their statutory cash reserves. But this idea was soon abandoned as studies showed that 'for most of the Indian scheduled banks and a number of foreign ...



B. K. Madan, Deputy Governor, 1964-67

banks', quotas for borrowings on the basis of owned funds 'would be more favourable than on the basis of statutory cash reserves'.

The subject of capital funds receded into the background for some years after the 1962 legislation. Some five years later, in November 1967, the Economic Department conducted a quick review of the capital funds ratios of Indian banks at the instance of the Deputy Governor, B.N. Adarkar. Summing up the review, the Economic Adviser, V.G. Pendharkar, remarked that caught between mounting costs in the industry, which affected the accumulation of internal resources, and the doldrums of the capital market, banks had failed 'to show much improvement in the matter of strengthening their capital base'. This was an understatement, the ratio of paid-up capital and reserves to deposit liabilities of all but three of the sixty-one Indian scheduled banks in respect of which data were collected actually having fallen sharply between 1961 and 1966. The three banks whose ratios went up were all small banks



which were overcapitalized even in 1961 and had become more so five years later. The average capital funds ratio of all the sixty-one banks fell during these five years from 3.9 to 2.9 per cent. Interestingly enough, since the norm accepted in December 1961 appears to have been revoked at the instance of the bigger banks, the ratios of medium-sized banks dropped faster and lower than those of the larger banks.

### IMPROVING BANKS' LIQUIDITY

For obvious reasons, as India's central bank, the Reserve Bank took a continuing interest in the liquidity position of commercial banks operating in the country. Commercial banks in India have traditionally been subject to two types of reserve requirements. Under section 24 of the Banking Companies Act, all banking companies were required to hold at least a fifth of their time and demand liabilities in India in the form of cash, gold, balances with the Reserve Bank, current account balances with other banks, money at call and short notice, and approved unencumbered securities. The latter principally comprised medium- and long-dated government securities. The chief object of this stipulation was to ensure that banks had enough liquid reserves to meet a drain, should one arise, on their resources. The practice of regarding medium- or long-term government paper as liquid assets was, no doubt, an unusual one. But its origins can be traced to the paucity of good quality commercial bills in India and the view that gilt-edgeds were the easiest stock to liquidate in a crisis. In 1960, scheduled commercial banks were also required, under section 42 of the Reserve Bank of India Act, to maintain with the Bank minimum balances which the latter could vary between 5 and 20 per cent of their demand liabilities and 2 and 8 per cent of their time liabilities. Section 18 of the Banking Companies Act required non-scheduled banks too, to hold cash reserves of similar proportions to their demand and time liabilities. The latter reserve was referred to at the time as the statutory reserve or the statutory cash reserve, but also as the cash reserve by which nomenclature it is most commonly known today. Until 1962, the cash reserve formed part of the overall liquidity ratio.

The cash reserve ratio was intended essentially as a tool of monetary policy. But it had implications for a bank's liquidity position, and liquidity issues took the forefront in discussions about banks' cash reserves during 1960-62. Conversely, while the overall liquidity ratio prescribed by the Banking Companies Act was intended essentially to secure the liquidity of banks, it was not without implication for their ability to expand credit. Nor was the exercise to increase banks' overall liquidity ratios entirely insensitive,

both during 1960–62 and in later years, to the need to create a protected market for the government's long-term debt. Indeed, while interest within the Bank in the liquidity position of the Indian banking system deepened after August 1960 as a sequel to the failure of the Palai Central Bank, it came under scrutiny also following the success of the banks in shifting the impact of the variable reserve requirements imposed earlier that year disproportionately onto investments in government paper.<sup>2</sup> In the process, a few banks came perilously close to the statutory minimum of 20 per cent written into the Banking Companies Act.

The liquidity position of Indian banks came up for discussion first at a meeting of the Committee of the Central Board towards the end of August 1960. In the course of making some general observations about the banking system, Iengar referred, innocuously enough, to the 'very low liquidity ratios' of certain Indian banks. Upon this, J.R.D. Tata, a member of the Committee who was closely associated with one of the banks named by the Governor, asked him about the liquidity positions of banks in the USA and the UK. Comparisons with banks' liquidity and advances-to-deposits ratios in Britain and the US revealed that Indian banks maintained lower liquidity ratios and higher advances-to-deposit ratios than their counterparts in these countries. The Committee of the Central Board returned to deliberate on the subject the following week, and the upshot of it was a review within the Bank of the adequacy of existing liquidity provisions in the Banking Companies Act and the Reserve Bank of India Act.

Two aspects of banks' recent functioning featured prominently in this review which was taken up in October 1960 and completed by February the following year. The first was the steep and almost continuous decline in the average overall liquidity ratio (i.e. the ratio of cash and balances with the Reserve Bank, gold, and unencumbered government securities to total deposit liabilities) of scheduled banks excluding the State Bank of India, from 43.3 per cent in 1951 to 33.1 per cent in 1960. The overall liquidity ratio in April 1960 of banks excluding those in the State Bank group averaged about 30 per cent, with several major banks having liquidity ratios of 28 per cent or less. The ratio of cash (i.e. cash and balances with the Reserve Bank of India) to the total liabilities of these institutions fell from 5.4 to 3.1 per cent over the same period. The credit-liabilities ratio of banks (again excluding the State Bank of India) rose from about 61 per cent in 1951 to 69 per cent in 1960, while their credit-deposit ratio hovered in the neighbourhood of 75 per cent.

<sup>2</sup> For a discussion of the Bank's experiment with varying marginal reserve requirements, see chapter 3.

In the future too, the Bank apprehended, the 'rising tempo of private investment' in the economy might cause the demand for bank credit to outpace the growth in deposits and further erode the liquidity position of the banks.

While it is necessary to provide for all genuine credit requirements of the economy, it is essential in such a situation ... to safeguard the soundness of the banking system through measures to raise somewhat the minimum requirements in regard to both cash reserves and liquid assets ....

This, Madan who piloted the proposal within the Bank argued, might also stimulate more 'effective mobilization of resources by banks to meet expanding credit needs'.

The second feature of the slide in the banks' overall liquidity ratio was the steady decline in their holdings of unencumbered government securities, from 34 per cent in 1951 to about 23.5 per cent in 1960. This fall was even steeper in the case of foreign banks, from 28 to 15 per cent. The tendency to get out of government securities or borrow against them from the Bank grew particularly marked in 1960 as banks attempted to relieve the pressure on their resources caused by higher marginal reserve requirements imposed during that year. The Bank's internal exercises to reconsider liquidity provisions were partly a response to this development as well, its officials seeking to

refine the cash reserve provision ... to provide for minimizing the impact on security holdings of any future action to raise reserve requirements by ensuring that with every rise in reserve requirements, the liquidity requirements can also be raised correspondingly.

It also became apparent by the end of 1960, that the higher cost of Bank accommodation which followed the recent introduction of the quota-slab system did little to enhance the attractiveness of government paper, with banks preferring outright sale of securities to borrowing from the Reserve Bank at the new rates. With the result, the aggregate investment-deposits ratio dipped sharply from 48.4 to 38.4 per cent between the end of 1959 and a year later.

Madan's proposals for revising banks' cash reserve and liquidity requirements, which he suggested should be related to total *deposits from the public* rather than banks' *liabilities*, came against this background. He proposed a minimum overall liquidity ratio of 27.5 per cent, and 'automatic variation in the liquidity ratio of scheduled banks for any change in the cash reserve ratio' by splitting the liquidity ratio into two parts, viz. the cash reserve component,

and other liquid assets. He also proposed, besides, assimilating the different reserve ratios currently prescribed for time and demand liabilities into a single reserve ratio applied to a bank's total deposits, with the Reserve Bank having the power to vary this ratio between 5 and 15 per cent. The proposal for a unified cash reserve ratio was intended to guard against demand deposits being switched into time deposits if the latter continued to be subject to a lower cash reserve ratio.

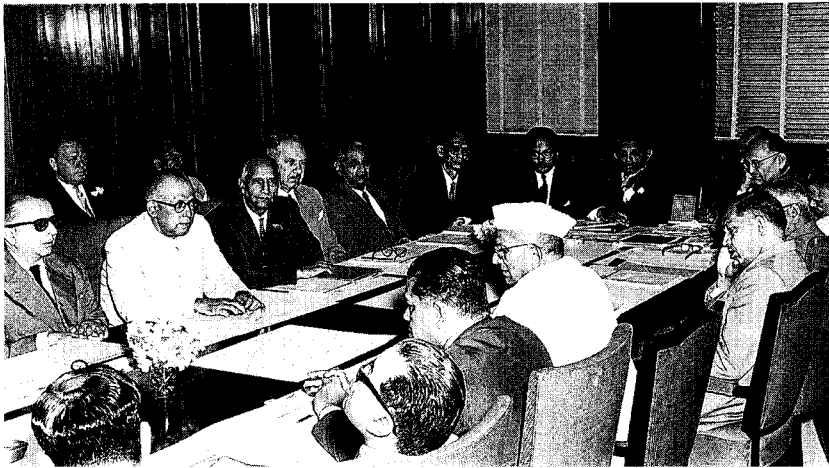
The Division of Banking Research prepared a sixty-page note elaborating on the reasoning behind Madan's proposals. A higher cash ratio, the note argued, was necessary because the turnover of current deposits had grown sharply from 22 per cent in 1945 to 58 per cent in 1960. Besides, fixed deposits were no longer 'as fixed as they used to be', with their average usance period having fallen from 6.5 months in 1935 to 2.8 months in 1960. The amounts of cleared cheques and the rate of turnover had also increased sharply during the 1950s.

With growing economic activity ... there is bound to be an even more rapid increase in the volume of banking transactions that will be settled through clearing and therefore through adjustments in banks' reserves with us. The present norm was fixed in 1935 and is clearly inadequate in the context of current and future needs.

Moreover with the decline in the cash balances of banks during the 1950s, the note declared,

a corrective in the form of higher basic statutory balances with the Reserve Bank becomes both desirable and inevitable in order to step up the overall cash reserve ratio to the minimum extent warranted by the current requirements of liquidity.

Since the liquidity ratio was also being raised simultaneously, banks might not be able to raise cash reserves without immobilizing their deposits. The Division of Banking Research therefore proposed giving them even two years, if necessary, to comply with the new requirements. This would also have the advantage of ensuring that banks that had a higher investment ratio than the 22.5 per cent proposed to be imposed did not rush to meet their additional cash reserve needs by selling securities. 'Since the primary objective of our new proposal is to ensure that future reserve increases are achieved without any pressure on the security markets', nothing should be done to provoke banks into liquidating government securities in large quantities.



Morarji Desai, Union Finance Minister, meeting bankers in New Delhi, 12 March 1961. Iengar is on his right.

A higher liquidity ratio, on the other hand, the Division of Banking Research indicated, was dictated primarily by the need to safeguard the liquidity of the banking system and enable it to withstand the strains of a sudden increase in withdrawals. As Iengar told the bankers when he met them in November 1961 to discuss the Bank's proposals, liquidity ratios in India were among the lowest in the world and deserved to be increased for their own sake. Besides, the present 'psychological atmosphere [of nervousness] ... might continue ... for some years'. Since 'liquid assets served as a buffer in absorbing shocks', the Governor argued, it was necessary to strengthen them.

Fearing the immobilization of a greater proportion of their deposit resources, banks in general were not very enthusiastic about these proposals. They suggested a maximum overall liquidity ratio of 25 per cent including the cash reserve component, and counting treasury bill holdings and balances with the State Bank of India towards cash reserves, and trade bills towards the overall liquidity reserve. The exchange banks too, objected to the proposals, arguing that their banks, which had 'very great funds abroad always at their support' were being made to pay the price for the 'weakness of a small section of the banking system'. If the Bank insisted on raising liquidity requirements, the exchange bankers argued, they should be allowed to deposit foreign securities with the Bank's office in London equivalent to 7.5 per cent of their deposit liabilities in India. This would put them and the Indian banks on a level playing field since the latter, unlike the exchange banks, could count the

proposed capital funds ratio (of 7.5 per cent of deposits) towards their liquid resources. Nothing, in the event, came of the latter suggestion since, as discussed above, the convention to relate capital funds of Indian banks to their deposit liabilities was abandoned no sooner was it adopted.

Nor was there much sympathy within the Bank for the changes proposed by Indian bankers. Their first suggestion, officials felt, was little more than a reformulation of the traditional demand of bankers for the central bank to pay interest on statutory cash reserves. The Bank, for its part, was determined to stick to the principle that statutory balances were a form of 'till money' banks maintained 'in the interest of their own liquidity', and that it was inappropriate to pay interest on them. Allowing banks to hold their statutory reserves with the State Bank and trade bills in their overall liquidity reserve, the Bank also felt, would weaken its ability to use reserve ratios as an instrument of credit policy. The proposal to set a unified reserve ratio on both time and demand deposits also evoked opposition, some bankers suggesting that it was unfair to institutions which had a large proportion of their liabilities in the form of time deposits and would discourage them from mobilizing deposits in the countryside where, apparently, time deposits were preferred to demand deposits. But the Bank did not go back on its view that time deposits should be treated on par with demand deposits for reserve norms because of the fall in their average maturities.

The Bank's liquidity proposals too were discussed at the November 1961 meeting with the banks. However, unlike in the case of capital funds where it helped narrow differences between the two sides and despite appearances to the contrary, the meeting did little to bridge the gulf that had developed between the Bank and joint-stock banks over liquidity requirements. In fact the letter Tulsidas Kilachand wrote to the Governor early in December 1961 proposing a compromise on capital funds—which in the event the Bank accepted—insisted that time and demand deposits should continue to be treated differently for fixing the cash reserve ratio, and that the overall liquidity ratio, including remittances through notified banks, should not exceed 25 per cent of total deposits.

Despite the distance still separating the Indian Banks' Association's views from those of the Bank, the Governor appears to have been keen to conclude a liquidity convention as well, even if it was only possible along the lines suggested by the association. Officials at the Division of Banking Research were, however, less enthusiastic. In particular they were puzzled by the association's view that the convention should fix the minimum liquidity requirement at a quarter of total deposits. Apart from the fact that a convention had to be 'within the four corners of the existing legislation' which specified

liquidity requirements in relation to total liabilities, the division believed the association was having second thoughts about the liquidity ratio it had more or less accepted at the meeting, of a quarter of a bank's total liabilities which was close enough to the Bank's (original) target of 27.5 per cent of total deposits. The division was also averse to the association's suggestion, which the Bank had rejected earlier as well, to include remittances through banks in the overall liquidity ratio. Remittances, a note by K.N.R. Ramanujam pointed out, might vary between 0.5 to 2 per cent of deposits. Including them in the overall liquidity ratio and fixing the latter at 25 per cent of deposits would mean 'maintaining the status quo' on banks' liquidity requirements.

The Indian Banks' Association's letter evoked serious misgivings about its intentions at other levels of the Bank as well. Madan noted that if the Governor's letter to banks establishing the new convention was based only on the changes the Indian Banks' Association appeared willing to accept, the proposal to alter liquidity requirements would have been 'watered down' to a point where it involved little change in existing liquidity provisions. Given the 'limits of moral suasion in this sphere, particularly ... on the eve of the busy season', Madan commented, it would be better to confine the Governor's letter, and the convention, to the 'capital funds problem'. Iengar too, saw Madan's point and agreed to defer efforts to alter banks' liquidity requirements till the end of the busy season.

Matters concerning the liquidity ratio had reached something of an impasse in December 1961 after the association's letter. As pointed out above, by June 1962 the Bank and the government had decided to moot legislation to replace the capital funds convention of December 1961. This amendment bill also presented the Bank with an opportunity to break the impasse and to put the revised liquidity requirements it envisaged for banks in the statute book. The proposals ventured in this connection in June 1962 differed little in substance from those considered earlier. The idea of separating the cash reserve ratio from the liquidity ratio was persisted with. So too plans to fix a single reserve ratio for both time and demand liabilities. However, the proposal to relate reserves to demand and time deposits, rather than demand and time liabilities, did not endure. The proposed legislation also shifted the balance between the cash reserve ratio and the liquidity ratio in favour of the latter. The minimum cash reserve ratio proposed was lowered from the 5 per cent discussed in 1961 to 4 per cent, while the liquidity ratio suggested was raised from the 22.5 per cent that the Bank had had in mind in December 1961 to 25 per cent in the amendment bill. When carried out, this change promised to enable banks to earn a return on a higher proportion of the liquid resources they were required to hold under the law, and boost the demand for government securities.

But the Indian Banks' Association was far from satisfied. It returned to the charge in July 1962, once again arguing that the proposed increases would impose 'too heavy a burden' upon banks which were now having to pay a premium to insure deposits under the new deposit insurance scheme introduced earlier in the year, and higher corporate taxes. The association also apprehended the effects of the impending wage award on banks' profitability, and of the proposal to compulsorily transfer a fifth of their disclosed profits to the reserve fund on banks' ability to service their existing and new capital base. The Bank once again relented, deciding to lower the proposed minimum cash reserve ratio further to 3 per cent. This level, incidentally, was lower than the cash reserve ratio actually prevailing in 1960 when the Bank initiated its moves to raise liquidity requirements! But the Bank refused to yield in its desire to peg the new liquidity ratio (excluding the cash reserve ratio) at 25 per cent. It was also proposed, as part of the same amendment bill, to allow the Bank to vary the cash reserve ratio of scheduled banks between 3 and 15 per cent, and amend the Banking Companies Act to require non-scheduled banks to hold minimum cash reserves of 3 per cent.

The necessary legislation was passed in September 1962 and came into force the same month. At their request, banks were allowed two years to come up to the new liquidity standards, which therefore formally took effect in September 1964. In the meantime, the chairmen of some Indian and exchange banks attempted in 1963 to persuade the Bank to refine the concept of liquidity further to ease the effect of the new regulations on their profit margins and on bank credit. The Indian Banks' Association too, made similar representations, suggesting that medium-term advances of banks should be treated as liquid assets, presumably because they were eligible for refinance under section 24 of the Banking Companies Act. But the Bank saw little reason to heed this suggestion.

## MANAGEMENT AND CONTROL OF COMMERCIAL BANKS

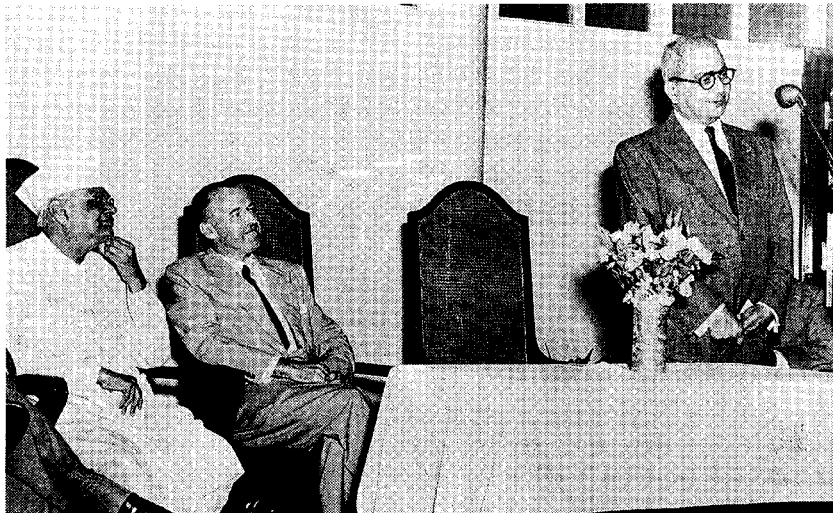
The Bank's interest in the way commercial banks were ordered and managed arose in two contexts. The first related to the implications for the soundness and stability of the banking system of the way banks' affairs were conducted. The other was the considerable public concern voiced in India, as in some other countries, over the control that identifiable business families or groups exercised over them. Such control, of course, raised wider issues extending well beyond the Bank and the period covered by this volume. Whatever its views on them, the Bank had good reasons of its own to take note of the apprehension that a few business houses might acquire control over a



significant proportion of the country's banking assets through the banks associated with them: besides raising questions about access to bank credit, such control might also jeopardize the interests of depositors if, as a consequence, banks became overexposed to individual firms or business groups.

Though no doubt the most public, control was not the sole context in which issues of management arose. Banks which were not controlled by any particular group were liable to be badly staffed or managed, and (as the adventures of Haridas Mundhra who did not control any banks reveal) liable to make badly-judged loans to one or more borrowers. Hence, tempting though it is in retrospect to view the issues addressed in this section as deriving their main salience from the public resonances they generated, the anxieties they reflected, or the course of public policy in later years, it is worth bearing in mind that the Bank's efforts to regulate the management and control of banks were also rooted in its concern for the institutional efficiency and stability of the banking system.

Thus soon after its inspections got under way, the Bank found that a large number of banks faced problems of a managerial nature and that many of them carried unqualified or inexperienced managers. Starting out as small and extremely local institutions, some of these banks had grown rapidly and expanded their area of operations during the second world war and the post-war boom. But they continued to be managed in traditional ways by persons who had either founded them or had been closely associated with their founders



Rama Rau inaugurating the Bankers Training College

and who had no formal exposure to modern banking methods. Besides coming in the way of banks adopting modern banking practices, such managers were often also a law unto themselves, even allowing their boards little say in their banks' affairs. The Bank attempted to strengthen and broaden the composition of the boards of such banks, often suggesting names of suitable directors. It also urged banks to engage trained and experienced bankers for key positions, generally professionalize the management, and structure the rewards of top managers in such a way as to avoid waste and give an incentive to qualified managers. Not infrequently, however, these suggestions fell on deaf ears, as managements of banks were loath to appoint an 'outsider' to important positions, much less as the chief executive or to their boards.

The more serious handicap facing banks in India was the shortage of 'trained and experienced' professional managers. Hence as early as 1953, i.e. even before the first round of bank inspections was complete, the Reserve Bank resolved to repair the gap as quickly as possible through a scheme to train managerial personnel of Indian commercial banks. After consultations with the major banks the Bank set up a committee of bankers under Deputy Governor Ram Nath to prepare the scheme, and sponsored the visit to India under the Colombo Plan, of two senior executives of London clearing banks. By the middle of the same year the Bank's plans had advanced sufficiently for the formal decision to be taken to set up a training college 'for the purpose of imparting training to banking personnel and improving the quality of the management' of banks in India. Under the original plan the expenses of setting up and running the college were to be shared by the Bank and the participating commercial banks. But with the latter soon balking at the commitment, the Bank decided to meet the 'entire expenditure' of establishing and maintaining the training college. This, Rama Rau argued in a memorandum to the Committee of the Central Board in August 1953, was 'reasonable' since, 'as the central banking authority', the Reserve Bank was 'interested in the orderly development of banking in the country ....' The Bankers Training College came into existence in 1954.

To some extent, of course, issues of management were difficult to separate from those of control. Public concern had been widespread in many parts of the world since the late nineteenth century over the access business groups might acquire to large deposit resources through their control of banking institutions. In India too, the possibility of individual business groups taking control of banks was anticipated even at the time the original Banking Companies Act was passed. Section 12 of this Act contained a safeguard which took the form of restricting the maximum voting power of any single shareholder of a bank to 5 per cent of the total, regardless of the size of his or

her stake in the institution. But by the mid-fifties, there were apprehensions of *benami* shareholdings being used to maintain or extend control over banks. Besides, 45 scheduled banks and nearly 250 non-scheduled banks which were incorporated before January 1937, when the Indian Companies Act was extended to banking companies, were exempt from the section 12 restrictions. Several of these banks were quite large ones, and there was some evidence too of concentration of voting power in these institutions. Therefore, the Banking Companies Act was amended in 1956 to extend the section 12 restrictions to the older banks as well. Secondly, as a means of making it more difficult for interested shareholders to circumvent these restrictions through the *benami* route, the Banking Companies Act was amended to accord recognition, except where genuine transfers had been made or the real owner was a minor or a lunatic, only to a person registered as a shareholder in the bank's records, even if the title to those shares was vested in another person.

The 1956 amendments also sought to address the phenomenon of interlocking of banks and non-banking companies. Section 16 of the Banking Companies Act, which stipulated that no individual could be a director in more than one *banking* company, was ineffectual in checking this, intended as it was merely to prevent the interlocking of two banking companies. Hence this section of the Act was strengthened by making it unlawful for a bank to have among its directors, individuals who happened also to be directors of companies controlling among themselves a fifth or more of the total voting rights of its shareholders.

The amendments carried out to the Banking Companies Act in 1956 helped strengthen the Bank's influence over the managements of commercial banks in other ways as well. As discussed elsewhere, the amended Act now empowered the Bank to give directions to commercial banks which it judged were necessary to safeguard the interests of depositors, and to depute observers to banks with rights to attend meetings of their boards and committees. Another amendment passed at this time gave the Bank the power to call for information on the shareholdings of the chairmen, managing directors, and chief executive officers of banks. Mild as these amendments might appear in retrospect, they nevertheless aroused considerable controversy at the time. This was particularly true of the amendments empowering the Bank to issue directions and appoint observers. While some members of Parliament felt these did not go far enough, others suggested, no doubt with some exaggeration, that the amendments amounted to 'nationalizing banks through the back door'. Appointing an observer, a few members also felt, would merely hasten a bank's destruction.

Soon after they were passed, the Bank felt the 1956 amendments gave it a degree of 'control ... over commercial banks' which was 'comprehensive and wide enough to ensure high standards in their methods of operations'. But less than three years later, the Bank utilized a suggestion by the government to review the Banking Companies Act as part of an overall exercise to examine the adequacy of the country's company laws in general, to widen its authority over banks, particularly in spheres related to their management. Thus, while in 1956 the Bank had acquired powers to approve the appointment of the managing director and other whole-time directors of a banking company, through another set of amendments moved in 1959, the Bank's powers in this respect were extended to cover all directors of a bank including those liable to retire by rotation. The 1959 amendments also gave the Bank powers to remove from office the chairman, director, and top executives of a bank if they were found by a judicial authority to have contravened the provisions of any law, and the Reserve Bank felt their continued association with a commercial bank was not in the latter's interest.

The next set of legislative amendments relating to the management and control of banks was taken up in response to the banking crisis of 1960. These amendments and the background to them are discussed in the next chapter. Thereafter, however, public and parliamentary opinion and the government set the pace for legislation intended to regulate the management of banks and reduce the possibility of abuse by business groups of the control they might exercise over them. By 1963, public interest in the management of banks had quickened to a point where the question of their ownership was beginning to come to the forefront of public debate; and in March the same year the government responded to a non-official resolution moved in the Lok Sabha by Subhadra Joshi, a member of the ruling Congress party, for the nationalization of banks with the assurance that it would bring forward amendments to the Banking Companies Act to further regulate the control that particular individuals or groups exerted over some banks.

The bill to amend the Banking Companies Act which the government sponsored soon afterwards reflected the concerns raised in the course of the debate on Subhadra Joshi's motion, and contained some radical proposals. Under the proposed amendments, chairmen and chief executive officers of banks could no longer be appointed for indefinite periods and were to be bound by five-year terms in office. The bill empowered the Reserve Bank to remove from office any director, chief executive officer, or any other officer or employee of a bank in the public interest, if it judged such action necessary to prevent the bank's affairs from being conducted in a manner detrimental to the interests of depositors or in order to ensure its proper management.

The draft bill also contained a provision authorizing the Bank to appoint up to five additional directors for renewable terms extending to three years. In August 1960, S.L.N. Simha, the Deputy Economic Adviser, had proposed that the Bank should acquire the power to nominate one non-voting director to the board of each bank. Simha's suggestion was made in the background of the scheme for deposit insurance that was being discussed within the Bank at the time and which, he argued, imposed 'greater responsibility' on the central bank. While outsiders, Simha implied, could be nominated to the boards of the smaller banks, officers of the Bank should be nominated as directors of the larger ones, since the Bank would then learn 'a lot of things' about such institutions 'on a continuing basis'.

The proposal has also some disadvantages; in particular, the RBI will be blamed for the acts of commission and omission on the part of a bank. However, even otherwise the RBI has to share the blame if the affairs of a bank go wrong. It is better we have the close association through our nominee so that we can take steps to correct undesirable practices at an early stage.

Better supervision over banks lay at the heart of Simha's suggestion. But in advocating the appointment of senior officers of the Bank as directors of commercial banks, Simha was clearly looking to the future. 'If nationalization should come about', he added, 'this experience will stand us in good stead'. Simha's suggestion evoked little response elsewhere within the Bank, and nothing came of it at the time. But it was a sign of changing attitudes that only three years later, proposals were mooted to give the Bank powers to appoint as many as five directors to the board of a bank.

Another important legislative change proposed in 1963 was to section 12 of the Banking Companies Act, further restricting the voting rights of the larger shareholders of commercial banks. The proposal emanated from a quick study the Division of Banking Research conducted in 1960 at the Governor's instance, of the concentration of ownership of bank capital on the basis of information contained in inspection reports of banks. A limited survey conducted by the Bank earlier in 1954 of eighteen banks revealed a concentration of their shares in a few hands. The findings of the 1960 study underlined these conclusions. Concentration of shareholding was reported in twenty-three of the sixty-four banks examined, including three major ones having deposits of over Rs 25 crores each, with directors of these banks and their associates holding shares in excess of 30 per cent of the total share capital of these institutions. The study however felt preventing the concentration of banking capital was easier said than done. For one thing, start-up capital

requirements for banks were relatively low. Although, as discussed above, these were raised for new banks in 1962, little could be done to increase the capital of existing banks except in the very long term. Nor would issues of fresh capital lead necessarily to the dilution of ownership since the Companies Act allowed pro rata allotment of new capital. There were also limits to the action the Bank or the government could take to restructure managements of banks paying regular dividends, without evoking opposition from shareholders and the public. Hence the Bank judged the practical solution to the problem of concentration of bank ownership to lie in further separating ownership from control, by reducing the maximum voting right of any individual shareholder from the prevailing 5 per cent of total votes, to 3 per cent. In the event, the government decided to limit the maximum individual voting right even further, to one per cent.

The 1963 bill also contained a number of provisions relating to the credit exposure of banks. The earlier prohibition (section 20) on granting unsecured loans to directors of banks and to private companies in which they were interested was extended to cover public limited companies in which the chairman of a banking company was interested as chairman, director, or managing agent. It was also proposed to institute stricter control over banks writing off advances to companies in which their directors were interested, by subjecting such write-offs to prior approval by the Bank. Following an initiative by the Governor, P.C. Bhattacharyya, the Bank considered stipulating ceilings on the individual and group exposures of banks. There was little enthusiasm within the Bank for the move. Existing and proposed legislative provisions relating to unsecured advances and the close scrutiny which banks' advances attracted during inspections, officials within the Bank argued, rendered such ceilings superfluous. Besides, credit ceilings would make it difficult for large industrial units and corporations in the public sector to arrange bank finance. However, the Economic Adviser, V.G. Pendharkar, pleaded strongly for such ceilings, stressing that it was undesirable in principle for a bank to tie up a large proportion of its resources in the business of a single borrower or a small group of borrowers. In the end, rather than amending the Banking Companies Act directly to set a limit on the individual and group exposure of banks along the lines of the legislation in other countries, it was decided to amend section 21 of the Act to authorize the Bank to stipulate the maximum amount of advances or other financial accommodation and guarantees that a bank could make to an individual, firm, association of persons, or a company.

Expectedly, the 1963 bill ran into fierce opposition from the banking community, some of which echoed through the Board Room of the Reserve

Bank. The Indian Banks' Association protested the move to further limit the maximum votes an individual shareholder could exercise, since among other things as its chairman, Tulsidas Kilachand argued, it would make it harder to get competent and experienced persons to stand for election as directors of banks. The Central Board of the Bank, which met in November 1963 to consider the draft bill, agreed that this proposal deserved to be reconsidered since it would serve no useful purpose. The association also opposed the proposal to empower the Bank to remove officials of banks without giving them an opportunity to represent their case since it could lead to arbitrary and undemocratic consequences, while the provision to appoint five nominee directors on a bank's board without considering the latter's strength, it was felt, could lead to the virtual takeover by the government of the management of a bank. The association suggested that officials facing action by the Bank should be given a right to be heard; besides, the vacancy caused by their removal should not be filled by the Reserve Bank, as it was originally proposed, but by the concerned bank's board of directors in consultation with the former. Finally, representatives of banks argued that prohibiting unsecured advances to some borrowers (section 20) would adversely affect many firms of sound financial standing. Moreover, advances against government supply bills and trust receipts for clearing imported goods were treated as unsecured advances, and the Bank could not interfere with a commercial bank's best judgement of unsecured advances or credit and guarantee limits of individual borrowers without causing needless hardship to them and hampering the country's industrial development. As the Indian Banks' Association declared,

Indian Banking has come into its own and made rapid strides in development only since independence and ... if it is to make further rapid progress, its freedom, initiative, and spirit of enterprise should be allowed as much scope as possible.

These arguments did not altogether go unheeded. The Reserve Bank conceded the association's demand that a bank official facing action should have a right to represent his or her case and file an appeal to the government. The Bank also decided to limit the number of directors it could appoint to the board of a bank to a third of its original strength, and to exempt advances against commercial bills of exchange, trust receipts, and government supply bills from the scope of unsecured advances under section 20 of the Banking Companies Act. But the Bank refused to resile from the proposal to limit the maximum votes an individual shareholder could command, arguing that it would help democratize the management of banks and encourage competent

persons enjoying the confidence of shareholders but not owning large blocks of shares to stand for election as directors of banks.

Some of these revised amendment proposals also came in for criticism in the *Central Board of the Bank*. R.G. Saraiya, who did not attend the meeting of the Central Board held early in November 1963 to discuss these amendments, felt the ban on extending unsecured advances to public limited companies in which a bank's directors held an interest would lead to a divorce between industry and banking with unfortunate consequences for both. A 'pure banker', Saraiya argued, 'cannot often see the difficulties of a pure industrialist and vice versa'. He also criticized the move to empower the Bank to regulate the accommodation granted by a bank to an individual borrower as one which imposed an 'unnecessary obligation on the Reserve Bank' and reduced the 'flexibility of ... operations of the banking system. After all, a banker is supposed to use discretion and have a sense of responsibility ....' Saraiya's views were not unrepresentative of those held by other members of the Central Board, and gave expression to the reservations that many among them harboured about a bill containing proposals which were felt to be *too radical* for their times. In an unusual move, the Central Board of the Bank passed a dissenting resolution which, apart from opposing the proposal to reduce the maximum votes of an individual shareholder of a bank to one per cent, characterized the extension of the existing section 20 provisions dealing with unsecured loans to public companies as 'inopportune' and likely to 'hamper industrial development'. Besides suggesting some minor changes to the bill, the Board also insisted that the Bank should exercise its powers to give directions to banks about the maximum financial accommodation they could give to any single borrower (or 'party') only after it was satisfied that it was 'desirable to do so in the interests of the depositors'.

The Banking Laws (*Miscellaneous Provisions*) Bill, 1963 was introduced in the Lok Sabha on 26 November 1963 and taken up for consideration towards the middle of December. The government championed these provisions of the bill in Parliament as a part of its efforts to free commercial banks from the influence of big business. Consequently, much of the debate on the bill ran along ideological lines, with some members of the opposition, notable among whom were Himmatsingka and M.R. Masani, protesting that the proposed measures amounted virtually to the government or the Reserve Bank taking over the management of the country's commercial banks. Masani, in particular, argued that the bill proposed to concentrate more powers in the hands of the Reserve Bank than it could handle without sacrificing the 'quality of supervision and leadership' it was set up to provide. Suggesting the postponement of the bill, Masani demanded the establishment, in the meantime,



of a high-level commission to go into the management of the banking industry. Cherian J. Kappen, the Member of Parliament from Muvattupuzha in Kerala where the Reserve Bank had become the target of campaign by some interests since 1960, thought the bill amounted to nationalization 'by proxy' of commercial banks. It also gave the Bank such wide powers that 'even God in heaven may become jealous of the Reserve Bank'. On the other hand, some members of the ruling Congress Party and the left-wing parties felt the bill gave too few powers to the Bank and the government, and that the test of the effectiveness of the intended provisions would lie in the manner in which they were utilized. The debate also became the occasion for the demand, which by now had become something of a ritual during parliamentary discussions on banking and financial matters, to nationalize banks in India. The bill was passed by the Lok Sabha on 20 December 1963 and the Rajya Sabha three days later. It received the President's assent on 30 December 1963, and its provisions came into effect on 1 February the following year.

This piece of legislation was, however, far from being the last word on what was to prove a contentious political issue during the second half of the 1960s. The debate over social control in 1967 revived some of the matters



Bhattacharyya (second from left) talking to a group of bankers at a dinner in Bombay, July 1966

thought to be settled earlier, while another kind of a denouement was reached in 1969 with the nationalization of fourteen of the largest Indian banks that year. Both developments lie outside the scope of this volume.

### REGULATING COOPERATIVE BANKS

Regulating the activities of India's cooperative banks first came into focus as an adjunct to the extension of deposit insurance to this sector of banking. During discussions about the Bank's schemes for deposit insurance, fears were voiced in many quarters including the central government and the Agricultural Credit Department of the Bank, about the consequences for cooperative banks' deposits of a scheme devoted solely to protecting depositors of commercial banks. On the other hand, there was little prospect of the proposed Deposit Insurance Corporation providing cover to the former so long as the Bank had no statutory powers to control or regulate cooperative banks. There was little agreement among state governments and cooperators over the manner in which insurance or guarantees might be extended to depositors of cooperative banks. But there was general consensus, evident for example at the meeting of the Standing Advisory Committee on Agricultural Credit held in June 1962, that the arrangements to insure their deposits should be in line with those for overseeing, regulating, inspecting, and if necessary winding up, the affairs of cooperative banks.

The Governor, P.C. Bhattacharyya, sought to break the impasse by attempting to place the issue of cooperative banking regulation itself in a wider context. At the end of June 1963, the total liabilities of primary non-agricultural credit societies and the total credit extended by them were estimated at about 8.5 per cent and 9.5 per cent respectively of scheduled banks' aggregate liabilities and credit. Cooperative banks also played a prominent role in financing certain sensitive sectors of the economy in lending to which scheduled banks were bound by selective credit control regulations. Hence, addressing the Standing Advisory Committee in July 1963, Bhattacharyya remarked on the 'important bearing' operations of cooperative banks had on the 'currency and credit situation'. These banks not only received 'substantial funds by way of created money from the Reserve Bank', they also accepted deposits from the public and financed agriculture, industry, commerce, and trade. Besides, with the State committed to a policy of 'positive support to cooperative bodies', the impact of cooperative credit institutions on the monetary and credit situation would 'become more and more significant' over time. Therefore it was necessary to bring cooperative banking institutions 'within the ambit of statutory control of the Reserve Bank', and to give the latter powers over

cooperative banks 'analogous' to those it enjoyed over joint-stock banks. As well as *strengthening* the cooperative banking sector, Bhattacharyya stressed, this would also allow the Deposit Insurance Corporation (whose setting up is described in the next chapter) to extend protection to depositors of cooperative banks.

These ideas formed the basis of a note the Agricultural Credit Department formulated in August–September 1963 dealing with the extension of the Bank's statutory control to cooperative banks and the legislative measures needed to bring this about. While the Reserve Bank of India Act and the Banking Companies Act would doubtless have to be amended, the central question concerned the implications of the 'duality of statutory control' to which these institutions might have to be subject by virtue of *the administrative sway state governments held over them*. The Agricultural Credit Department also pointed out that the existing body of laws dealing with licensing, amalgamation, or liquidation of joint-stock banks would have to be adapted before they were applied to cooperative banks. A *joint-stock* bank was merely 'one among many'. In contrast, there was only one state cooperative bank in each state, and it was rare for a district to have more than one central cooperative bank. A large number of the latter were unviable and were likely to remain so in the near future, but the Bank would find it difficult to deny any of them licences. Neither could the Bank deny a licence to a central cooperative bank, or withdraw one, without making other arrangements to finance the district's cooperative societies. Most important, the Bank had powers to wind up or amalgamate a *joint-stock* bank it found unsuitable for a licence. But it had no powers in either regard over cooperative banks which were governed by the laws of the state government and the orders of the Registrar of Cooperative Societies.

The choice before the Bank, the Agricultural Credit Department argued, was whether it should rely on the Registrar to implement its recommendations as to the future of a cooperative bank and its management *without itself* acquiring any powers to enforce them, or whether it should acquire powers to direct cooperative banks to wind up operations, amalgamate with other institutions, and supersede their managements. The latter course, the Agricultural Credit Department noted, would require *amendments not merely to central laws, but also to cooperative societies acts in the states*, and it was 'doubtful' whether many legislatures would surrender any of these powers to the Reserve Bank. Pleading therefore for 'complete understanding' between the Bank and state governments, the Agriculture Credit Department insisted that the Bank (and eventually the Deposit Insurance Corporation) should recognize 'collaboration' with state governments as an 'essential part of the

*scheme to ensure good management* of cooperative banks. Although the 'working understanding' that existed currently between the Bank and Registrars had not been 'wholly satisfactory in practice', they or their governments were unlikely to disregard the Bank's advice on rehabilitating or winding up a cooperative bank. 'From the point of view of the banking structure as a whole', the Agricultural Credit Department remarked, the situation created by a Registrar's 'failure' to take 'logical steps' to wind up, amalgamate or supersede the management of a cooperative bank along the lines suggested by the Bank 'would be as much a matter of concern to the State Government as ... to the Reserve Bank'. Therefore, a written 'undertaking' by a state government that it would heed the Bank's advice and a 'working agreement' between the Bank and the Registrar would suffice 'for the present'.

Such views found little support outside the Agricultural Credit Department. Although the Governor had attempted to separate the two issues in the remarks he made to the Standing Advisory Committee in July 1963 and this separation was later to be reinforced at the legislative stage, the shadow of deposit insurance still loomed over these discussions. The consensus of opinion at a meeting to discuss the regulation of cooperative banking held early in September 1963 and attended by the Governor and all three Deputy Governors was that it would be inappropriate and 'discriminatory' to expect the Deposit Insurance Corporation to provide cover to the deposits of cooperative banks 'knowing fully well that the Reserve Bank ... would not have powers for amalgamation or liquidation of a cooperative bank'. If the Bank could not be vested with these powers through a central legislation, the meeting felt, each state would individually have to undertake amendments to the local cooperative act in the manner suggested by the Bank before securing the 'benefit of insurance' for its cooperative banks.

On the basis of these guidelines, the Agricultural Credit Department formulated draft amendments to the Reserve Bank of India Act, the Banking Companies Act, the Deposit Insurance Corporation Act, and the cooperative acts of state governments. These amendments were discussed at another meeting attended by the Governor and the three Deputy Governors a fortnight later. The amendment that expectedly evoked the most discussion at this meeting concerned empowering the Bank to *require the Registrar to supersede* the management of cooperative banks. These powers were handy in dealing with sick cooperative banks. They gave the Registrar, who already had them, a useful means to correct the working of cooperative banks and a practical alternative to dissolving them. Nor was there much dispute within the Bank about the need for similar powers for itself. But as those present at the meeting observed, the Bank did not enjoy analogous powers over joint-stock

banks, and Bhattacharyya and M.V. Rangachari, Deputy Governor, believed the Bank should not order the supersession of managements of cooperative banks except in the event of their deposits being eroded. Therefore, while it would be of positive benefit to cooperative banks if governments ceded this power to the Bank voluntarily, the Governor, in particular, felt it should not be made a precondition for extending deposit insurance to cooperative banks.

The legislative amendments needed to extend the Bank's statutory powers of control and deposit insurance to cooperative banks were discussed at a meeting of the Standing Advisory Committee on 25 October 1963. At the Governor's instance, the Standing Advisory Committee decided to place these proposals before a specially convened conference of representatives of the Government of India and state governments, Registrars of Cooperative Societies, chairmen of state cooperative banks, and members of the Standing Advisory Committee.

This conference took place on 19 November 1963, less than four weeks after the decision to convene it. Addressing the conference, Bhattacharyya spoke about the growing importance of cooperative banks, the impact of their operations on the Bank's monetary and credit policies, and the necessity for regulating their functioning. It would be possible to regulate the working of cooperative banks with little or no damage to the autonomy and integrity of the cooperative movement, he argued, merely by extending to them certain provisions of the Banking Companies Act. Cooperative banks had 'come of age', and deserved to be treated as an integral part of the banking system. Commercial banks had benefited enormously by becoming scheduled and licensed institutions, and the 'time was ripe to remove the differentiation' between them and cooperative banks by granting to the latter the 'appropriate status of scheduled and licensed banks'. Should cooperative banks come under the statutory control of the Reserve Bank, the Governor added, 'it would follow as a natural corollary' that they would also be admitted to the benefits of the Deposit Insurance Corporation. The Governor's remarks were endorsed by V.L. Mehta and D.R. Gadgil both of whom also underlined the expanded responsibility the Bank was now proposing to shoulder, not only in financing cooperative banks but also in assisting their development along sound lines.

Some state governments and state cooperative banks favoured the Governor's proposals, and several others were undecided. On the whole, however, according to the Bank's record of the proceedings, the response of state governments was 'not encouraging'. The conference witnessed intense debate over the virtues of vesting in the Bank powers to liquidate a cooperative bank or supersede its management, with the Madras government, in particular,

marshalling ideological, constitutional, and practical arguments against the idea. Mysore joined Madras in suggesting that regulation by the Bank was too high a price to pay for extending insurance cover to deposits of cooperative banks. Representatives of the Ministry of Cooperation in the Government of India threw their weight behind the Bank's proposals but maintained it should take 'only the minimum powers' needed to develop cooperative banks as sound banking institutions. Speaking in his 'personal capacity', M.R. Bhide, the Ministry's top civil servant who would soon come to the Bank as Deputy Governor, argued that cooperative banks would find themselves unable to mobilize adequate resources to expand their lending activities unless they submitted to the central bank's regulations. Greater control by the Reserve Bank, Bhide also suggested, would enable cooperative banks to resist political pressures.

As Gadgil, Mehta, and Bhide underlined, besides enabling cooperative banks to insure their deposits, the Bank's desire to see a better regulated system of cooperative banking also signalled its willingness to play a bigger role in the development of this sector. Registrars of Cooperative Societies and officials of state governments continued, however, to nurse reservations about the implications for the cooperative movement of giving to a central agency powers of control over cooperative banks, and the manner in which this agency would exercise its new powers. The Bank made strenuous efforts to dispel these reservations, its officials clarifying that the Bank would advise the state government and the Registrar whenever it contemplated taking serious action against a cooperative bank. The Governor too assured the conference that the Bank would entrust its powers to regulate cooperative banks only to the Agricultural Credit Department which was familiar with the working of these institutions and sensitive to their special needs. Besides, the Bank's regulatory standards and practices would be adapted to the distinct motivations and objectives of these institutions, and 'administrative arrangements for statutory control' would be such as to preserve the 'autonomous ... and voluntary character of the cooperative movement'. Finally, the Governor clarified, state governments having 'conscientious objection' to the proposed amendments did not have to carry them out so long as they were prepared to forego the benefit of deposit insurance for their cooperative banks.

Despite the delay in many state governments communicating their final views on the proposals discussed at the November conference, the Bank resolved to press forward with the necessary amendments to the Reserve Bank of India Act, the Banking Companies Act, the Deposit Insurance Corporation Act, and the cooperative acts of the states, and these were discussed within the Bank and with the Government of India during the next few

months. It was originally proposed to bring under the statutory control of the Bank all primary cooperative societies functioning both in the urban and rural areas with owned funds of Rs one lakh or more and which mainly did banking business. However, S.K. Dey, Union Minister for Community Development and Cooperation, saw no reason to include rural credit societies at all in the proposed legislation. There were, he pointed out, only about three hundred large rural credit societies with owned funds in excess of Rs one lakh each and their total deposits, a major part of which was in the form of fixed deposits not withdrawable by cheques, amounted to Rs 2.5 crores. (This represented one per cent of the total deposits of the cooperative banking system of Rs 250 crores.) Following suggestions made by Gadgil and others earlier, the Bank had withdrawn a proposal to bar agricultural credit societies with owned funds of less than Rs 50,000 from undertaking banking business. The Bank also did not consider it feasible, administratively, to cover all non-agricultural credit societies numbering about 13,000. As a sequel to Dey's intervention, therefore, the Bank decided in April 1964 to leave rural credit societies out of the bill altogether unless these institutions chose to style themselves as primary cooperative banks, and to confine its ambit to state and central cooperative banks. The bill also covered a limited category of 'primary' cooperative credit institutions, viz. non-agricultural credit societies with owned funds of Rs one lakh or more, which mainly undertook banking business, and whose bye-laws did not permit the admission of any other cooperative society (except, as the Bank clarified later, subscribing central and state cooperative banks) as a member.

The Ministry for Community Development and Cooperation also opposed the clause authorizing the Bank to issue directives to cooperative banks in the 'public interest', on the ground that these powers were too wide and that only the legislature could define what constituted the 'public interest'. Bhide, who had moved meanwhile to the Bank, told his former colleagues that similar provisions existed in several statutes and that it was not practical to approach the legislature every time the Bank contemplated action against a cooperative bank. However, he assured the Ministry, the Bank would adopt the convention of consulting the Standing Advisory Committee in such matters; nor did it have any objection to the Registrar of Cooperative Societies also instituting proceedings against cooperative banks on his own initiative.

Following these discussions the Bank sent the Government of India a draft amendment bill in May 1964. But with consensus among state governments still proving elusive, the Government of India decided in September to take up the legislation in two stages, deferring for the time being the proposal to

extend deposit insurance to cooperative banks since it involved changes to states' acts, and confining the proposed legislation to extending certain central laws to cooperative banks. Thus in December 1964, the government introduced the Banking Laws (Application to Cooperative Societies) Bill to extend to state cooperative banks, central cooperative banks, and primary cooperative banks, certain provisions of the Reserve Bank of India Act and the Banking Companies Act. Land mortgage banks, all primary agricultural credit societies and non-agricultural credit societies having paid-up capital and reserves of less than Rs one lakh were excluded from its purview, while cooperative banking institutions such as industrial cooperative banks could be covered under it once state governments deemed them to be state or central cooperative banks. Non-agricultural societies not defined as banks under the bill were to give up their banking business before the expiry of a transitional period of one year. The bill required primary credit societies which became primary cooperative banks after its enactment to apply for a licence within three months of becoming a primary bank. Cooperative banks, other than central cooperative banks, could no longer open new branches except with the prior permission of the Reserve Bank. Every cooperative bank, excepting a scheduled state cooperative bank, had to maintain either with itself or with a higher financing agency, a cash reserve of at least 3 per cent of its total demand and time liabilities, and liquid assets, including the minimum cash reserve, of not less than 20 per cent of its total time and demand liabilities. The bill prohibited cooperative banks from combining trading with banking, holding non-banking assets, creating a floating charge on assets, and required them to obtain the Bank's approval for investment in shares of cooperative concerns that were not within their areas of operation.

The bill also provided for amending the Reserve Bank of India Act to enable the Bank to include state cooperative banks in its second schedule. Each scheduled cooperative bank was to maintain with the Bank a minimum average daily balance of 3 per cent of its total demand and time liabilities, as against the requirement of 2.5 per cent of demand and one per cent of time liabilities in the case of banks which were not scheduled but nevertheless took advantage of the Bank's remittance facilities.

This bill was moved in the Lok Sabha on 17 December 1964 and taken up for discussion in February 1965 only to be deferred indefinitely. In the meantime, the board of the All-India State Cooperative Banks' Federation met in Bangalore in February 1965 to discuss the proposed legislation. Representatives of several state cooperative banks expressed their misgivings about a piece of legislation which extended Reserve Bank control over them without offering any tangible benefits such as deposit insurance in return, and



the federation's board unanimously resolved to ask the Government of India to modify the bill to provide insurance to deposits of cooperative banks of states agreeing to amend their cooperative acts suitably. Responding to the memorandum presented to him by the conference's chairman, D.R. Gadgil, Finance Minister T.T. Krishnamachari expressed himself willing to renew in Parliament the government's earlier assurances of its intention to extend deposit insurance to cooperative bank deposits, but maintained that the initiative now lay with state governments who had first to amend their enactments along the lines recommended by the Bank. Cooperators, the Finance Minister told Gadgil, could play an important role in educating state governments about the importance of deposit insurance and in removing their misapprehensions about the proposed amendments.

The draft legislation was also criticized by urban cooperative banks, particularly in Maharashtra, which wanted a better recognition of their place in the cooperative credit structure, concessional finance from the Bank, and the right to open branches within their areas of operation without the Bank's prior approval. The All-India Federation of Industrial Cooperative Banks apprehended, for its part, that the new laws would inhibit the financing of cottage and small industries. The federation also maintained that cooperative banks should not be evaluated on the basis of standards set for commercial banks, and that the Bank should exercise its regulatory powers only in consultation with state governments.

The Banking Laws (Application to Cooperative Societies) Bill finally came up for consideration in the Lok Sabha on 18 August 1965 and, for all the controversies to which it had given rise, was passed the same day. The bill was introduced and passed in the Rajya Sabha on 9 September 1965 and received the President's assent on 25 September. The Act came into force from 1 March 1966 from which date the Banking Companies Act was also rechristened the Banking Regulation Act. The Bank followed the enactment of this legislation with detailed instructions to Registrars of Cooperative Societies about the definition of the terms 'bank', 'banker', and 'banking' under the new Act; and to urge them to ensure that cooperative banks answering to the definition of banks obtained a licence from the Bank, and that those not satisfying that definition gave up banking business within a year of the Act coming into force. The Bank also framed the Banking Regulation (Cooperative Societies) Rules, 1966 and brought them into force from December the same year. Some minor amendments to the Banking Regulation Act and the Reserve Bank of India Act were moved in 1967 and passed in 1968 with the object of easing the hardships experienced by cooperative banks in the transition to statutory control by the Bank.

## REGULATING NON-BANK DEPOSIT INSTITUTIONS

Banks were not the only institutions to accept deposits from the public in India. Several trading and manufacturing companies, notably textile mills in Bombay and Ahmedabad, had long followed the practice of financing a portion of their working and block capital requirements through deposits from the public. According to the findings of the Central Banking Enquiry Committee, public deposits in Bombay, where they financed working capital needs of industrial companies (mainly textile mills), were accepted for durations of six months to a year at interest rates ranging from 4.5 to 6 per cent. In Ahmedabad, in contrast, deposits could be for as long as seven years, and depositors often had a share in the commission of the managing agency. Although initially deposits were held mostly by friends and relatives of the firm's promoters or managing agents, thanks to the higher rates they offered, these companies soon began to attract the interest of the wider public in these areas. The 1950s also witnessed the expansion of the lending and deposit activities of 'hire-purchase finance companies' specializing in making loans to finance the purchase of trucks and motor vehicles. Though precise figures were still lacking, the growth of non-bank deposits during the 1950s was palpable and raised two issues of importance. The first related to protecting the interests of the depositing public which put its money into these companies, while the second concerned the implications for the Bank's credit policies of the existence of a large volume of unregulated deposits outside the banking system. The first consideration preyed on the minds of the Bank and the government during much of the 1950s, and remained the overwhelming one during the rest of our period. The latter consideration, however, began coming to the fore during the 1960s when the Bank acquired powers to regulate the deposit-related activities of non-banking companies.

The problems of depositors of 'concerns other than banks and insurance companies' came to the Bank's attention in January 1953 following a representation by the *Thevidar Parishad* (Depositors' Association) in Poona to the government alleging that a large number of firms which accepted deposits from the public had gone into liquidation or were not in a position to meet or service their deposit liabilities. At the Finance Ministry, D.L. Mazumdar, the Officer on Special Duty, and the Secretary, K.G. Ambegaokar, who examined the representation at the instance of the Finance Minister, C.D. Deshmukh, were both in favour of prohibiting joint-stock companies from accepting deposits from the public

Officials at the Bank felt deposits from the public were not 'desirable' from the point of view of the borrowing firms. With the Industrial Finance

Corporation enlarging its activities, state financial corporations coming into existence, and the growing possibility of floating shares and debentures to meet fixed capital requirements, officials hoped, firms would reduce their recourse to fixed deposits from the public which, according to the Central Banking Enquiry Committee, were often in the nature of 'fair weather friends'. However, before considering any statutory action, the Bank felt, investigations were needed to ascertain whether the failure of companies to repay deposits was widespread or was a feature confined to Maharashtra. Statutory prohibition, the Department of Research and Statistics of the Bank pointed out, would divert the deposits of companies to banks.

It may be observed in this connection that during the years 1947-1952 the total number of banks ... which have failed is 159. We cannot, therefore, say that deposits with banks are much safer than deposits with private companies, especially as we have not heard of defaults on any appreciable scale ... in other parts of India.

Finally, the Bank felt, the explanation to section 5(1)(c) of the Banking Companies Act, which excluded from the definition of banking the acceptance of deposits from the public by a trading or manufacturing company for the purpose of financing its own business would have to be dropped in order to stop the practice, but this had been 'specifically inserted by the legislature' at the time the Act was passed, 'since the practice of financing by means of deposits was very widespread in India' and had apparently not led to any serious abuses.

Following the Bank's suggestion, the Government of India decided to obtain from state governments information available with them about the extent of the deposit liabilities of industrial companies, and of the nature of abuses that had crept into the system. The data received from state governments revealed that while the practice of trading and manufacturing concerns accepting deposits from the public was fairly widespread, 'cases of abuses' were 'very few' and were 'practically confined' to the Poona District of Bombay state. Hence, even in the government's view, there was 'no strong case' to prohibit firms from accepting fixed deposits. As Deshmukh himself remarked in August 1954 in the course of these deliberations, 'a modicum of caution on the one hand and honesty on the other are necessary for business contracts. Where they are lacking no legal safeguards will be of any use'. He however wondered whether it should not be made illegal for companies formed in the future to receive deposits from the public.

The Bank saw little merit in the Finance Minister's suggestion. There were

no good reasons to stop a practice which had spread widely because companies and the depositing public found it convenient for their respective purposes. Besides, as the Department of Banking Development pointed out, while firms were free to float debentures rather than raise deposits, they preferred the latter course to the former because it was a more flexible source of finance. Deposits were, in effect, an 'additional facility' available to firms to gather resources in circumstances when it was not always easy for the private sector to approach the capital market. In fact, as Ram Nath noted, an advantage for a firm of raising funds on deposit was that it left it 'free to mortgage its immovable assets or pledge or hypothecate its movable assets for raising its ... credit requirements'. However, in order to safeguard the interests of depositors, the Bank appears even in 1955 to have been willing to consider preventing companies from accepting deposits in excess of their paid-up capital. Little came of this proposal immediately as the Bank's own study of the published balance sheets for 1957 and 1958 of 1,001 public limited companies (which formed over three-quarters of such companies excluding banks, insurance companies, and other financial institutions) revealed that their total public deposits amounted to Rs 24 crores in 1958 (as against Rs 21 crores in 1957) and accounted for only a little over one per cent of their total liabilities.

After 1960, deposits of non-banking companies began to rise substantially, and according to a Bank estimate, the public deposits of the corporate sector alone amounted to Rs 56 crores by 1962-63. Moreover, it transpired that in wooing depositors aggressively, several joint-stock companies issued advertisements promising high rates of interest but containing little information of value about their financial position or management. The diversion of deposits to the non-banking sector and the proliferation of institutions depending substantially on public deposits but not subject to any kind of financial or monetary discipline also became matters of some concern. Bankers, who feared diversion of their deposits to non-banking companies, pointed out to the Governor at a meeting with him in January 1963, that besides carrying higher rates of interest, deposits of companies were often repayable on demand. They sought suitable action from the Bank in the form of reserve requirements on such deposits.

The initiative to entrust to the Bank powers to regulate the deposit activities of non-banking companies came, in the event, from the government which was engaged in September 1963 in considering measures to adopt stricter control over private sector banks. Although the Company Law Department was considering amending the Companies Act to regulate corporate advertisements soliciting deposits from the public, the Department of Economic

Affairs sought a more comprehensive regulation of such activity through amendment to 'our own laws'. The Bank's draft bill, which was sent to the government in October 1963, proposed adding a new Chapter (IIIB) to the Reserve Bank of India Act dealing with non-banking companies. But the government favoured strengthening the Bank's proposals further, and envisaged among other things, a system of licensing and inspection of financial institutions by the Bank. The final draft bill, framed in consultation with the government, authorized the Bank to regulate the issue of prospectuses soliciting deposits and specify the terms and conditions relating to them. The Bank was not at this stage in favour of licensing financial institutions. It was content, instead, to have powers to call for information about their deposits from all institutions accepting them, and from investment and hire-purchase companies even when these did not accept deposits, and to issue directions to them. Finally, the draft bill also contained provisions enabling the Bank to conduct inspections of all such companies and to impose penalties on institutions that did not comply with its directions.

These amendments were introduced in Parliament as part of the wider Banking Laws (Miscellaneous Provisions) Bill, 1963 in November 1963. When the bill was taken up for discussion the following month, R.R. Morarka moved an amendment seeking to exclude from its purview firms with paid-up capital of less than Rs one lakh. The government accepted the amendment and, as noted above, the bill was passed by the two houses and received the President's assent towards the end of December 1963. From conception to fruition, this section of the bill dealing with the deposits of non-banking companies had taken only about three months.

The first step the Bank took on the basis of this legislation was to collect information on deposits of joint-stock non-banking companies. In May 1964, soon after the bill came into effect, the Bank issued orders requiring companies that were not banking companies, companies involved in hire-purchase business or financing such transactions, and those engaged in lending or investment operations, to furnish information to the Bank on their deposit-related activities. The orders did not apply, however, to government companies, companies limited by guarantees, and non-profit associations registered under the Companies Act. Of the 2,300 companies that submitted returns for the five years ending 31 March 1964, 1,789 companies reported deposits. The total volume of deposits of non-banking companies came to Rs 186 crores. This was considerably larger than earlier estimated and amounted to about 8 per cent of the deposits of scheduled banks. Besides, as the survey revealed, spurred by interest rates that were much higher than those offered by the major scheduled banks, non-banking deposits had grown very rapidly in recent

years, and by some 21 per cent during 1963–64 alone. In contrast, deposits of scheduled banks had grown by about 12 per cent during the year. Firms in Maharashtra were the biggest borrowers in the market for non-banking deposits, followed in that order by those in West Bengal, Madras, Delhi, and Gujarat. About a third of the deposits were accounted for by firms in the cotton textile industry, while trading companies accounted for another 10 per cent.

Most worrying for the Bank, the survey also found that more than half (52 per cent) of the non-banking deposits had no fixed maturity and could be withdrawn on demand or at the end of a specified notice period, while a third were held for one year or less. Hence, as the Bank noted, about 85 per cent of non-banking deposits were of the 'short-term' variety 'which may be considered as directly competitive with the banking system'.

Following these findings, in particular the last, the Bank felt the need to take steps to control the deposits business of non-banking companies, both to 'provide a measure of protection to ... depositors and to facilitate regulation of the credit system....' The initial proposals, made by the Deputy Economic Adviser, K.N.R. Ramanujam, and the Economic Adviser, V.G. Pendharkar, in June 1965, envisaged (a) disallowing demand and notice deposits and term deposits of less than one year, (b) restricting the permissible *public* deposits (i.e. deposits excluding those of managing agents, secretaries and treasurers, and other companies) of a company to a fifth of its owned funds, (c) prohibiting companies which had incurred losses for three successive years from accepting deposits, and (d) prescribing the minimum information that a firm soliciting deposits must furnish to the public. In addition, the Bank intended restricting the total borrowings of hire-purchase companies to a maximum of five times their 'net capital', and stipulating a 'liquidity ratio' of at least 8 per cent of their assets in the form of cash or as balances with banks and at least  $6\frac{2}{3}$  per cent of their assets in the form of aggregate monthly receipts due under hire-purchase contracts.<sup>3</sup> In the course of preliminary discussions within the Bank and with the government, it was also proposed to make it obligatory for all companies accepting deposits to furnish to the Bank their audited balance sheets once a year and their interim accounts every six months, and to reduce the minimum period for which hire-purchase companies could accept deposits from one year to six months.

These regulations did not apply to other financial companies, such as investment companies, *nidhis* (mutual benefit or 'permanent' funds dealing only with their members), and loan companies, since their financial positions

<sup>3</sup>'Net capital' represented the excess of a company's paid-up capital, reserve funds, and balance of profit and loss accounts over its fixed assets, unquoted investments, goodwill, and capitalized expenses.

were, in the Bank's view, 'fairly sound'. While the affairs of chit funds were 'far from satisfactory', the Bank felt it was necessary to study their position more closely over some years to ascertain 'the vulnerable aspects of their working' before considering ways to regulate them.

Ramanujam's proposals ran into trouble at the very outset, both within the Bank and with the government. R.K. Seshadri, who represented the Government of India in these discussions, felt the move to limit deposits of non-banking companies to a fifth of their owned funds would be too harsh in its impact on public companies whose deposit record was generally good. Officials within the Bank considered raising the limit to 30 per cent and later 35 per cent, and making it applicable to all deposits. But the Deputy Governor, B.N. Adarkar, felt the new proposal meant a 'substantial weakening of control over public companies' (for whom the actual overall ratio was 13 per cent) and 'immediate hardship to private companies' (with a ratio of deposits to owned capital of 47 per cent). The modifications, according to Adarkar, also involved

directing our attention from the starting point of attracting deposits to the banking sector to a *new* objective of driving deposits from private to public companies. At a time when companies are unable to expand their equity base, I wonder whether we should not explore the alternative of regulating interest rates as a means of controlling the growth of deposits ... of companies.

Following Adarkar's intervention, the Governor decided in August 1965 that the Bank's directives to non-financial companies should be confined to stipulating the minimum period for which they could accept deposits and the minimum information they should furnish in their advertisements.

Adarkar and Seshadri also objected to the liquidity ratio for hire-purchase companies, in particular to the one stipulating that their monthly receipts should equal at least  $6\frac{2}{3}$  per cent of their outstanding contracts in the previous year. Since this was thought to be too rigid, Pendharkar and Ramanujam revised this ratio downwards to half-yearly receipts of a quarter of outstanding contracts. But even this, Adarkar felt, implied that hire-purchase companies would generally be unable to provide credit for more than twenty-four months. The Bank, he argued, should 'strike a balance between the interests of the companies, the depositors, and the consumers'. Of the three, 'the last category was by far the most numerous':

By prescribing a ceiling of twenty-four months for the average term of a hire-purchase contract ... we may be discouraging sales

*of essential items like trucks or agricultural tractors or other agricultural machinery ... Our objective is to safeguard depositors' interests, and not to limit consumer credit.*

The former, he suggested, could be more simply achieved by making deposit rules more rigid, for example by restoring the minimum period of deposits to one year, than by imposing requirements that affected the *duration of the loan facilities that hire-purchase companies extended to their enterprising borrowers.*

It transpired on closer examination that Adarkar's understanding of the '25 per cent of half-yearly receipts' requirement was based on some *incomplete figures compiled by the Economic Department.* His objections and the Economic Department's efforts to answer them help, nevertheless, to illustrate the various considerations weighing with the Bank when it decided to exercise the powers given to it under the 1963 legislation to regulate the functioning of hire-purchase companies. In the event, the final proposals that emerged from these discussions in November 1965 envisaged a minimum maturity of one year for deposits of *non-financial companies and six months for those of hire-purchase companies.* They also advocated a 'selective approach in the control of non-financial companies' and a 'more detailed' form of control over hire-purchase companies which 'might also include inspection'. Hence it was intended to ask all non-banking companies to provide to the Bank audited balance sheets every year and provide interim half-yearly accounts. They were also to provide information regarding their management and finances *in their advertisements soliciting deposits.* The financial information required to be advertised included profits during the three years preceding the advertisement, dividends declared, paid-up capital, free reserves, deposits, and any other *secured or unsecured loans and advances obtained by the company.* Hire-purchase companies were subject to some additional restrictions. Their maximum borrowing limit (both secured and unsecured) was set at five times the 'net capital'. They were to *maintain as cash, current account balances in scheduled or notified banks, and central, state, and trustee securities, at least 9 per cent of their assets in India.* Hire-purchase companies were also to so order their contracts that their half-yearly receipts were at least a quarter of the value of the contracts outstanding at the end of the previous year.

Although Bhattacharyya wanted the Bank's new regulations on the deposits of non-banking companies to be announced at the same time as the 1965-66 busy season credit policy, formal consensus within the Bank and with the government over their substance proved elusive until the end of 1965. Finally, the Bank's two notifications regulating the deposits of non-banking (*non-financial*) companies and hire-purchase companies, and containing the final



proposals summarized above, were issued early in January 1966. Subsequently, these notifications were amended in minor respects in April 1966, while at the end of June 1966 the Bank issued a modified directive to hire-purchase companies accepting public deposits, asking them to maintain a liquidity ratio of 10 per cent of their outstanding public deposits.

The response of the non-banking companies to the new regulations was relatively muted because they were so long in coming and had been attenuated in various ways to minimize the hardships they might cause. Predictably, however, the Indian Banks' Association welcomed the two notifications. Addressing the association in April 1966, its Chairman, K.M.D. Thackersey, welcomed the measures as a 'good compromise' which allowed banks to compete among themselves for shorter-term deposits, and promoted competition between banks and non-banking firms for the medium- and longer-term savings of the public. 'Regulated competition' of this nature, he suggested, might

enable the Reserve Bank to achieve an orderly pattern and realistic structure of interest rates, under which the spread between short-term, medium-term, and long-term rates of interest [was] satisfactory, nominal rates being allowed for short-term deposits which would remain with the banks and the market rate ... being offered for ... medium and long-term savings.

No reasons were explicitly set forth by the Bank for choosing not to regulate the interest rates offered by non-banking companies. But Thackersey's appraisal of its initiative appears on the whole to have been a realistic one. By allowing non-banking companies to compete directly with banks in the market for longer-term deposits, the Bank might have hoped, incidentally, to help relieve the dampening effects on the mobilization of longer-term savings of interest regulation in the banking sector and of the rising cost of banking intermediation. Against this background, regulating the activities of non-banking companies was vital to stabilizing the market for long-term deposits and reducing the risks on them; and though many officials at the Bank would no doubt have liked to impose other conditions (including a ceiling on deposits individual non-banking companies could accept and restraining loss-making companies from soliciting deposits), the outcome that emerged represented a compromise between the Bank and the government which favoured, at least for the present, relatively light regulations on non-banking deposits.

The directions of January 1966, which among other things required non-banking companies to submit annual audited balance sheets and interim half-yearly accounts to the Bank, led to some expansion of the central bank's

responsibilities. It had now to make arrangements to study the information submitted by non-banking companies, conduct surveys of deposits of these institutions, supervise their functioning and carry out inspections, and review the impact of regulatory measures. Ramanujam, who oversaw non-banking companies on behalf of the Bank in the early years, therefore proposed the creation of a division within the Economic Department to undertake the new responsibilities. But at the instance of the Governor, the Bank decided in January 1966 to establish a full-fledged Department of Non-banking Companies. This department came into existence in March 1966 in Calcutta where office space, which proved to be in short supply elsewhere, was found for it in the new building of the Bank.

A review by the Bank of the working of these regulations in August 1966 led, in the event, to the revival of some of the regulatory proposals that were abandoned two years earlier. The review revealed that company deposits had grown in the meantime to Rs 230 crores. While some of the increase was no doubt accounted for by better reporting, officials at the Bank were concerned that the deposits of non-banking companies continued to grow faster than those of banks. It also became apparent that poorly managed, smaller private companies tended to rely on deposits to a much larger extent than their capital base justified. Some private companies which had accepted deposits from the public were also reported to have failed in the Delhi area.

Ramanujam, who had played a major role in drafting the original proposals in June 1965 which were successively watered down in the following months, argued on the basis of the review that it would not be possible to restrain the growth of non-banking deposits and protect depositors lured by the high rates of interest offered by unsound private companies, unless interest rates were regulated and a ceiling imposed on the volume of deposits a company could accept. Other officials at the Bank felt companies offering up to 12 per cent on deposits mopped up resources that would otherwise have flowed into longer-term savings schemes of banks and the government, while Seshadri, who had meanwhile joined the Bank as an Executive Director, now argued that the unlimited access companies had to public deposits adversely affected monetary and credit management. Generally, the view prevailed that in the absence of restrictions on the deposit rates of the smaller scheduled banks and non-scheduled banks, little could justifiably be done to restrain companies offering high interest rates. A ceiling on the volume of deposits they could accept was felt however to be a more practical proposition, and after reviewing the rising debt-equity ratio of firms in a large number of industries, the Bank favoured limiting the public deposits of a firm to a quarter of its paid-up capital and reserves.

Following these discussions, the Bank framed a new set of directions applicable to all specified financial companies whether or not they accepted deposits, including loan companies, hire-purchase finance companies, housing finance companies, investment companies, *nidhis* and mutual benefit funds, and the non-chit financial businesses of chit funds. A second set of directions framed at the same time applied to non-financial companies collecting public deposits, including those belonging to the government. The two directives provided for controlling the terms and conditions of deposits largely along the lines enunciated earlier, restricted the volume of deposits of companies (excluding those in the housing finance and hire-purchase sectors) to a quarter of their paid-up capital and free reserves, prescribed liquidity requirements for hire-purchase and housing finance companies of 10 per cent of their outstanding deposits, and sought the collection of hire-purchase debts within a reasonable period. All financial companies were also required to supply to the Bank detailed information about their operations, while non-financial companies were to provide information about their deposits and hire-purchase transactions.

Despite receiving no word from the government about these directions which were sent to it in September 1966, the Bank decided to issue them at the end of October 1966 for bringing into force from 1 January the following year. These regulations, particularly that limiting the volume of deposits a company could mobilize, came in for criticism from representatives of trade and industry. They argued that it would starve companies of funds and proposed raising the ceiling to 100 per cent of paid-up capital and free reserves, the latter defined rather more liberally. The Bank's directions allowed two years for over-borrowed companies to reduce their outstanding deposits, and demands were voiced to raise this to five years.

The Bank's directions also stipulated that no interest should be paid on deposits withdrawn prematurely. This rule was made with two objects in view. The first was to prevent companies and depositors from circumventing restrictions on the minimum periods for which non-banking deposits could be accepted. Secondly, non-banking companies (with the exception of hire-purchase companies) not being subject to any liquidity requirements nor being eligible to draw emergency accommodation from the Bank, the restriction was intended to help forestall the eventuality of a run on their deposits. The Bank however retained the power to sanction exceptions to this general rule, as a result of which it was inundated by representations from many non-banking companies seeking permission to repay deposits prematurely with interest. Following these requests, the Bank decided in April 1967 to issue modified orders stipulating that no interest would be payable on deposits

withdrawn before the minimum deposit period (of six months for hire-purchase companies and one year for other companies) had expired, as also the minimum and maximum rates payable on deposits withdrawn prematurely beyond this period.

However, a few weeks later in June 1967, the Deputy Prime Minister and Finance Minister, Morarji Desai, suggested a further relaxation of these terms which he felt were 'onerous and should not be imposed' on non-banking companies. He also sought measures to liberalize the other directives issued in October 1966, and a ceiling on the rate of interest companies could offer on their deposits. In the discussions which followed, the Bank failed to convince the government about the necessity of an interest ceiling on premature withdrawals which was lower even than those applicable to banks, particularly since, unlike in the case of the latter, the interest rates companies could offer on their deposits were completely unregulated. Finally, as its differences with the government were resolved in August 1967, depositors withdrawing their non-banking deposits during the minimum period were allowed the same rate of interest as commercial banks offered for the corresponding period, while deposits withdrawn prematurely after the minimum period had elapsed were to be paid interest at one per cent below the agreed rate for the full term. The Bank stuck to its view that the upper limit on the volume of deposits a company could accept should not be raised. However, it agreed to increase the time companies were allowed to comply with this directive from the prevailing two years to five, provided they were financially sound, maintained a good dividend record, and had adequate unencumbered fixed assets to cover unsecured loans and deposits. The Bank also managed successfully to resist the government's suggestion to regulate interest rates on the deposits of non-banking companies.

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