
Crisis, Consolidation, and Growth, 1951–67

The Banking Companies Act was passed in 1949 towards the end of a decade that witnessed a large number of bank failures in India. No fewer than 365 banks, with aggregate paid-up capital of Rs 68 lakhs, failed during the second world war. The post-war years were also years of severe stress for the Indian banking system as 207 banks went out of existence between 1946 and 1950. Of particular concern, the banks that failed during the later period were generally larger in size than those failing earlier, these 207 banks having an aggregate paid-up capital of Rs 5.33 crores. The year 1948 was the worst year for the relatively larger banks, the paid-up capital of the forty-five institutions which closed down that year, for example, averaging about Rs 4 lakhs each.

Thanks to Partition, the post-war banking crisis was especially severe in West Bengal and Punjab. Two hundred and five of the 634 banks that went out of business during 1940–51 did so after 1947. Of these, no fewer than eighty-three banks, having outside liabilities of Rs 26 crores, were from West Bengal alone. Some of these were listed in the second schedule of the Bank Act at one time or the other and included such well known names as the Nath Bank. But the large majority of the banks failing in this eastern state were little more than loan companies that had over-reached themselves by opening more branches than they could sustain on the strength of their resources and by making large loans against property or inadequate security.

Fewer banks (twenty-four) failed in Punjab during 1947–51. But at Rs 62 crores, the outside liabilities of these institutions were considerably larger. Thirty-two banks from Madras and twelve from Bombay, including the Exchange Bank of India and Africa which faced a run mainly on its foreign branches, may be added to this list, but the total outside liabilities of these institutions were of the order of only about Rs 3 crores.

The pace of bank failures did not immediately abate following the passage of the Banking Companies Act, fifty-three banks downing their shutters in the year in which the legislation was passed, another forty-five the following

year, and a further sixty-two in 1951. A positive feature, one however which *understandably did little to diminish public concern*, was that the banks which ceased to function during 1949–51 were generally smaller than those that failed in the three years immediately preceding this period. Besides, by 1951, the worst had perhaps been overcome, with more than half the banks in existence in 1940 having collapsed by then. Yet at the end of that year, there were still as many as 566 banks in existence in India. Of these, only seventy-six Indian banks qualified for inclusion in the second schedule of the Reserve Bank of India Act. There were, in addition, sixteen foreign banks. Besides not being eligible for inclusion in the second schedule, the majority of the remaining 474 banks were small, unsound, and poorly managed institutions which, even with the greatest goodwill in the world, had little chance of surviving for any length of time as viable, independent banks.

Hence, even though the bank failures of the 1940s might be said to have greatly eased the task of consolidating the banking system and placing its institutions on sound foundations, the latter was still by no means easy of accomplishment. More so as the Bank had little prior experience in the area. The passing of the Banking Companies Act in the midst of a crisis raised public expectations from the legislation and the Bank, particularly in some areas where the state of banking panic bordered on hysteria, but it was largely an untested instrument at the beginning of our period. The Bank, according to the public view, was now sufficiently well armed to prevent commercial banks falling like ninepins as they had done in the 1940s. The most significant new feature of the Banking Companies Act, and the most important instrument potentially of banking consolidation, was the power it gave the Bank to license commercial banks. But as we note below, the Bank could not use this power lightly to put out of business, in one fell swoop as it were, all banks whose affairs were not in order, and the constraints it had to negotiate and the dilemmas it had to resolve gave its licensing policy a somewhat double-edged character. Moreover, until the 1960s, despite affirmations to the contrary, the Bank's powers to effect the consolidation of the weaker elements of the banking system were not commensurate with the challenges it faced in this area. These powers were wanting in two important respects, as the Bank could neither declare a moratorium on a bank nor enforce the compulsory amalgamation of unwilling banks. As later events proved, these powers were a necessary complement to the *Bank's licensing regime, and the pace of banking consolidation picked up considerably in the 1960s after it acquired them in the aftermath of the collapse of the Palai Central Bank.*

For all the diffidence and indecision of the 1950s, therefore, the period covered by this volume saw the Bank achieve major success in weeding out

unsound institutions and giving a semblance of soundness and solidity to the Indian banking system. An unwieldy banking edifice of 566 banks of all descriptions in 1951 had been pared down by 1967 to a more homogeneous and manageable arrangement comprising ninety-one banks, all but twenty of which qualified for inclusion in the second schedule. In illuminating contrast, only ten banks went out of business during the two decades after 1967. Although there were some notable failures during 1951–67 such as those of the Palai Central Bank and the Laxmi Bank, both in 1960, one or two relatively minor banking panics, and some banks had to be placed under moratoria, the consolidation process was accomplished in an atmosphere free from any prolonged and widespread fear of bank failure. Indeed, thanks to the measure of consolidation achieved and the introduction of deposit insurance in 1962, by 1967 the phenomenon of large-scale bank failures and of the public losing the larger part of its deposits was largely relegated to the past.

CONTROVERSIES OVER THE BANKING SITUATION IN WEST BENGAL

Some idea was given above of the extent of the banking crisis in Bengal in the latter half of the 1940s. By the time the curtain rang down on the period covered by the last volume of the Bank's history, the worst of the crisis had clearly passed. There had been some positive developments as well. In December 1950 four banks in Bengal, viz. the Bengal Central Bank, the Comilla Union Bank, the Comilla Banking Corporation, and the Hooghly Bank, faced a run on their deposits in the uncertainty that followed the failure of the Nath Bank. By March 1951 these four banks had been amalgamated with some assistance from the Reserve Bank to form the United Bank of India. This was the first major banking amalgamation to take place after the Banking Companies Act came into force. The United Bank of India quickly earned the confidence of West Bengal's banking public, its deposits and liquid funds rising by a few crores of rupees within the next few months.

But there was still the detritus from the past. In 1951, according to the Bank's rough count, proceedings were under way to liquidate at least fifty banking concerns which went out of business between 1947 and 1950, involving deposits of about Rs 30 crores. Proposals mooted by Bengal politicians and officials to establish a 'reconstruction bank' in the state to take over the business of some of the banks under liquidation or working under schemes of arrangement foundered on the recognition that the financial position of these institutions, which were also characterized by a high proportion of illiquid advances, was 'extremely unsatisfactory'. A 'reconstruction bank',

the Bank informed the government in June 1951 in response to its suggestion, was not a 'feasible' idea in West Bengal.

Liquidation was therefore the only means of salvaging at least some portion of these banks' assets for distribution among their depositors. But since 1948, the feeling had grown in West Bengal that proceedings to liquidate banking companies were extremely elaborate, involved considerable delays, and worked against the interests of their creditors. The state government appointed a committee in March 1949 to devise ways in which to expedite liquidation proceedings in the interests of a bank's creditors. This committee suggested some legislative amendments and executive actions by the High Court and the government. Following this the Banking Companies Act was amended in 1950 to facilitate swifter winding up proceedings by conferring exclusive jurisdiction on High Courts to decide all claims involving banking companies and to try 'in a summary way', offences such as misfeasance or malfeasance committed by directors and officers of banks under liquidation. The new enactment also laid down the procedure for the amalgamation of banks.

In practice, however, the 1950 Act did little to speed up liquidation proceedings or relieve public unease in the state. This for two reasons. More than a year after these provisions came into force, several High Courts, including all importantly that in Calcutta, had failed to frame the rules for the new procedure which, as a result, remained inoperative in most states. The Calcutta High Court was also remiss in other respects, having failed to recommend the appointment of a special liquidator for banking companies in the state, or other staff to assist the special liquidator and supervise the financial management of banks under liquidation.

More importantly, the new legislative provisions related mainly to a summary procedure for suits against banks' borrowers that would help liquidators make recoveries without having to file regular suits. But liquidation proceedings remained vulnerable to many other legal, procedural, and official delays. Writing to P.C. Bhattacharyya, Joint Secretary in the Ministry of Finance, towards the end of August 1951, the Deputy Governor, Ram Nath, identified ten points at which liquidation proceedings tended to be held up. Appointing the liquidator, for instance, could take several months. At the other end of the tunnel, legal provisions inhibited courts from enforcing a liquidator's decision to call up unpaid share capital from contributories, were it to be challenged in court by even one shareholder refusing to admit the liability.

Public anxiety in West Bengal over the delays attending banks' liquidation proceedings was compounded by the failure of liquidators to realize a substantial proportion of the assets of many banks, and the high costs relative

to assets realized, of their legal services and proceedings. According to an official of the Bank well versed in these matters, of the eighty-two banks that suspended payments in Bengal during 1947–50, only thirteen banks working under schemes of arrangement had made ‘small payments’ to their depositors. ‘Nothing whatever’ had been ‘paid by way of dividends’ by any of the other banks, including those under liquidation. The negligible dividends depositors received fuelled public resentment in West Bengal against the prevailing banking and legal systems. As an elderly resident of Sukhchar in the 24-Parganas remarked in a letter she wrote to Jawaharlal Nehru in 1950, middle-class and rural depositors who lost the moneys they put into banks ‘scheduled and affiliated [sic] by the Reserve Bank’ had come to the conclusion that the central bank was ‘only meant for the Big Pandas who ... only know how to squeeze’ the poor and who were ‘sleeping with oil in their noses’. Loss of public faith in the government and its institutions, the letter concluded, would force the people of the region to court their ‘worst fate’ and ‘join ... hands’ with the communists.

The Bank's Role in Liquidation Proceedings

Ineluctably then, the Bank was dragged into the fray. More so, as the view prevailed even among informed officials who might have been expected to know better, that it had somehow a major role to play in speeding up liquidation proceedings, even those who did not lay the blame for their slow progress at the Bank's door insisting that matters would be helped if the latter became the official liquidator of banks in India.

The proposal to make the Bank the official liquidator of banks was of long standing, and at one stage had *Mint Road's* blessings. In 1939, when proposals for a comprehensive banking legislation to protect the interests of depositors were first mooted, the Bank had suggested simplifying liquidation procedures and designating it by statute as the liquidator. This was the Bank's response at the time to the concern voiced even then, over the ‘high cost’ of banks' liquidation proceedings when these were carried out under the ‘ordinary company law’. This suggestion was largely repeated when efforts were next made in 1944 and subsequently to frame banking legislation in India. The clause assigning to the Bank the duties of official liquidator ‘in all proceedings ... for the winding up by the court of a banking company’ was retained in the bill that was moved in the Constituent Assembly in 1948. Soon thereafter, however, brought face to face with the magnitude of the banking liquidation problem and the paucity of trained staff, the Bank began to harbour second thoughts about this provision. The Banking Companies (Control) Ordinance, which was promulgated in September 1948 in the wake of the anticipated

delay in passing the Banking Companies Bill, allowed the Bank considerable latitude in the matter, providing for its appointment as official liquidator only upon the Bank applying to the court for such an appointment.

Feeling it 'impracticable for the Reserve Bank to undertake the liquidation of all banking companies required to be wound up', the select committee on the 1948 bill elected largely to retain the formulation contained in the ordinance. It was also now felt that besides encouraging the public to nurse unrealistic expectations, putting the Bank in charge would actually drive up the cost of liquidations and lower the dividends payable to depositors of small banks. Hence the Bank took the view that it should only take up the liquidation of 'big banks with deposits of Rs 5 crores or over'. The demand to make the Bank the sole official liquidator of banks was also raised during the debate on the bill in the Constituent Assembly. Though an amendment to that effect moved by Naziruddin Ahmed, a member from Bengal, was defeated and clause 38 (as it then was) passed into law unchanged, Finance Minister John Matthai's speech to the Assembly appeared to imply that clause 38 was intended as a transitional arrangement to be superseded 'as soon as possible' once the Bank was in a position to take over as the official liquidator. In the meantime, according to excerpts of the speech the government sent to Mint Road, Matthai offered that the Bank would apply to be appointed as the official liquidator 'not only on its own initiative but also when pressed by the public' or by the government acting on 'public representations'. The Bank, which until the early 1950s was willing to undertake the liquidation of banks holding 'large public funds' did ask to be appointed the liquidator of the Nath Bank. But the latter still owed the Bank Rs 72.5 lakhs lent to it in the form of emergency financial assistance in September 1948, and a petition before the Calcutta High Court drawing attention to the likely conflict of interests between the roles of the Bank as creditor and as liquidator ended the brief experiment and led to the appointment being withdrawn.

There was no such conflict of interest in the case of a majority of the banks under liquidation in West Bengal. 'Public representations' were also not hard to come by in the charged atmosphere prevailing in 1950-51. The tardy progress and the less than satisfactory outcome of liquidation proceedings was raised more than once in Parliament and outside by representatives from West Bengal, in particular by A.C. Guha, MP, who took something of a crusader's interest in the issue. Writing to the Finance Minister, C.D. Deshmukh, in August 1951 some months after the Calcutta National Bank filed for liquidation, Guha accused the Bank of having 'shirked its responsibilities' in earlier bank failures, and hoped the Finance Minister would 'at least this time ... make the Reserve Bank not ... betray the cause of the depositors'. Some

officials in the *Government of India*, including Bhattacharyya and S.K. Sen, Deputy Secretary in the Finance Ministry, complemented Guha's zeal with some of their own, and attempted in their own ways 'to try and give effect' to the purported 'intention of the legislature' to involve the Bank more closely in liquidation proceedings. Dharendra Nath Sen, a member of the Central Board of the Bank, also added his voice to the chorus, pleading with the Bank 'as the custodian of the entire credit structure of the country' not to allow either the 'enormity of the task' or the 'cost involved' to stand in the way of carrying its responsibility for protecting banks' depositors 'to its logical end'. Consequently, the Bank came under intense pressure during these months to act against its better judgement and become the sole official liquidator of banking companies at least in West Bengal.

On the other hand, the very features of prevailing liquidation proceedings others cited to justify the Bank taking them over appeared to the latter to reinforce its case for adopting the contrary course of action. These features derived largely from factors which were outside the powers of the Bank to influence. As Ram Nath informed Bhattacharyya in August 1951 in the course of a detailed, seven-page letter giving 'cogent reasons for not placing this responsibility on the Reserve Bank', regardless of who undertook banking liquidations 'under present conditions', delays in realizing assets and distributing them to creditors were 'unavoidable'. Not only had several High Courts, 'including the Calcutta High Court', failed to frame the rules needed to bring into operation amendments to the Banking Companies Act passed in 1950, a recent study of liquidations under way showed that delays occurred 'at almost all the stages' of the proceedings. Listing ten bottlenecks in the smooth progress of liquidation cases, Ram Nath pointed out that unless 'necessary legislative and procedural changes were devised', the 'Reserve Bank would be just as helpless as any other liquidator'. At the same time, however, it would be exposed to public criticism for faults which lay either in the nature of liquidation proceedings or of the assets the failed banking companies had on their books. 'The longer the liquidation lasts the higher would be the costs and the greater the dissatisfaction of the creditors'. If the Bank undertook the liquidation of all banking companies, 'creditors would expect quick and high dividends'. But they would almost certainly be 'severely disillusioned'; and however undeserved, criticism by 'disgruntled creditors' could not but damage the Bank's prestige.

Rather than react to criticism and adopt ad hoc solutions, the Deputy Governor advised the government to carry out an urgent review of existing legislative provisions dealing with the liquidation of banking companies and of procedures followed by High Courts. The problem of banks going out of

business, he warned, would extend beyond West Bengal 'during the next few years' as several small banks might suspend payment upon finding themselves unable to satisfy some provisions of the Banking Companies Act. The government should therefore set up a committee comprising one or two eminent lawyers, representatives of the government, and an official of the Bank to investigate bank liquidation proceedings and devise reforms which would enable banks to be wound up and their assets realized more speedily. The scope of the committee's investigation, Ram Nath also proposed, should extend beyond legislative changes to include the framing of uniform rules governing liquidation procedures in various High Courts and suggesting an administrative machinery which could work closely with the liquidators.

The government accepted the Bank's suggestion to set up the committee three months later in November 1951. But this did little to ease the pressure on the Bank to play a more active role in liquidating banks in West Bengal. The campaign in the press continued, with one newspaper issued from Calcutta even carrying the gist of the Reserve Bank's communications to the government on the subject. In December 1951 the Bank advised the government to exclude the question of what role it should play in liquidation proceedings from the terms of reference of the inquiry. The proposed committee, Ram Nath told the government, was mainly concerned with matters of a 'technical character' and the issue of which agency, if any, would undertake bank liquidations had little bearing on the 'fundamental problem' of how to make them 'more prompt and less expensive'. The committee, he suggested, might however consider whether some 'statutory relationship' should not be established 'between the Bank and liquidators of banks' to enable it to 'keep in touch with the progress of bank liquidations and tender suitable advice in the interests of the depositors'.

The Bank had hoped the committee proposed by it would complete its work within a few weeks. But for various reasons, the government was unable to constitute the committee until July 1952, when Dharendra Nath Mitra, Legal Adviser to the Finance Ministry, was appointed to head it. R. Mathalone, a lawyer who was also the Court Receiver and Liquidator attached to the Bombay High Court, and R.C. Deb, another lawyer from Calcutta, were its other members; while R.K. Desai, the energetic and knowledgeable Deputy Chief Officer of the Department of Banking Operations in Calcutta with long experience of dealing with bank liquidations in Bengal and the original author of the proposal for the committee, was appointed its Member-Secretary. Not only did the government overrule the Bank and ask the committee to report on the advisability of 'establishing statutory relations' between the Bank and banks in liquidation, its chairman, D.N. Mitra, was himself 'anxious' that the

Reserve Bank should play a more active part in bank liquidation proceedings. As late as November 1952, barely a month before the Mitra Committee submitted its findings, reports that Pakistan's new central bank had set up a separate *Liquidation Section* to undertake the winding up of eight of the ten banks that had filed for liquidation in that country and of the offices of banks that had gone into liquidation in India added to pressure on the Bank to follow suit.

The Dhiren Mitra Committee (which was formally referred to as the Banks' Liquidation Proceedings Committee) submitted its report at the end of December 1952. It contained a scathing indictment of the prevailing state of banking liquidation in India. The committee estimated that as many as 321 banks were under liquidation in various parts of India in 1952. Schemes of arrangement had succeeded at only a few places, notably in Punjab where at least two-thirds of the funds of depositors of the affected banks were said to be safe. Elsewhere, liquidations were the norm. But liquidation proceedings promised little to depositors. Of the seventy-eight banks under liquidation in Calcutta, only one bank had declared a dividend to depositors, and that of a paltry 10 per cent. The cost of management of these banks, excluding legal expenses and liquidator's commission, was also extremely high, accounting in some cases for as much as four-fifths of the recovered assets. The committee also reported that liquidators found it impossible to recover the *benami* assets of officials of the failed bank who had misappropriated its funds.

The committee made a number of recommendations both to deter banks from being mismanaged and to expedite the winding up of failed banks and the recovery of their assets. Suffice it to note here that the committee did not, in the event, recommend entrusting to the Bank the task of undertaking bank liquidations, feeling it was neither 'desirable nor feasible' to do so. Even the more limited idea, of entrusting to the Bank the responsibility for inspecting banking companies which were being liquidated by private liquidators, was watered down at the draft stage as the Bank felt it did not have the resources to inspect the books of the few hundred banks falling in this category. However, the committee was in favour of enabling liquidators to seek advice from the Bank on matters which lay within its competence, and of empowering the Bank to obtain from liquidators any information it required about the affairs of banks under liquidation and about their winding up proceedings. The Bank actively favoured the latter recommendation: neither it nor the government had any means at present of gathering information about banks under liquidation and the absence so far of information about them was proving to be a source of much embarrassment to both. Another major recommendation of the committee directly of concern to the Bank related to the elaboration of

section 45 of the Banking Companies Act dealing with its consent to a scheme of arrangement. The committee was of the view that the Bank's decision on a scheme of arrangement presented to it should turn on whether in its view grounds existed, 'prima facie', for a probe into the conduct of its directors. Opposing the suggestion, the Bank argued that the 'past sins of the persons in charge of the management of ... banks should not be visited upon ... depositors'. The Bank, moreover, could not possibly detect and report all acts of misfeasance by the directors of a bank. Officials at Mint Road also privately alerted the committee to the dangers, which bodies such as the Indian Banks' Association and some members of the Central Board later highlighted, of its recommendation to place the burden of proof on directors and officers of banks charged with malfeasance, fraud, or negligence having the effect of deterring competent persons from entering the banking profession or becoming directors of banks. But the committee persisted with this recommendation in its final report, its chairman arguing that directors of banks in India did not properly understand their responsibilities and that even after the proposed recommendations were adopted, sufficient legal redress remained open to them.

Another issue where the Bank's views differed from those of the committee and the government concerned the recommendation that entries in the books of accounts of a banking company were sufficient as proof of the 'matters therein recorded', i.e. principally of the debts of its borrowers. Initially the Bank saw considerable merit in the suggestion. Subsequently however, it came round to the view that the recommendation, if implemented, 'would place the debtors and other respectable constituents of a bank in a most helpless position'. It was not possible for any borrower to have conclusive proof that he was not liable, or if he was liable, to establish the exact extent of his indebtedness. On the other hand, the recommendation opened the doors to mischief by directors opening fictitious loan accounts in the names of the bank's constituents before filing for liquidation or helping themselves to the bank's resources while debiting them to the loan accounts of its other borrowers. At Dhiren Mitra's instance, the government proposed to confine the evidentiary value of such entries to establishing the indebtedness only of directors of the bank under liquidation and not of its other debtors. But refusing to 'resile from the stand' it had taken in the matter, the Bank informed the government in July 1953 that there was 'no justification' for subjecting even directors of banking companies to these unjust provisions. The Bank's opinion had, however, little influence on the government.

The Bank's views on the committee's recommendations and the legislative measures needed to give effect to them were otherwise largely favourable,

and these were communicated to the government in the summer of 1953. The pressure of parliamentary business however came in the way of passing the necessary amendments to the Banking Companies Act, and at the instance of a member of Parliament who, according to a note by the Private Secretary to the Finance Minister, was 'very much interested in getting the Bank Liquidation Bill passed as early as possible', the government decided, against the Bank's advice, to promulgate an ordinance in October 1953 to realize some of the 'important, non-controversial, and benevolent recommendations' of the committee. This ordinance, which was issued on 24 October 1953, was replaced by a bill less than a month later, when Parliament reconvened. The task of *moving the bill through Parliament* fell fittingly enough on A.C. Guha who had campaigned tirelessly for some of its provisions and who had in the meantime become the Deputy Minister of Finance in the central government. Guha's moment of triumph was not, however, without its ironies. Not only had success eluded his campaign as a backbencher to put the Bank in charge of proceedings to liquidate banking companies, Guha was now in the awkward position of having to explain to his former colleagues the government's reasons for rejecting a demand he had done more than anyone else to promote. The liquidation bill passed the Lok Sabha on 3 December and the Rajya Sabha on 15 December 1953, and received the President's assent two weeks later.

Mystery of the Missing Banks

Even as legislative measures were being contemplated to speed up banks' liquidation proceedings, controversy erupted between the Bank and the government over West Bengal's allegedly 'untraceable banks'. On a visit to Calcutta in June 1953 Guha, who had recently been appointed Deputy Finance Minister, sought and obtained a 'personal note' from R.K. Desai according to which 146 of the 194 non-scheduled banks listed with the Bank at the end of March 1953 were 'defunct or untraceable'. A letter written around the same time by B.C. Roy, the Chief Minister of West Bengal, to Guha suggested that 'in many cases' the Bank advised non-scheduled banks to 'give up banking and go to something else' after suitably altering their memoranda of association. But the change in their declared line of business did nothing to prevent such institutions from 'all the time cheating the depositors'. Soon afterwards on his return to Delhi, Guha remarked that the situation pointed out in Desai's note was 'scandalous'. It was no use 'citing legal and technical difficulties' and this *state of affairs* 'should be stopped at the earliest', he minuted.

The Governor, B. Rama Rau, to whom the government forwarded Guha's remarks, took exception to their tone and substance. The view within the Bank was that Guha's minute, and his approach to the issue raised in it, was

somewhat disingenuous. Although Ram Nath, who directly oversaw banking, was in Calcutta at the same time as Guha and was in fact working in a room adjoining Guha's own, the minister had not thought it fit to meet him. Nor had he sought information officially from the Bank or discussed the issue with its senior executives, but had chosen instead to form his own conclusions on the basis of a 'personal note' solicited from an official of the Bank.

Arguing that it was 'not usual for a responsible member of the government to use in relation to ... the Reserve Bank such expressions as "scandalous" on the basis of an unofficial note given to him', the Governor sent Deshmukh a lengthy, seven-page memorandum dealing with the subject of Guha's minute. The note pointed out that the 'so-called scandal' was not of recent growth but was a legacy of the period before the Banking Companies Act came into force. A majority of West Bengal's banks, Rama Rau informed Deshmukh, were loan companies lending against property—a form of business that well run commercial banks were loath to enter. These banks offered, besides, very high rates of interest to attract deposits, 'spent lavishly on advertisements and opened numerous branches'. They made rapid progress during the war when 'the public had large surplus funds for investment', but failed to use their resources wisely. The few inspections conducted in 1946 of these banks showed that their financial position was 'very unsatisfactory', and little improvement had taken place since.

In the last three years, Rama Rau pointed out to the Finance Minister, the Bank had managed to inspect those of West Bengal's non-scheduled banks which it could trace. Even the Registrar of Joint Stock Companies in the state, whose cooperation the Bank sought, confessed his inability to find all but a few of these banks. 'If the Registrar with the assistance of the administrative machinery of the West Bengal Government cannot trace these banks, the Reserve Bank cannot obviously locate them.' Reacting to Roy's suggestion that the Bank should appoint a special inspector to scrutinize the affairs of the missing banks, the Governor pointed out that while the Bank had an efficient system of inspecting banks, it was not possible to inspect banks which were either 'defunct or untraceable'.

We do not know of any remedy, legal or otherwise, by which we can resurrect for inspection and appropriate treatment a bank which has been dead for some time. Nor is a post-mortem examination possible until the corpse can be found.

As for the apprehension that the conversion of banking companies into non-banking companies was prejudicial to the interests of the depositors of such concerns, the Governor noted that it must be presumed that those who

initiated the Banking Companies Act had satisfied themselves that such would not be the case. It was their 'intention—of which the public no less than the banks must be deemed to have been aware—that some banks will be weeded out'. The advice the Bank tendered to banks seeking to become non-banking companies was not only a continuation of earlier policy, it was 'also implicit in the Act'. The Bank's legal advisers were also of the view that the change in the business of a former banking company would not affect the rights of its depositors, except in one 'minor procedural' respect that the company could no longer honour cheques issued by them. Nor was it practicable, as the internal notings in response to Guha's intervention established, for the Bank to impose restrictions on banks that had become trading concerns. There were, as Ram Nath noted, already two sets of banks under the Banking Companies Act—*licensed and unlicensed*—and once the Bank attempted to 'control banks which have become trading companies', it would 'get drawn into the business of controlling other trading and industrial concerns that accept deposits'.

The Governor's long note caused considerable confusion in the Finance Ministry. The Secretary, K.G. Ambegaokar, who would join the Bank as a Deputy Governor in March 1955, was caught between the loyalty he owed his minister and the strength he recognized in the Bank's view. He thought there was nothing in Guha's note to which Mint Road could take exception since it represented

a statement of fact and did not impute any reflection on the working of the Reserve Bank. It cannot be denied that the actual position is "scandalous" and some remedy has to be found for it.

But he also added that there appeared to be no obvious remedy. Nothing could be done about these companies until they were traced, and the next step therefore was for the West Bengal government to take. Perhaps pulled up by Deshmukh, Guha disclaimed any intention of 'putting the blame on the R[eserve] Bank'. However, he maintained that both the Bank and the Registrar of Joint Stock Companies in West Bengal 'appeared to have been fooled' by 'those people' (meaning presumably the missing banks), while the Chief Minister of West Bengal too could not 'suggest any redress'.

While the mystery of the missing banks was put on the back-burner for want of any obvious means of solving it, the Bank considered whether anything could be done to safeguard the interests of depositors of former banking companies. The problem, as an internal note pointed out, was that a banking company did not need permission under the Banking Companies Act to convert

itself into a non-banking company. On the other hand, there was no advantage to be gained from liquidating these small companies 'since their assets are generally frozen and the liquidation charges may ... be more than the realizable value of [their] assets' Nor was it practical to ask a bank seeking conversion to pay off its depositors in full since this might force its liquidation; whereas as a 'going concern', the company may be able to 'realize most of its assets in due course'. The Bank also felt the position of the depositors of the converted companies would be no different from that of depositors in 'industrial concerns in Maharashtra and elsewhere in the country' The Bank briefly considered adding a new section to the Banking Companies Act to make the conversion of banking companies into non-banking companies conditional on the Reserve Bank certifying that it was not 'detrimental to the interests of the depositors' of the company. But the move was quickly abandoned.

Following this controversy, the Bank ordered an investigation into the position of non-scheduled banks in West Bengal which revealed that of the 165 non-scheduled banks reported to exist in the state at the end of June 1954, the whereabouts of 107 banks were not known. The investigation recommended that all but six of the 165 banks could be refused a banking licence without any noticeable void being created in the availability of banking facilities in the state, and that the Registrar should strike off the names of banks which had become defunct.

LICENSING BANKING COMPANIES IN THE 1950s

Under section 22 of the Banking Companies Act, 1949, every bank was required to hold a licence from the Reserve Bank. This measure was intended to check the mushroom growth of unsound banks of the kind that Bengal and other parts of the country had witnessed during the war, and promote a sound banking system. According to the Act, no new bank could be set up after it came into force, without a licence from the Bank. While this was simple enough, the licensing of existing banks was a slow and laborious process which took the best part of two decades to be completed. Initially, the Bank used licensing as an instrument of banking regulation, hoping to get individual banks to bring a semblance of order to their affairs by dangling before them the carrot of a licence or brandishing the stick of denying them one and putting them out of business. But complemented by other powers the Bank acquired in 1960, licensing became part of the arsenal it deployed more actively during the course of the decade to eliminate weak and unviable banks, and consolidate the banking system through the creation of a relatively small number of sound banks.

Before granting it a licence, the Bank generally sought to satisfy itself, usually through an inspection, that a commercial bank was in a position to pay its depositors in full as and when their claims accrued, and that its affairs were not being conducted in a manner detrimental to their interests. At the beginning of our period, only some banks satisfied both conditions. There were also banks which were intrinsically so unsound—for example the small banks in West Bengal—that the Bank had little doubt about their unsuitability for a licence. But there was little progress towards ‘de-licensing’ in the early years because the Banking Companies Act prohibited the Bank from denying a licence to an existing bank within three years of its coming into force.

The Bank’s main dilemma thereafter arose, however, from the large number of banks which did not belong to either extreme. These were typically institutions whose finances and functioning needed remedying, but the interests of whose depositors were not in any immediate or fundamental jeopardy. As pointed out already, such banks were required merely to apply for a licence within six months of the Act coming into force, and were allowed to carry on business until formally denied one by the Bank. The Bank felt such institutions could not be given a licence yet because the public would justifiably see it as ‘a seal of approval by the Reserve Bank of the soundness of the bank’s financial position and banking methods’. On the other hand, neither could they, in the Bank’s judgement, be formally denied a licence and forced prematurely to close down, since many of these banks were capable, given time and guidance, of qualifying for a licence in the not too distant future. In any case, the Bank felt, denying licences to institutions that were not intrinsically unsound without giving them a chance to rectify their affairs was not in the best interests of their depositors and of the Indian banking system. A precipitate policy of ‘de-licensing’, the Bank apprehended even in 1949, could lead in particular to ‘small traders and interior localities’ being ‘denuded’ of banking facilities.

Since the banking habit is still in an embryonic stage in India and there are not enough banks in relation to the population, we have to try and strengthen those banks which are not beyond salvation. Action under section 35 [i.e. denial of a licence] will, therefore, have to be taken with great circumspection.

Besides, as the Bank noted four years later in the context of the banking situation in West Bengal, ‘any large scale refusal of licences in any particular area would undermine the confidence of the depositing public in banks in that area’. Its role, the Bank moreover felt, ‘should not merely be to discharge “police” functions but to guide banks to ... adopt sound banking practices’.

Consequently, five years after the Banking Companies Act came into force, the Bank had issued licences to thirty-three banks. But only sixteen banks were denied admission to this privilege. In addition, as we noted above, many banking companies converted themselves into non-banking companies in order to avoid attracting the provisions of the Banking Companies Act.¹ The pace of licensing picked up somewhat in the next two years, with the number of licences issued to banks rising to forty-nine at the end of 1956. Seventy-seven banks had been denied licences until then, while a licence granted to a bank in 1950 was revoked in 1956.

The delay in the licensing of banks evoked comments more than once in Parliament and from the government, but the Bank refused to be hurried, arguing that while issuing licences liberally would vitiate the object of developing a sound banking system, refusing them on a large scale would do more harm than good. Thus between 1957 and 1961, only twenty-five more institutions were added to the list of licensed banks, while sixty-two banks were denied banking licences.

Clearly as later events revealed, the Bank's attitude towards awarding banking licences was poised on a knife-edge in the 1950s. The blade, moreover, grew sharper every passing year as many of the banks allowed to flourish without licences increased their deposits on the back of an expanding economy and attractive interest rates. Some of these institutions were also extremely tardy in carrying out the reforms recommended by the Bank, and their affairs showed little improvement over time. Consequently they were no nearer securing a licence in 1959 than they had been at the beginning of the decade. On the other hand, although the Bank was empowered to prohibit a banking company from receiving fresh deposits, it could not use these powers lightly where it still hoped to turn a bank around. It was not unknown for the Bank to ask institutions in the latter category not to open new branches, propose new deposit schemes, or advertise their deposit facilities, but it could do little directly to prevent them from accepting fresh deposits unless it was prepared to see them close down. As can easily be imagined, the growth of these unlicensed banks with each passing year lent greater piquancy to the Bank's task of dealing with them.

The Bank's dilemma, though it is moot whether contemporary officials saw it as such, was particularly acute in the Travancore-Cochin region of Kerala. For reasons that need not detain us here, the economic landscape of Kerala, and in particular its Travancore-Cochin region, was dotted by numerous

¹ Banking was defined in the Banking Companies Act, 1949, as 'accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order, or otherwise'.

small banks. In 1955, there were 163 banks in this region, of which no fewer than 148 were local institutions. Barely a handful of these were scheduled or licensed institutions. According to a survey conducted by the Travancore-Cochin Banking Inquiry Commission in 1956, of the 136 banks that responded to its questionnaire, sixteen had working funds in excess of Rs 40 lakhs, while as many as ninety-five banks had working funds of less than Rs 10 lakhs. Thirty-nine of these banks had paid-up capital and reserves below the minimum applicable to them under section 11 of the Banking Companies Act which was extended to the region from 1 April 1955. Twenty-one of these banks continued to operate on the basis of special individual exemptions from the Reserve Bank. As for the other eighteen, let alone increase their capital and reserves, they had not even made applications to the Bank to be allowed to carry on banking business with their present level of owned resources!

The Travancore-Cochin Banking Inquiry Commission noted that a large number of these 136 banks had been set up in 'mere hamlets'. On the other hand, a majority of them, including more than half the smallest banks, had been in existence for more than a quarter of a century. The 136 reporting banks had 571 offices in 1955, of which more than a third (197) were in centres with populations below 10,000, the corresponding figure in Bombay and Madras being 13 per cent and 18 per cent respectively. It was, in the words of the Travancore-Cochin Banking Inquiry Commission, 'indeed commendable' that the region's villages had witnessed 'wide-scale expansion of banking activity' even before the Rural Banking Enquiry Committee underlined the importance of spreading the banking habit to rural areas.

Commendable as this progress was, it did little to ease the Bank's difficulties. A majority of these banks, big and small, originated in *kuris* or *chit* funds which continued to remain an important part of their business, and followed unsound banking practices. Much of the blame for the latter, according to the Travancore-Cochin Banking Inquiry Commission, could be attributed to bad managerial policies. The Commission also recognized that many of the 136 reporting banks were weak and possibly unviable institutions. Yet while urging the Bank to exercise 'vigilance and be strict whenever the occasion demands', it warned against 'drastic measures' against small banks and 'extreme steps' in the case of the larger banks 'that would lead to their closure'. The Commission even proposed that banks whose paid-up capital and reserves were lower than the minimum applicable to them under section 11 of the Banking Companies Act should be allowed up to the end of March 1960 to make up the deficiency. Following this report and representations from the Travancore-Cochin Bankers' Association that their clients were growing nervous about the prospect of the region's banks being refused

licences, in May 1957 the Bank resolved to 'go slow' with the refusal of licences to Kerala banks and to keep in abeyance the tentative decision it had taken to refuse licences to eighteen banks in the state. The Committee of the Central Board reviewed the Bank's 'go slow' policy in Kerala in February 1960 and decided to persist with it. According to the memorandum submitted to the Committee, of the 108 banks in existence in Kerala at the end of 1959, 103 were non-scheduled and a hundred banks operated without a licence. In the Bank's opinion, eighty-seven of these hundred banks were likely to qualify for a licence within a few years. But the collapse of the Palai Central Bank some months later in August 1960 and the changes in public opinion and banking legislation that followed in its wake led to a period of large-scale amalgamation of banks which reduced the number of banks in the state to less than a tenth of the number that existed before that fateful August day.

Elsewhere in India, the Bank faced fewer problems. In December 1957 it decided to refuse licences to twenty-one non-scheduled banks because they were thought to be beyond repair. Eight scheduled banks and fifty-four non-scheduled banks whose financial position and working were judged to be satisfactory were allowed more time to repair their position, while four scheduled banks with total deposits of nearly Rs 13 crores were advised amalgamation with other banks. The Bank's decision to deny it a licence was challenged in Court by a small family-owned bank which operated out of a suburb of Madras until March 1957, on the ground that section 22 of the Banking Companies Act was unconstitutional and that the Bank had been arbitrary and unreasonable in the exercise of its power under this section. This challenge was unsuccessful. Nevertheless, the frenetic activity of 1957 was followed by two years of relative lull which was relieved only by the Bank's energetic response to the banking crisis of 1960.

THE BANKING CRISIS IN KERALA AND AFTERMATH

The year 1960 was one of great stress for the Indian banking system. At the end of May that year, the Bank filed an application in the Bombay High Court for winding up the Laxmi Bank, Akola, a scheduled bank with deposits of over Rs 3 crores, in the wake of a run on the bank and reports of misappropriation of funds by its top management. Barely ten weeks later on 8 August 1960, even before the waters could fully settle over the Akola bank, the Bank approached a High Court once again, this time in Ernakulam, to wind up another scheduled bank, the Palai Central Bank. While the failure of the Laxmi Bank evoked relatively little comment, the collapse of the Palai Central Bank sparked off controversy, especially in Kerala where it remained

You Said It

By LAXMAN



**I became so nervous reading about
that bank crash that I went and
withdrew my savings from our bank!**

— *Tol.* 20 Aug. 1960

a major political issue for some time. The bank failures also ushered in a brief period of banking uncertainty which coincided with a decline in the volume of bank deposits during 1960.

The Palai Central Bank was the largest bank to fail in independent India and the second major bank to suffer that fate in the Travancore-Cochin region within a quarter of a century.² Its failure brought to an end a decade of

² In 1938, the Travancore National and Quilon Bank (TNQ Bank), which was the largest bank at the time in the area with over 75 offices and deposits of more than Rs 3.5 crores, was forced to close down. For details, see pp. 183–90 of the earlier volume of the Bank's *History*.

relatively trouble-free growth of the Indian banking system beginning with the easing of the banking crisis in West Bengal after 1950. Virtually coinciding with the first decade of the Banking Companies Act, these years saw the Bank nurse a number of weak banks to health and to licensed status. But the Palai Central Bank, which came up and flourished when there was little or no regulation over the functioning of banks and followed banking methods that were, to say the least, unorthodox, was in many respects untypical of the institutions which proved amenable to the Bank's efforts to rehabilitate them. For one, though badly managed, it was Kerala's largest bank and among the country's twenty-five largest, with deposits of over Rs 9 crores and a network of twenty-five offices including several outside the state at the time of its collapse. Not only had it withstood the depression, the banking crisis of 1938 when the much larger TNQ Bank went under, and the post-war banking crisis, its deposits continued to grow during these years and after. By the 1950s, the Palai bank had become a considerable presence in the Travancore-Cochin region where, as already noted, the majority of the over 150 banks dotting the landscape were minuscule institutions. Reform was not easy as the bank's size and presence emboldened its management to resist the Bank's efforts in that direction. Until the moment it became inevitable, on the other hand, winding up appeared to be the counsel of despair, particularly from the point of view of the depositors of the troubled institution. The Palai Central

Too Late



—Shankar's Weekly, 28 Aug. 1960

Bank thus presented the most serious challenge and dilemmas to the Bank's regulatory authorities.

The Bank's handling of the Palai Central Bank right from the time the institution first came to its notice in 1948, to its final days as a functioning entity in July–August 1960, is discussed in some detail in appendix C. The remainder of this section deals with the fallout of the collapse of the Kerala bank, the Bank's efforts to contain it, and the legislative and other measures adopted to ensure that Palai became the last of the major bank failures in India.

The failure of the Palai Central Bank inaugurated a period marked by a number of minor banking panics in several parts of the country. Far away in Delhi, five banks (the Punjab National Bank, the Oriental Bank of Commerce, the New Bank of India, the Lakshmi Commercial Bank, and the National Bank of Lahore) experienced unusually heavy withdrawals of their deposits at various times during the remainder of the year. The Madras-based Indian Bank too, was caught up in the panic. Though symptomatic of the nervousness that prevailed among depositors after the collapse of the Palai bank, none of these scares was directly connected with the events in Kerala. Nor, once they broke out, did they take long to subside. In contrast, the incidents of 8–9 August 1960 led to a prolonged banking crisis in Kerala, particularly in the Travancore region, which culminated in moratoria being imposed on several small banks in the state and eventually in the amalgamation and consolidation of its numerous banking institutions.

There were 103 functioning Kerala banks (i.e. banks incorporated in the state) at the time the Palai Central Bank downed its shutters. These had between them 476 offices. Only five of the 103 banks (which accounted between them for 128 offices) were scheduled and eight banks (with sixty-two offices) were licensed. But ninety-two banks were neither scheduled nor licensed. The total deposits of these 103 banks in July 1960 amounted to about Rs 50 crores. This figure fell by about Rs 6.68 crores between the end of July 1960 and the end of November that year. The bulk of the fall (to the extent of about Rs 4.25 crores) took place in August and September. Five banks in the Travancore region, viz. the Travancore Forward Bank, the Kottayam Orient Bank (which were both scheduled banks), the Bank of New India, the Trivandrum Permanent Bank, and the Seasia Midland Bank, felt the brunt of the losses, their deposits alone going down by nearly Rs 4.8 crores between July and November. The other banks hit badly by the panic also belonged mainly to the 'central Travancore' area, and were based in Kottayam where the Palai Central Bank had many branches. It was reported that while a large part of the funds withdrawn from these banks was 'hoarded', the State

Bank of Travancore, the State Bank of India, and twenty-two other banks experienced a growth in their deposits during these months. However, if the experience of the State Bank of Travancore which saw an absolute decline in time deposits and a rise in demand deposits is anything to go by, the maturity structure of the deposits of even these banks may have grown shorter during these months.

The Kerala banking crisis was not entirely unanticipated. The run on Palai began late in June, and the Bank had been alert to the likelihood of its spreading to other 'Kerala Banks'. It devoted close attention to the possible effects on them of any steps to wind up the troubled institution. A note by the Department of Banking Operations of 5 August pointed out that time deposits represented 'a major portion' of the deposits of Kerala banks. The only exception to this was the Palai Central Bank itself, less than half of whose deposits were in that form. Besides, their 'unencumbered liquid assets ... generally cover[ed] a major portion, if not the bulk of their demand deposits'. This note, which was seen the same day by C.S. Divekar, the Executive Director dealing directly with the emerging crisis in Kerala, and the Governor, H.V.R. Iengar, appears to have reassured them that while the Bank might have to step in to invoke section 18 of the Reserve Bank of India Act to extend emergency assistance to banks in Kerala, 'in theory at least', the banks were 'in a position to absorb the shock'. Nevertheless, the Bank issued a press statement on 9 August reassuring the public that despite Palai, there was no occasion for a banking scare in the state, and that it stood by to grant assistance 'with utmost expedition' to any bank whose affairs were 'satisfactory'. The procedure for granting emergency advances as laid down in 1947 was somewhat elaborate, and contemplated among other things, an inspection of the applicant bank. This requirement, a carry-over from its early days, had considerably delayed the Bank's ability to help the TNQ Bank in 1938 and occasioned much comment at the time. Officials now proposed that in the event of the Governor certifying that a banking emergency had arisen in Kerala necessitating emergency advances from the Reserve Bank, they could dispense with inspections and instead undertake a 'rapid examination' of the books of accounts of banks applying for assistance. It was proposed, besides, that the Bank should not insist on applicant banks complying strictly with certain provisions of the Banking Companies Act if they could satisfactorily explain their violations and were able to offer an 'adequate quantum of eligible assets'.

Although the Governor was willing to invoke section 18 of the Bank Act even on 9 August 1960, the anticipated banking emergency did not arise until eight days later. In the meantime, the Bank despatched M.V. Rangachari,

Deputy Governor, to Trivandrum to take stock of the situation. On 13 August 1960, two scheduled Kerala banks (the Travancore Forward Bank and the Kottayam Orient Bank) and two non-scheduled banks (the Bank of New India and the Seasia Midland Bank) applied to the Trivandrum office of the Reserve Bank for emergency assistance. According to officials of the Kottayam Orient Bank, it had lost deposits of about Rs 40 lakhs since the fall of the Palai Central Bank. They feared the outbreak of a 'general crisis' within a few days and for their ability to weather it despite being in possession of substantial liquid resources. The Bank, for its part, felt that there was nothing yet in the nature of a run on any bank in Kerala, but that the press and the politicians in the state were working up an atmosphere of crisis which might precipitate a flight of bank deposits. Five days after the two banks made their applications, on 18 August, M.L. Gogtay, the Deputy Chief Officer of the Bank in Trivandrum, urged the Bank that the time had come to invoke section 18 of the Bank Act, and the Governor accordingly passed orders the same day, in words which were cleared earlier with the Bank's legal advisers, that a 'special occasion' had arisen which made it

necessary and expedient for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture, that action should be taken under section 18 of the Reserve Bank of India Act, 1934.

Following this, the Trivandrum office of the Bank was asked, in the first instance, to grant accommodation 'against the applicant bank's advances secured by the pledge of government and other trustee securities, quoted shares and debentures and gold ornaments including bullion'. Requests for accommodation in respect of advances secured on pledge of merchandise were to be entertained only in special cases, with Bombay's prior approval. Banks were to be lent up to 70 per cent of borrowers' outstanding balances against these securities. Earlier, the Bank had appeared willing to consider granting advances against the pledge of 'immovable property mortgaged to ... banks or owned by them', but the instructions to Trivandrum remained silent on this aspect. The Deputy Chief Officer of the Bank in Trivandrum was authorized to sanction advances up to Rs 5 lakhs in anticipation of approval from Bombay, while advances for larger amounts required prior approval by the central office. The first advances under section 18 were made on 29 August 1960, and the final advances two months later. In all five banks took emergency loans from the Reserve Bank aggregating Rs 1.03 crores during these weeks. Of these five banks, the two scheduled banks accounted for over three-quarters of the advances, the Travancore Forward Bank alone accounting

for over half. The Bank of New India borrowed Rs 22 lakhs by way of emergency advances, the Seasia Midland Bank, Rs 3 lakhs, and the Venadu Bank, Rs one lakh. These advances were repaid by December 1960.

Legislative Enactments, September 1960

In the public and parliamentary outcry that followed the collapse of the Palai Central Bank, the issue of speeding up the liquidation of banks once again came into focus. Initially it was suggested both in Parliament and in the press, and also by a number of Kerala ministers, that it would be simplest for the State Bank of India to take over the assets and liabilities of the failed bank. The Advocate-General of Kerala too, suggested that the State Bank should take over the 'good and readily realizable assets' of the bank at a valuation which provided for immediate payment, and the other assets at some reduced value to be paid as and when they were realized. The Bank, as Iengar informed the Central Board at its meeting on 17 August, was not averse to the idea. But the State Bank of India refused to entertain it since, according to its Chairman, P.C. Bhattacharyya, the bank's founding Act allowed it to take over only the business of 'surplus banks', i.e. banks whose assets exceeded their liabilities. Bhattacharyya also insisted that 'under no circumstances' would the State Bank of India or the State Bank of Travancore take over assets which were not good or easily recoverable. Nor did an unorthodox proposal by the Canara Bank—involving no 'scheme of arrangement' much less one to reconstruct or amalgamate the Palai bank—to advance 25 paise in the rupee to the latter's depositors on behalf of its liquidator against proceeds from the sale of the bank's assets, get off the ground.

Thoughts then turned towards other ways of providing early and suitable relief to depositors of the closed bank. There was broad consensus among officials of the Bank, the Government of India, and the State Bank that 'immediate and suitable legislation' was required to cut out of liquidation proceedings steps which were 'purely formal and time-consuming', and promote swifter realization and distribution by the liquidator of the bank's assets. One such step related to priority creditors, for example holders of trust accounts, who were entitled to preferential treatment. Kerala's Advocate-General proposed granting such claimants a fixed time limit within which to lodge their claims, and the Bank and the government accepted this suggestion. It was also proposed that once preferential payments or adequate provisions for the purpose were made, depositors with savings accounts should be paid the balance to their credit up to a maximum of Rs 250. (The prevailing limit was Rs 100.) Besides, under the existing law, other depositors were not entitled to preferential payments. This was now proposed to be changed to

enable them to receive up to Rs 250 after the preferential claims of holders of savings accounts were met or provided for, and in priority to all other debts.

Liquidation procedures, the role of the State Bank in them, and ways to protect the small depositor were the major talking points at these discussions. But they also paved the way for legislation on other issues of importance including some which had eluded agreement earlier. As banking law and practice had evolved up to that point, the Bank might respond to a severe run on a banking institution by making emergency advances to it or by applying to the High Court to take it under liquidation. The former could be extended only up to a point, or sometimes as in the case of the Palai bank, not at all, the decision whether to make emergency advances and in what quantity turning on the Bank's judgement of the quality of the assets of the banking institution needing them and of its ability to pay off depositors in full. On the other hand the alternative, of applying for liquidation, not only tended to be harsh on depositors, it might also be unnecessary in circumstances where only the difficulty of realizing its assets immediately prevented a bank from meeting a panic withdrawal of deposits. An intermediate measure, such as a moratorium intended to stop the run whilst allowing the bank facing it to make certain preferential payments to depositors according to the law, conserve its assets in their interest, and seek assimilation within a larger institution, it was felt, would better enable small banks to withstand panic and realize their assets.

Moratoria were possible before 1960, but only at the instance of a bank which felt unable to meet its obligations temporarily. The Bank itself could not impose or apply for one, and giving it the power to do so might obviate liquidation and reduce or prevent depositors' losses in many cases; more so if it could be combined with that to ensure compulsory amalgamation of banking institutions judged by the Bank to be unviable and which failed to enter into voluntary merger arrangements. The moratorium proposal was first made by Dhiren Mitra at the meeting of the Central Board on 17 August 1960, and the Bank lost no time in pursuing it with the government. In contrast, proposals to give the Bank or the central government the power to enforce compulsory mergers of banks were urged at various times during the 1950s and as recently as 1959. The Bank even more than the government was cold to the idea on these occasions, but their resistance did not survive the shock-waves emanating from Kerala in 1960.

Initiated in the third week of August, i.e. within a few days of the crash of the Palai Bank, these proposals made it to law in the span of about one month as the Banking Companies (Second Amendment) Act which came into force on 19 September 1960. At first blush it seemed the new provisions might save

the Palai bank from liquidation. A plan was put forward to amalgamate it with the Punjab National Bank, while the Palai bank and some of its creditors too, applied to the High Court separately to be allowed to reconstruct the failed bank. But these hopes died a quick death after the Bank, which examined these schemes at the High Court's instance, certified that they were neither feasible nor in the interests of the Palai bank's depositors. Although of little immediate assistance to the unfortunate creditors of the Palai Central Bank, final payments to whom were settled in December 1987 at 67.75 paise per rupee of their 1960 deposits, these legislative enactments helped the Bank check the banking panic in Kerala and reorganize its smaller banks and others elsewhere in the country.

Reorganizing Kerala's Banks

Thanks to its recent banking history and its numerous small and unviable banks, Kerala was on everyone's mind when the amending legislation of September 1960 was passed, and it was to Kerala that the Bank first turned after arming itself with new powers. Ten days after the amendments came into force, Divekar arrived in Trivandrum to examine the possibility of banks in the state entering into voluntary mergers and amalgamation. He was prepared for a cold, 'even hostile' reception. Rumours were afoot that the Bank was determined to use its new powers to enforce compulsory amalgamation of smaller banks in the state. These were as grist to the mill for the region's bankers who, apart from being 'strongly individualistic', were 'well entrenched in their present positions and in the political life of the State' and had a 'vocal press at their command'. But to his surprise, Divekar found a 'majority of the bankers' in a 'pensive mood'. Though some banks insisted 'even now' on maintaining their separate identity, in general the 'amalgamation idea' had 'been favourably received' in the state, and the state government too was willing to give it 'a good measure of support'. Being himself a strong advocate of an early consolidation of Kerala's banks, Divekar urged immediate action. However 'formidable' the difficulties, he warned Iengar, the Bank should be prepared to take steps to protect the interests of depositors in the state, 'even if in the process we are subjected to all sorts of calumny'. Urgent action was needed, Divekar felt, because Kerala's banking crisis threatened to spread, with the Kottayam Orient Bank likely to find itself unable to stand the strain of withdrawals 'beyond another six weeks or so'.

When Divekar returned to Kerala in the middle of October 1960, 'propaganda against amalgamation' resumed, with 'politically powerful ... interested parties ... apprehensive of losing their hold on [the] power and patronage' control over banks gave them, stoking fears that the Bank intended

to amalgamate Kerala's over one hundred banks into six big units. Such rumours fed public apprehension that credit facilities would be curtailed in Kerala's rural areas. Nevertheless, *public opinion in the state had grown 'critical of bank managements and appreciative of the Reserve Bank's action'* in closing down the Palai Central Bank. Many of the other banks, Divekar also reported, were in a 'bad way', and their managements in a 'less recalcitrant mood'. The Chief Minister and the Deputy Chief Minister of the state too, were of the view that the Bank should not 'hesitate to proceed with schemes of amalgamation'. 'We should take immediate advantage of the situation', Divekar proposed, 'and merge or reconstruct' the weaker banks. The Bank, he also felt, had done enough by way of 'preliminaries'. The 'time ... for action' had come, Divekar exhorted, and there was no longer any need to hold further discussions with the state's bankers.

There were, besides the Kottayam Orient Bank, six other banks (the Bank of New India, the Seasia Midland Bank, the Martandam Commercial Bank, the Trivandrum Permanent Bank, the Venadu Bank, and the Travancore Forward Bank) which officials felt were in deep crisis and in need of urgent action by the Bank. Some of these banks, as Iengar informed Finance Minister Morarji Desai in October 1960, were 'afraid to publish the latest statements' of their position since they would 'show a heavy fall in deposits' and were urging the Bank to take action before the end of the year when their annual statements would have to be finalized.

By December 1960 the mood in Kerala had undergone another shift. The immediate reason for this appears to have been a rumour, which once again had little foundation, that the Bank proposed to declare a widespread moratorium on banks to expedite their amalgamation. These rumours, *in turn, fuelled something of a banking panic* in the state. At the same time, as Rangachari found when he visited the state on 5 December 1960, some banks which had earlier been receptive to proposals for their merger had begun to have second thoughts. In particular, the Travancore Forward Bank believed it 'had turned the corner' and 'should be left alone', and this view was backed by some senior officials of the State Bank of India and the State Bank of Travancore. The Chief Minister of the state, P. Thanu Pillai, and the Finance Minister too, impressed on the Deputy Governor the depth of feeling *within the state against merging* some of its banks with the State Bank of India, and the uneasiness that prevailed generally about the likely consequences for the state's economy of the disappearance of its smaller banks. The moratorium which would

precede banking amalgamation, they also appeared to feel, would further upset the economy of the state, shake wider public confidence in its banks, and lead to a run on sound banks as well. The Deputy Governor, who was accompanied to the meeting by Bhattacharyya, assured Pillai that the Bank did not propose to impose a general moratorium and that voluntary mergers of banks whose deposits were intact could be put through without one. Moratoria, he stressed, would be necessary only where banks' deposits had been eroded and it had become necessary to write off a portion of their deposit liabilities before amalgamation. Notwithstanding these assurances,

the Ministers ... again and again came back to the point that it may be best in all the circumstances to leave the situation as it is with the vigilance of the Reserve Bank securing that things do not go wrong any further.

'This attitude', the Deputy Governor remarked, created a 'somewhat difficult situation' that required 'careful handling'. Following consultations between Iengar and Rangachari, the Bank decided on 10 December to leave the Travancore Forward Bank to its own devices 'for the time being' and proceed with efforts to amalgamate the Kottayam Orient Bank and the other three banks.

But rumours of a moratorium refused to go away. Indeed, they had become self-fulfilling by 8 December when a run began on some banks in the state. This run soon 'assumed the proportions of a panic', with the Travancore Forward Bank, the Kottayam Orient Bank, the Bank of New India, and the Seasia Midland Bank losing additional deposits of nearly Rs one crore during the course of the following week. On 15 December, Gogtay wrote to Bombay warning of the rumours and to advise against the imposition of a moratorium unless one became absolutely unavoidable, since otherwise the Bank's action would only confirm public suspicions and trigger fresh panic. But the same day, the Governor received a telephone call from the Chief Minister of Kerala that he had been informed by his 'banker friends' that 'a serious crisis' had developed in the affairs of the Travancore Forward Bank and the other three banks. This, according to the Chief Minister, called for an 'immediate moratorium' and a scheme of amalgamation which the Reserve Bank should undertake and complete 'in 4 or 5 days'. The Governor felt the Bank had been placed in an 'impossible position' by the Travancore Forward Bank which made 'extravagant' claims about its soundness and profitability one day and declared itself facing a crisis the next. While there was no dearth of 'panicky messages', the facts were still cloudy. The Chief Minister was

not fully aware of either the legal position or even of the actual facts of the situation in Kerala. The Ministers themselves have been subject to as many swings of opinion as the banking community in Kerala. However, while this merely adds to our difficulty, it is clear that we have to take a decision on the best judgement that we ourselves make.

But the Bank's decision was made for it by the four Kerala banks who, unable to withstand the run on their deposits, themselves applied for a moratorium which was then imposed on 18 December 1960. The Venadu Bank also came under moratorium the same day.

Contrary to the 'expectations of some Jeremiahs', the moratorium did not lead immediately to a run on the other banks in Kerala. Although initially, the 'unnatural calm' which settled after the moratorium was feared to portend deeper turmoil in the future, and rumours abounded over the next fortnight about runs on banks in various parts of the state and of more banks, including some from outside the state, being placed under moratoria, the scale of panicky withdrawals that followed was controlled with relative ease. The runs which did arise were relatively minor and confined to four or five banks. While some of the affected banks hinted at the possibility of drawing emergency assistance from the Bank, none, in the event, proved necessary. Subsequently, two other small non-scheduled banks in the Travancore area, the Catholic Bank of India and the Anthraper Bank, faced a run and asked for a moratorium which was granted from 7 January and 19 February 1961 respectively. According to Gogtay, the effect of the moratorium of 18 December on public confidence was not more severe or widespread because it 'did not come as a surprise'. These banks had lost deposits soon after the crash of the Palai bank and again in December, and their 'vulnerability ... had ... become more or less known to the public'. Nevertheless, he advised, the Bank should strive to avoid giving the impression that 'more and more banks are going to be placed under moratorium', by not resorting to compulsory amalgamation unless they became 'inevitable'.

The moratorium was not, however, without controversy. There were many complaints that it affected the availability of bank credit to plantations, especially to growers of rubber, pepper, tea, and cardamom. An inquiry carried out by an official of the Bank at the end of January 1961 confirmed that the moratorium had led to a 'temporary cessation of banking facilities' to plantations, since there was no other bank in many of these areas 'to fill ... the void' created by the closure of the Travancore Forward Bank and the Kottayam Orient Bank, and the 'one or two local banks still functioning in a few places'

were 'cautious not to increase [their] advances portfolio on account of the uncertain conditions'. Allegations abounded, including one from a member of the state's Legislative Assembly belonging to the Congress Party, that Kerala's banks 'which were managed efficiently' had been 'deliberately ruined' by their managements and by 'the authorities of the Reserve Bank' who had little 'goodwill' for these institutions, and that the moratorium was an 'act of revenge' on the people of Kerala. Bankers and others in Kerala also raised the spectre of the state's banks, which were described as the 'key to our granary', being taken over and run by outsiders.

It was fairly clear to the Bank and to everyone else who took an interest in Kerala's banking affairs that the moratorium could not be lifted without the affected banks being strengthened through mergers and amalgamations. But the managements of these banks appear to have taken advantage of the breathing space yielded by the moratorium to indulge in fresh bickering about their relative positions in the new bank that was expected to be formed by merging them. Some newspapers in the state also made out that the banks under moratoria were 'financially ... sound' institutions and that amalgamations were 'intended only to reconstruct them'. This increased the likelihood that 'the blame for scaling down' the deposits of these institutions would be 'laid at the doors of the Reserve Bank', more so as the state's bankers sported 'an air of injured innocence'.

Despite the controversy it evoked, the December moratorium gave a fillip to plans to amalgamate Kerala's banks. The Bank's original proposals involved merging the five banks granted moratoria in December 1960 into one unit, but these foundered on opposition from the constituent banks, in particular the Travancore Forward Bank. It was then proposed to reconstruct the other four banks and merge them to form one unit through a scheme involving writing down the deposits of three of these four banks and compulsorily converting deposits to the tune of over Rs 17 lakhs into share capital. But these two features of the scheme did not find favour with the state government which expressed itself willing to contribute the additions necessary to the share capital of the new bank and to place a substantial long-term deposit with it. This proposal evoked opposition even within Kerala, with some opposition parties charging the state government with attempting to rescue the bank's incompetent management at the cost of public funds. The Bank's Local Board in Madras and the Committee of the Central Board also had little hesitation in turning down the state government's suggestions which, by implying that amalgamations should not involve scaling down of deposits, would make them 'virtually impossible in many cases'. On the other hand, allowing the state government to invest in the share capital of the new bank

too involved reversing past policy which had resulted in the conversion of former state-associated banks into subsidiaries of the State Bank of India. Nevertheless, the Bank decided to explore the possibility of amalgamating these four banks with 'another (large) bank without any scaling down of deposits', and to take a 'firm stand' if the Kerala government 'objected subsequently to a particular bank selected for the purpose'.

In the event, the Travancore Forward Bank, the Kottayam Orient Bank, and the Bank of New India were merged with the State Bank of Travancore in June 1961. In order to enable this merger, the Banking Companies Act was amended, first through an ordinance promulgated in February 1961 and then by an Act of Parliament passed the following month, to empower the Bank to prepare schemes for amalgamation involving the State Bank of India or its subsidiaries as the 'transferee bank'. The Bank of Kerala and the Seasia Midland Bank were merged with the Canara Bank, which used the opportunity presented by the banking crisis in Kerala to pursue an 'aggressive' takeover policy, in May and June 1961 respectively. The Venadu Bank was taken over by the South Indian Bank in June 1961.

BANKING CONSOLIDATION IN THE 1960s

The moratorium and consequent amalgamation of these Kerala banks inaugurated a period of rapid consolidation of the Indian banking system. Between 1960 and the end of the period covered by this volume, as many as 204 banks were either merged or their assets and liabilities transferred to other banks. Fifty-seven banks were also placed under moratorium during these years. Of the 204 banks, twenty banks preferred voluntary amalgamation to the stigma of a moratorium and compulsory merger. The Bank encouraged voluntary amalgamation, making available to banks a detailed note on the procedure involved, keeping itself regularly informed of their progress in this regard, and persuading them to speed up the process wherever possible.

Forty-five of the 204 banks were compulsorily amalgamated under the new powers granted to the Bank. Thirty of these compulsory mergers took place in 1961 alone, and by the middle of that year misgivings were voiced in some quarters about the effect on the banking structure of compulsory amalgamation. The Bank was sensitive to these apprehensions, and as the Governor informed L.K. Jha in July 1961, the 1960 amendments to the Banking Companies Act were not intended to do away with 'small banks, as such' and encourage 'only big institutions'. The Bank and the government were, however, out of step with each other, and Morarji Desai and Iengar met in July 1961 to discuss the issue. It was suggested to the Bank at this meeting that it should

'go slow' with the amalgamation of banks whose positions had not worsened in recent years and give them a chance to improve themselves. Though it continued to disagree with the government, the Bank volunteered to undertake a thorough study of the position of small banks based on recent inspections, as a prelude to reviewing its policy on banking consolidation.

Following the study, the Governor proposed to the government that compulsory amalgamation should be confined only to banks which were 'grossly mismanaged', had failed to carry out the Bank's directions, or had lost (or were about to lose) a part of their deposits. The Bank, as Iengar informed the government, would also 'hold its hand' unless banks themselves approached it for a moratorium as they had done in Kerala, or a run on a bank made one 'inescapable'. Nor would it frame new proposals for amalgamation until the government had taken a policy decision in regard to the circumstances in which they could be resorted to.

On the whole, big, if ever it was, had ceased to be beautiful, and the pace of compulsory amalgamation now slowed to a crawl.³ Only one bank was amalgamated compulsorily in 1962 and 1963, nine in 1964, and four in 1965. No banks were compulsorily amalgamated in the two remaining years covered by this volume. Interestingly, depositors of thirty-one of the forty-five banks which were compulsorily amalgamated received full credit for their deposits. However, the significance of the new section 45 of the Banking Companies Act empowering the Bank to enforce mergers extended beyond the number of institutions directly attracting its provisions. As the Bank and the government recognized at the time and as hinted at above, the threat of compulsory amalgamation spurred banks to enter into other arrangements such as voluntary amalgamation and transferring their assets and liabilities to other banks under section 293(1)(a) of the Companies Act, 1956.

The latter was, in fact, the most popular route for banks going out of business, no fewer than 122 banks taking it during 1960-67. More than half of these (62 to be exact) went out of existence in 1964 alone. Forty-five of these sixty-two banks were from Kerala where the business of many of the so-called 'gold loan banks', which were institutions lending mainly against the pledge of gold ornaments, suffered greatly from the imposition of the Gold Control Order in 1962. Besides voluntary amalgamation, compulsory amalgamation, and transfer of assets and liabilities, seventeen banks were merged with the State Bank of India or its subsidiaries. Many of these were minor state-associated banks such as the Bank of Baghelkhand and the State

³ As discussed below, the Bank's policy on branch licensing too, changed in 1962 to protect the interests of the smaller banks.

Bank of Mayurbhanj, the reprieve they gained as the Bank fastened its attention on the Imperial Bank of India and the major state-associated banks in the wake of the Report of the Rural Credit Survey not enduring the events of the early 1960s and the drive towards banking consolidation resulting from them. In addition, forty-five banks went into voluntary liquidation, and twenty banks were compulsorily liquidated.

The process of banking consolidation was accompanied by a somewhat more active licensing policy. One of the first responses of the Bank to the Palai bank crash was to review its earlier approach towards licensing banks. Reacting to a note he saw on the subject in September 1960, Iengar deplored the existence, after so many years, of more than 250 unlicensed banks in the country. According to the note, fifty of these banks might qualify for a licence in two or three years, nearly 170 banks might require five to ten years, while some forty to fifty banks were unlikely ever to graduate to the status of licensed banks. This, according to the Governor, was 'clearly a most unsatisfactory position'. The 'solution', he argued, did not 'lie in ... lowering ... standards to any substantial extent'. It lay instead in eliminating

institutions which have no chance of survival and in the energetic exercise of the powers newly conferred on Government by the recent amending Act. The objective should be to have, within a relatively short period, say 2 to 3 years, a smaller number of banks which would be viable and qualify for a licence. We must really aim at seeing that thereafter there are no unlicensed banks at all.

It was also desirable, he felt, to move towards abolishing the distinction between non-scheduled and scheduled banks. 'This may well happen if the process of amalgamation is successful on any large scale.'

As discussed above, aided by stronger legislative provisions, greater effort on the Bank's part, and some fortuitous developments, bank amalgamation picked up momentum in the aftermath of the Palai crisis. But with the government preferring a cautious approach, the Bank was to never fully shed its earlier diffidence, the Central Board taking the view even in 1965 that it was largely up to the banks themselves to speed up licensing by improving their working and coming up to the requisite standards. So long as the interests of depositors were in no immediate danger, a Board memorandum argued, the balance of advantage lay in giving banks time to improve their working and qualify for a licence, or failing that to enter into schemes of arrangement or mergers. Nevertheless, the pace of 'de-licensing' accelerated unmistakably during these very years. No fewer than 139 banks were formally denied

licences to operate between 1962 and 1967, taking the tally of such institutions for the whole period 1951–67 to 278. Of these, sixty-two banks—the largest number in any single year—were denied licences in 1964 alone, and sixty-seven banks during 1965–67. On the other hand, only fifteen banks were awarded licences between 1961 and 1967.

Unlicensed banks were not the only ones to undergo mergers and amalgamation in the 1960s. A number of licensed banks also went the same way, so that although the Bank issued about eighty-nine licences in all since the time the Banking Companies Act came into force, only fifty-seven licensed banks (six of them non-scheduled) were in existence at the end of 1967. In the same year, there were thirty functioning banks which had neither been granted a licence nor yet denied one by the Bank. These institutions were, however, of little significance overall, accounting as they did for a mere 2 per cent of the deposits of the Indian banking system.

But there was little room for complacency. Many of the units which survived the consolidation or grew stronger as a result of it had also to be nursed, suffering as they did from common deficiencies such as poor management, ineffective branch control, and a shortage of trained staff. The Bank continued to keep a close watch on their operations through periodic scrutinies, formal and informal observation, and of course, inspections at regular intervals. The Bank also began using its powers to appoint chief executives more freely now, and resorted sometimes to regulating banks' dividends.

BRANCH LICENSING DILEMMAS

The Banking Companies Act (section 23) obliged banks to obtain the permission of the Reserve Bank before opening a new place of business. Permission to open new offices depended in principle on the financial position of the applicant bank, the general quality of its management, the adequacy of its capital structure, its future earning prospects, and on whether public interest would be served by the opening of the proposed branch. Simple as this seemed, the Bank's branch licensing policy gave rise, however, to persisting controversy. At its heart was the apprehension that by discouraging the expansion of unsound or poorly managed banks, the policy discriminated in favour of the larger, all-India banks and against weaker regional and other smaller banks. This sentiment proved hardy enough to survive the thrust towards banking consolidation after 1960 and pose a dilemma to the Bank which it resolved in favour of a more 'equitable' branch licensing policy in 1962. Besides, the Bank discovered that while it was easy enough to deny banks permission to open branches at places of their choice, it was far harder

to encourage them to extend their operations into 'unbanked' areas. The Bank's licensing policy was reviewed several times between 1956 and 1965 in the light of these considerations, until it was decided in the end to adopt a differentiated approach towards branch expansion by various categories of banks and formulate coordinated medium-term branch expansion programmes for individual banks.

The first review of branch licensing policy took place in 1956 against the background of the criticism that existing practice favoured big, all-India banks at the expense of regional or local institutions. According to this review, there was no substance in the criticism, nor any evidence to show that the Bank's branch banking policy tended to divert business from smaller banks towards the relatively bigger ones. Nothing came of this review and the Bank's executives elected to wait until the Travancore-Cochin Banking Inquiry Commission, whose recommendations might have some bearing on the future of small banks elsewhere in the country, returned its report. But branch licensing policy was liberalized in December 1956 to help sound banks open more branches at the smaller urban centres. As discussed elsewhere, the newly formed State Bank of India was embarked on a speedy branch expansion programme at this time. Important as the success of this programme was to the development of banking facilities in large parts of the country, the Bank could not ignore the desire of other banks to expand their operations. Hence it decided not to reject applications from other commercial banks to open branches at the same centres as the State Bank, but merely inform them of the latter's plans. Unlicensed banks satisfying the conditions laid down by section 23 of the Banking Companies Act too, were to be allowed to open branches more freely than in the past.

The charge that the Bank's branch licensing criteria would end in the elimination of the smaller banks revived in 1959 along with the demand to classify banks into three categories: all-India, regional, and district banks. The last were to be encouraged to set up branches at small locations, all-India banks at the district centres, and regional banks in the other towns. In 1956 the Bank had opposed reserving spheres of operation for banks since it would prevent the dispersal of banking risk and lead to the Bank being associated too closely with business decisions of commercial banks. The Bank broadly stuck to this view in 1959, but acknowledged the strength of its critics' argument by reducing the population norm for a new branch from 10,000 to 5,000 for a small bank expanding its operations into an adjoining area. Besides, while adhering broadly to section 23 of the Banking Companies Act, the Bank decided to take a more relaxed view of the standards used to judge the financial position of such banks. There was some tightening of this policy in

June 1960, with applications from licensed or unlicensed banks submitting progress reports to the Bank on major deficiencies and those from banks marked by poor head office control over branches now coming under closer scrutiny.

If the object of the liberalized policy was to promote the expansion of banks into hitherto 'un-banked' areas, it ended in failure. Although nearly a third of the new offices opened between 1957 and 1961 were at centres without banking facilities, the overwhelming majority of such offices were opened by the State Bank of India. Besides, nearly 1,400 of India's 3,018 towns still lacked banking facilities. This failure occasioned a reappraisal of the role of smaller banks in extending the reach of modern banking to new places, at almost the same time as the latent sentiment in influential circles against rapid banking amalgamation began to come into the open. The review that followed of the Bank's branch licensing policy in 1962 led to the virtual overturning of past practices, and the threefold classification of banks mentioned above now became part of the official policy. Cities and the bigger centres (having populations of one lakh or more) without banking facilities were now the responsibility of the larger banks, regional banks were allowed to expand within their traditional areas of operation, particularly into 'un-banked' towns and those with populations in excess of 50,000, while the less populous centres within their respective areas were to be the preserve of the smaller banks. However, in an apparent signal of its continued commitment to banking consolidation, the Bank proposed to permit only licensed banks and those likely to receive licences within the next few years to open new offices.

Another important change introduced in 1962 was the replacement of the relatively opaque and asymmetric queuing system with one where the Reserve Bank endeavoured to extend the reach of the banking system in a more planned and transparent manner on the basis of three-yearly expansion programmes formulated by individual banks. The first three-year cycle lasted from August 1962 to July 1965 during which fifty-nine banks submitted their expansion plans. The number of centres allotted to each eligible bank depended on its size, resources, and past performance in opening new offices. Within their overall quotas banks were allowed to open offices at two banked centres for every office at an 'un-banked' centre. Of the 606 branches opened under this programme during these three years, 231 were at 'un-banked' centres.

The success of this programme encouraged the Bank to extend it for two more years from August 1965 with some important modifications. The criteria for distinguishing between small and regional banks was further refined,

while the practice of not allowing larger banks into towns with populations below one lakh was abandoned in favour of one which allowed them to enter such places provided they were 'un-banked' and no small or regional bank proposed to open an office there. Regional banks were similarly to be allowed into towns with populations above 25,000, while small banks remained free to open offices at 'un-banked' or 'under-banked' centres in their areas of operation with fewer than 50,000 inhabitants. As there were still some 900 centres, according to the Bank's estimate, with no access to banking facilities, the practice persisted of linking licences for offices in 'banked' centres with those for offices at centres without any banking facilities. Since states such as Assam, Bihar, Jammu and Kashmir, Orissa, Madhya Pradesh, Uttar Pradesh, and West Bengal continued to be 'under-banked', with each office of a bank serving a population in excess of one lakh, all-India banks were asked to ensure that one in three of their new branches was located in these states. The larger regional banks were also asked to adopt a similar course wherever possible.

Four hundred new branches were opened in the last two years of the original three-year programme ending in July 1965. The two-year programme commencing in August 1965 envisaged opening 600 new branches. While the Bank approved 663 applications, including 239 for offices at 'un-banked' centres, shortages of accommodation and trained staff meant that only 370 offices could be opened until June 1967.

Finally, a few words while we are still on this subject, on the licensing of foreign banks which also saw some changes of policy during these years. Until 1959 the Bank followed the restrictive policy suggested by the Central Banking Enquiry Committee (1931) of confining foreign banks to port towns. In 1959, however, the Bank decided to place exchange banks on the same footing as Indian banks: not only did the policy of discrimination go beyond the guidelines offered by the Banking Companies Act, international economic relations being reciprocal in nature, little, it was felt, would be gained by discriminating against foreign banks at a time when Indian banks wishing to expand overseas were not subject to similar barriers and India needed the goodwill of the international community to ensure the success of its development plans. Thanks to the liberal policy adopted in 1959, the number of offices of foreign banks in India, which had largely been stationary for some time, increased from sixty-six in that year to seventy-four in 1961.

But this liberal regime soon came under a cloud. The policy of non-discrimination was turned on its head by those who argued that no country with the exception of the United Kingdom (which however was the major country of domicile for the majority of the exchange banks operating in

India) freely opened its doors to banks of other nationalities. Nor did foreign banks in India offer services Indian banks could not reasonably provide. The expansion of the former's business, it was moreover argued, would result in outflows of foreign exchange in the form of repatriated profits. Consequently, in 1962 the Bank resumed its earlier policy of confining foreign banks to port towns, but also decided to consider their request to be allowed to open new offices only after the foreign exchange situation eased. This policy was renewed in 1965. Despite the more restrictive policy, foreign banks expanded their presence in India greatly after 1961, the number of offices rising to 111 by 1967. In contrast, the number of offices of foreign banks had increased from 64 in 1951 to 74 in 1961.

INTRODUCTION OF DEPOSIT INSURANCE

The Deposit Insurance Corporation, and with it the insurance of bank deposits, came into existence in 1962, directly as a consequence of the crash of the Palai Central Bank. The idea had first cropped up in India in the late 1940s in the context of the banking crisis in Bengal, and again in the early 1950s when both the Rural Banking Enquiry Committee and the Shroff Committee adverted to the advantages of insuring bank deposits. Since the late 1950s, opinion within the Bank came to favour deposit insurance as a means not only of protecting depositors, but also of helping to consolidate and strengthen the banking system. Hence the Bank responded quickly to the banking crisis of 1960 with a blueprint for insuring bank deposits. But its implementation foundered on misgivings among the larger Indian banks and the exchange banks, and nervousness about the effect on cooperative bank deposits of confining the scheme to commercial banks. The Deposit Insurance Corporation Act, which was finally passed by Parliament and received Presidential assent towards the end of 1961, came into force from 1 January 1962 when the Deposit Insurance Corporation was established under the Bank's aegis with authority to extend insurance protection up to specified amounts for the deposits of all functioning commercial banks in the country. India as it happened, was only the second country in the world, after the United States of America, to provide insurance cover to bank deposits.

The introduction of insurance cover for deposits of commercial banks intensified fears about the implications of the scheme for the deposits of cooperative banks, and a strong demand came to be voiced to extend a similar facility to the latter's deposits. But this was easier said than done since the Bank had few powers to regulate or oversee the functioning of cooperative banks and it was loath to burden the Deposit Insurance Corporation, and

indirectly the commercial banking system, with blanket liability on account of cooperative banks over which it had no control. On the other hand, state governments which were entrusted with the power to regulate cooperative institutions in their states were not keen to relinquish it to a distant and central authority. Therefore, extending deposit insurance to cooperative banks had to be preceded by extensive negotiations between the Bank, the central government, and state governments, and a series of important legislative measures. The latter, as pointed out above, included the addition of a new part (Part V), dealing with cooperative banks, to the renamed Banking Regulation Act, amendments to the Reserve Bank of India Act, the Deposit Insurance Corporation Act, and finally to the cooperative acts of state governments. This process was inevitably time-consuming, so that it was not before the end of 1965 that the Bank acquired some powers to regulate the functioning of cooperative banks, and it was not until 1968 that these institutions were brought within the purview of the Deposit Insurance Corporation Act.

The Beginnings

The idea of deposit insurance was first mooted in 1948 in the background of the widespread failure of small banks in West Bengal. But it did not progress very far since the Bank felt the proposal was premature and Indian banking too poorly developed for deposit insurance to be viable. As the Governor, C.D. Deshmukh, told the government when the subject was raised again the following year, deposit insurance should wait until the Reserve Bank had a better picture of the health of commercial banks in India. The Bank had only recently acquired powers to inspect and regulate commercial banks under the Banking Companies Act, and the Governor wished at least one round of inspections to be completed before it could, with confidence, 'advise on the inclusion of a maximum number of banks in the scheme'. The Rural Banking Enquiry Committee (1950), which also gave some thought to this issue, felt the time was not ripe for such a scheme, and proposed that once the Bank's control and inspection machinery had developed fully and a sufficient number of banks been issued licences, it should set up an expert committee to consider 'whether a scheme limited to banks holding a licence ... cannot be put into operation'

The Bank had made only modest progress towards satisfying these preconditions when the Committee on Finance for the Private Sector (or the Shroff Committee, 1954) considered a deposit insurance scheme prepared by B.K. Dutt, one of its members and the General Manager of the United Bank of India which, readers will recall, was a child of the recent banking crisis in

Bengal. Though stopping short of endorsing Dutt's scheme, the committee urged the adoption of deposit insurance as a means of strengthening the banking system and increasing public confidence in it, provided banks agreed amongst themselves about its advantages. Placing the recommendations of the Shroff Committee before the Central Board in June 1954, the Governor, B. Rama Rau, reported that according to the evidence collected by the committee, the leading banks were 'sharply divided' on the 'desirability of deposit insurance'. Since the scheme involved the payment of premia by banks, Rama Rau suggested, commercial banks should first agree amongst themselves before the Reserve Bank or the government moved in the matter. The question of deposit insurance, he also proposed, should be taken up for consideration '*after the process of licensing banks has been completed*'. After unsound banks have been weeded out by refusal of licences, it would be easier to organize such a Corporation [emphasis in the original].'

Within two years of this, however, the Bank was forced to re-examine its earlier view that the consolidation of the banking system should precede the adoption of deposit insurance. The context was provided by a letter from the Ministry of Finance in March 1956 asking the Bank to give 'active consideration' to a 'scheme for ensuring the safety of the money of the small depositor'. Such a scheme, the Ministry suggested, would support the 'accepted policy to develop banking in the rural areas and ... encourag[e] savings', and should not be deferred until the process of licensing of banks, which was 'bound to take time', was completed.

The Department of Banking Operations decided to address the sequencing issue head on. Its lengthy note, running into twenty-five pages, contended that the school of thought which held that deposit insurance should precede the strengthening of the banking system through the weeding out of unsound banks, assumed that conditions in India in the mid-1950s were similar to those that prevailed in the United States before that country introduced a similar scheme. Nothing, Banking Operations argued, could be further from the truth. Unlike in the US before the Federal Deposit Insurance Corporation was brought into existence, there was no 'general loss of confidence in banks' among depositors in India. On the contrary, deposits were increasing rapidly. Bank failures in India arose from the 'individual weakness of the concerned banks', rather than due to generalized panic. Better control and supervision was therefore the more suitable remedy, and the Bank's efforts had already done much to improve the situation in this regard. In any case, the Department of Banking Operations maintained, the success of deposit insurance depended ultimately on the soundness of individual banks. Therefore, far from being an end in itself, deposit insurance would have to

be accompanied, as in the US, by 'rigorous control and comprehensive supervision' of banks' affairs.

Remarking on the state of commercial banking in India, Banking Operations pointed out that since inspections began the Bank had inspected 580 banks at least once. Of these 329 banks had been 're-inspected'. However, the Bank found only forty-four scheduled and two non-scheduled banks eligible for a licence under section 22 of the Banking Companies Act. The affairs of the remaining banks remained unsatisfactory, and as many as 405 of them had been asked to submit quarterly or monthly reports of their progress in removing the defects detected in their working. The position of these banks was such that while some would be able to improve their affairs and qualify for a licence in due course, 'many others would be unable to do so and may, therefore, have to be eliminated from the banking field'.

In the context of such a position, where the continued existence of a number of banks which have not been found eligible for a licence is itself in doubt, or where even their ultimate disappearance would ... seem to be almost certain, the introduction of a scheme of deposit insurance on a nationwide scale would hardly seem to be justified

At the present stage of banking development in India, deposit insurance could only mean 'acceptance by the State of the responsibility of repaying the deposits of ... banks, a large portion of whose assets is known to be irrecoverable'. The total burden devolving thereby on the State, the note continued, 'would be disproportionate to the results ... achieved'. A smaller scheme confined to sound and well-managed banks, on the other hand, would hardly help strengthen public confidence in the banking system or be of any practical significance. In any case, licensed banks already accounted for 91 per cent of the total bank deposits in India, and as such the proposal to insure bank deposits had little 'immediate practical utility'.

Views in the Division of Banking Research were closer to those of the ministry. According to a note by K.N.R. Ramanujam, Director of Banking Research, deposit insurance should not await the completion of bank licensing which was 'bound to take a long time'. The objective of mobilizing resources for the second five-year plan necessitated the acceleration, in the meantime, of the pace of banking development, especially in rural areas, and a 'scheme of deposit insurance will be of immense aid in fostering public confidence in the safety of ... (bank) deposits'. Besides, deposit insurance should itself be seen as part of the process of consolidating the banking system, since the agency entrusted with the scheme would inevitably place greater emphasis on

keeping 'troubled' banks in operation through reorganization and mergers. Such a 'constructive and more positive attitude' would bring about 'at a quicker pace than at present', the 'strengthening' of the Indian banking system. Elaborating on this argument, Ramanujam pointed out in another note that the proportion of bank deposits to money supply had actually declined in the recent past. This was possibly because the recent growth in incomes had benefited those sections of the community who remained diffident about banking their resources. Deposit insurance, he contended, was just the measure needed to overcome the 'traditional reluctance of people in rural areas to have recourse to banks for placing their funds'. Although it was not an 'integral part of banking development in most countries', deposit insurance should be regarded in India as 'one of the essential services to be rendered by the State' for developing the banking habit in rural areas.

The Director of Banking Research also pointed out that although licensed banks accounted for 91 per cent of total deposits, nearly a third of the depositors held their deposits in smaller banks having total deposits of less than Rs 5 crores each. This proportion would be even larger if depositors of banks numbering 230 having aggregate deposits of less than Rs 5 lakhs each were also taken into consideration. 'Protection afforded to these depositors scattered all over the country would create confidence and cannot but redound to the prestige of the entire banking system' Ramanujam also put forward a tentative scheme providing cover of up to Rs 500 per account which would extend full protection to an estimated 61 per cent of the accounts of all banks and partial protection to the rest whilst covering only about 10 per cent of the total deposits of the Indian banking system. In order to help spread the risk and keep the incidence of premia low (the figure proposed was a twelfth of one per cent) in relation to banks' net profits, the scheme proposed to cover all banks large and small, with the exception of those found to be beyond redemption. The views of the Department of Banking Development were also largely along the lines of those of the Division of Banking Research.

Faced with a divergence of views on the subject within its portals, the Bank decided in February 1957 to send the Government of India a reply in rather general terms which recalled the Shroff Committee's view that deposit insurance had 'useful potentialities' in India and said the proposal was 'worth further examination' in the context of efforts to mobilize resources for the plan. Promising to give 'close attention to the proposal', the Bank told the government that it would formulate its final views on the subject after discussions with bankers. In the event, bankers were not consulted about the scheme until 1960, when the deposit insurance scheme was revived at the highest levels of the Bank under rather different circumstances and auspices.

In the meantime, the informal committee of the Bank constituted to consider the programme and priorities of the State Bank of India examined the issue of depositor confidence in July 1957 in the limited context of the new institution's role in realizing the frozen assets of moribund banks and of measures to simplify bank liquidations to minimize depositors' losses. Though exercises continued within the Economic Department and the Department of Banking Development to finalize a deposit insurance scheme, the issue appears generally to have been put on the back-burner until 1960. Interest in the proposal revived in April that year following a reference in Parliament, and gathered momentum in the wake of the failure of the Palai bank and the resulting banking uncertainty.

The New Push towards Deposit Insurance

The Division of Banking Research responded to the parliamentary reference in July 1960 with a revised scheme of insurance that would be compulsory for the State Bank and its subsidiaries and all licensed banks, but voluntary for other banks. This avoided the risk inherent in the earlier scheme, of banks whose deposits were denied cover suffering an immediate erosion of public confidence and a run on their deposits. Voluntary admission, the note by the Division of Banking Research argued, would not only largely eliminate this risk but would also ensure reasonably comprehensive coverage as banks, whether scheduled or not, would be attracted to the insurance scheme by the prestige and protection it offered. A scheme of this nature would also be simpler to administer. In forwarding the note, S.L.N. Simha, who had meantime become Director of Banking Research, maintained that the proposal for deposit insurance would encounter opposition from the major banks unless the Bank threw its own weight behind it. Drawing attention to the substantial assistance the scheme would require from the Bank in its initial stages, Simha suggested setting up a deposit insurance fund on the lines of the agricultural credit funds.

Banking Research's proposals hung fire until the Bank was galvanized into action by the events of August 1960. The Palai Central Bank downed its shutters on 8 August, and within the next week, Iengar had informally canvassed C.H. Bhabha, the chairman of the Indian Banks' Association, about a deposit insurance scheme. Though he anticipated 'difficulty from several banks', Bhabha apparently promised the Governor 'full support' if he decided to promote such a scheme. Following his meeting with Bhabha, Iengar minuted that 'we should go as fast as we can' in finalizing a plan for deposit insurance. The issue also appears to have been raised informally at a meeting of the Board on 17 August, and the next day Iengar constituted a working group

comprising a representative each of the Economic Department and the Departments of Banking Operations and Banking Development 'to prepare within a week a tentative scheme of Deposit Insurance'

The report of this working group acknowledged that recent bank failures had focused attention on the need to ensure the safety of deposits of 'vulnerable' banks, and the prompt payment of deposits in the event of liquidation 'particularly to persons of small means'. Apart from protecting the small depositor, insurance would 'inspire confidence in the banking system' and help sustain deposit growth. The working group prepared an insurance scheme administered departmentally by the Bank and open in principle to all banks. It proposed a maximum cover of Rs 1,000 per depositor which would fully protect nearly 80 per cent of account holders (this estimate was later revised to 72 per cent of deposit accounts) and secure 15 per cent of deposits. Since it was necessary to keep the premium as low as possible 'so as not to scare away the big banks' who felt they could afford to do without insurance, the working group proposed a levy of two naye paise per Rs 100 of total deposits. The Bank was also to contribute a sum of Rs 5 crores to the corpus of the scheme.

The proposals of the working group were immediately taken up at the highest levels of the Bank, somewhat to the chagrin of departmental heads who felt left out of the process, and sent to the Indian Banks' Association and the Exchange Banks' Association at Bombay for their reactions. They were also discussed at a meeting with bankers held in September 1960 and attended by the Finance Minister. At this meeting, Bhabha acknowledged the scheme to be 'necessary on merit and in the present context inescapable'. The Central Board of the Bank too, approved the draft outline of the deposit insurance scheme in general terms at its meeting in Madras in October 1960, and left it to the Committee of the Central Board to modify it in the light of comments received from the banks.

The formal response of the Indian Banks' Association to the deposit insurance scheme was, however, less positive than the Bank had hoped. The association apprehended that besides being incapable of preventing bank failures arising from bad management, deposit insurance would encourage unsound banking practices and encourage complacency in the supervision of banks. It also objected to putting well managed and badly managed banks on the same footing for the purposes of the scheme. Finally, the association wanted deposit insurance to be managed by a separate organization rather than by the Reserve Bank whose officers, it alleged, were likely to be prey to 'preconceived ideas ... embodied in ... inspection reports'. The Exchange Banks' Association's response was more positive. But it favoured calculating banks' premium liability on the basis of insurable deposits rather than total

deposits, since otherwise larger banks would be 'heavily subsidizing' the insurance scheme on 'behalf of the smaller banks'. Besides, the exchange banks argued, the Bank should also play a more active role in regulating deposit rates and helping to rehabilitate and control 'sub-standard' banks.

The government's reactions to the scheme, oddly enough since it had earlier endorsed the principle of deposit insurance if not the actual proposals *under consideration*, echoed the views of the bankers and came as an unpleasant surprise to the Bank. In two letters written to the Governor in October 1960, K.P. Mathrani, *Additional Secretary in the Ministry of Finance*, said the government was not 'committed' to the idea of deposit insurance which had not been 'tried on any large scale outside the United States' and was likely to arouse opposition within the country, and that a 'final view' on the 'desirability or practicability' of the scheme would have to await a 'fuller discussion' of the issues involved. In another letter, Mathrani also communicated the Finance Minister's view that the process of 'reconstruction and amalgamation' should precede the adoption of a deposit insurance scheme and that the Bank should take into account the reactions of the banks to the scheme.

The Finance Ministry's latest stand appears to have incensed the Governor who felt it put him in a 'very false position'. North Block's response was 'extraordinary' also because it presumed to teach him 'the pros and cons of the insurance scheme'. Besides, it was 'curious' that the Finance Ministry's arguments, though couched in more polite language than the note of the Indian Banks' Association which was 'offensive' in its reference to the Bank's officers, were identical to those of the bankers' body. 'I feel wedged between the Finance Ministry on the one side and the Indian Banks' Association on the other, and feel I ought to let the Minister know about my feelings on this subject', Iengar remarked bitterly. The Indian Banks' Association 'pretended to speak for the banking community in general', but it represented the views 'merely of a clique of bankers in Bombay'. The Governor had been informed by a number of bankers that they supported the deposit insurance scheme, while some others had written to the Bank on their own volition to press for it. But the association persisted in taking a 'contrary line'. He therefore proposed writing directly to individual banks for their views on the draft proposals. *Informal inquiries* made by the Bank also elicited the information that the Indian Banks' Association's response to the scheme was formulated at a meeting of its management committee where most of the big banks, spearheaded by Homi Mody, opposed the scheme. The smaller banks were 'nowhere in the picture'. But Bhabha himself continued to stand by his earlier views, and at his request, Iengar decided not to address individual banks until the association had had another chance to consider the subject.

Following this, Iengar wrote pointedly to L.K. Jha in December 1960 and January 1961 informing him that having discussed the issue with the bankers, the Bank was now in a position to prepare the details of a deposit insurance scheme. Before it did so, however, it was necessary to 'ascertain from [the] Government whether in their view, as a matter of policy, such a scheme is necessary at all at this stage'. The letters traced the background to the scheme, emphasized the urgency it had acquired in the context of recent bank failures, and cleared the air about the criticisms voiced against it. Iengar argued that deposit insurance was essential to promote the 'investment habit and mobilization of resources' and a banking structure which was not dominated by a 'small number of large institutions' but consisted of a 'number of medium banks of reasonable size in which the smaller people could deposit their savings'. In recent months there had been a 'steady erosion of deposits from the banking system' due to 'apprehensiveness among ... small depositors' arising from recent bank failures and moratoria on bank payments. The recent runs on the Punjab National Bank and the Indian Bank had shown that 'even the bigger banks' were not 'as invulnerable as ... generally claimed'. A measure of depositor protection in the event of bank failure, the Governor insisted, was necessary to restore confidence in the banking system. Finally, deposit insurance would give a 'fair start to the schemes of amalgamation' the Bank proposed to take up. In the prevailing state of public nervousness especially in Kerala, new banks born of amalgamation schemes might face a run on their deposits immediately. These new units would have to be 'nurtured' in the beginning and 'protected against unreasoned fits of nervousness' to which the 'depositing public ... has become more susceptible of late', and a scheme of deposit insurance would be an important aid in this task, Iengar concluded.

Jha responded in February 1961 to inform Iengar that the government viewed the scheme 'with sympathy' and that there were 'weighty' arguments in its favour. Soon afterwards, the Bank sent the government the final outlines of its plan for deposit insurance. This plan proposed a separate corporation under the auspices of the Reserve Bank, which would put up the initial paid-up capital of Rs one crore and an interest-free, ten-year loan of Rs 5 crores. The scheme would cover all institutions defined as banks under the Banking Companies Act, including the State Bank of India and its subsidiaries, and all types of deposits other than deposits of governments (central, state, and foreign) and inter-bank deposits. Deposits were to be insured to the extent of Rs 1,000, the liability arising only when a banking institution went into liquidation or a scheme of reconstruction or amalgamation involving scaling down of deposits was taken up. To start with, the premium rate was fixed at Re 0.05 per Rs 100 to be charged on aggregate deposits and payable quarterly. The

corporation, which would be staffed initially by the Bank's staff, was to be primarily concerned with the overall administration of the scheme and would make use of the existing Bank machinery for supervision and inspection.

The Deposit Insurance Corporation Act

This plan, which was sent to the government in February 1961, progressed quite swiftly through Delhi's corridors. The following month, the Finance Minister held a meeting with some bankers in the course of which he told them that he was 'personally in favour of deposit insurance', and that the Cabinet's orders would soon be taken on the matter. The government's approval too followed shortly in May 1961. The scheme as approved underwent some modifications, relating mainly to the paid-up capital of the new corporation and the loan it would receive from the Bank. The original Cabinet decision excluded the State Banks from the scheme, but this was quickly reversed. The bill to set up the Deposit Insurance Corporation was introduced in the monsoon session of Parliament. It was passed by the Lok Sabha in September 1961 and by the Rajya Sabha in November the same year. The President gave his assent to the legislation early in December, and the Deposit Insurance Corporation Act was brought into force from 1 January 1962 when the Deposit Insurance Corporation came into existence, two months before Iengar's term as Governor ended.

Under the Act, all functioning banks were to be categorized as insured banks. Insurance protection to a depositor was limited to Rs 1,500 or the total amount deposited, whichever was lower, and the premium was fixed at Re 0.05 per Rs 100 of total deposits in India less some specified deposits.⁴ The corporation had a capital of Rs one crore which was fully paid-up and allotted to the Bank. The Act required the corporation to maintain two funds, the Deposit Insurance Fund and the General Fund, and the Bank was authorized to advance to it a maximum of Rs 5 crores towards augmenting the former fund. The first Board of the corporation comprised the Governor as its Chairman, a Deputy Governor nominated by the Bank, a nominee of the Government of India, and two non-officials nominated by the Government of India in consultation with the Bank. The latter were to be selected from among persons who were familiar with banking, commerce, industry, or finance, but were not actively connected with any banking company. The Deposit Insurance Corporation was required to invest its funds entirely in the securities of the central government.

⁴ The limit of the insurance cover was raised to Rs 5,000 from January 1968, thereby fully insuring over 91 per cent of all deposit accounts and half of all assessable deposits at the end of the year.

Since all functioning banks were to be registered as insured banks and the Reserve Bank's powers of supervision and control under the Banking Companies Act extended to all of them, it was not considered necessary to assign any of these functions independently to the corporation which, it was envisaged, would function in close coordination with the Department of Banking Operations of the Bank. When the Deposit Insurance Corporation came into existence, all 293 banks which were then in existence were registered as insured banks under intimation to them. Of these 219 banks were unlicensed, twenty-one of whom, accounting for a total deposit liability of Rs 67 crores, had faced some erosion of their deposits. It transpired, however, that five of the 293 banks had ceased to transact banking business and one had gone into voluntary liquidation shortly before the establishment of the corporation, so that there were in all 287 banks whose deposits were covered by the insurance scheme when the latter got under way.

There were 55.42 lakh fully protected accounts (i.e. accounts with balances below Rs 1,500) at the outset of the scheme, accounting for 78.5 per cent of all deposit accounts. The proportion of fully protected accounts was higher (86.1 per cent) in the case of smaller banks, i.e. banks with aggregate deposits of Rs one crore or less. The number of fully protected accounts more than doubled to 118.7 lakhs by September 1967 at which stage they represented about 76.4 per cent of the total number of accounts. The proportion of insured to total deposits was about 23.1 per cent (roughly about Rs 392 crores) when the scheme began in January 1962. This proportion had risen to 26.2 per cent (or about Rs 943 crores) by September 1967. The Deposit Insurance Fund amounted to Rs 8.59 crores at the end of 1967, constituting 0.24 per cent of assessable deposits and 0.91 per cent of insured deposits. In the first six years of its operations, the Deposit Insurance Corporation cancelled the registration of 198 banks with total assessable deposits of Rs 52 crores. The corporation was not required to make any payment in respect of 187 of these banks since they either discharged their deposit liabilities in full before downing shutters, or transferred them to other banks. The corporation attracted a total liability of about Rs 57 lakhs on account of the other eleven banks. These included the Habib Bank, which involved the largest single gross liability of Rs 17.63 lakhs, the National Bank of Pakistan, and the Bank of China whose licences were cancelled for reasons that had little to do with their viability. The net liability (i.e. the corporation's payments to depositors less the reimbursements received from the concerned bank or the official liquidator) on account of these eleven banks amounted only to about Rs 24 lakhs. This, according to the corporation, indicated a 'favourable risk experience'.

Nor did the fears expressed earlier by exchange banks and several officials within the Bank, that deposit insurance would persuade depositors to move their funds from the bigger and sounder banks, which paid lower interest, to smaller and weaker banks offering higher rates of interest materialize despite the insurance scheme being introduced, unlike in the USA, without any regulation of the interest rates banks offered on deposits. Indeed, as discussed elsewhere in this chapter, the impressive growth in deposits and deposit accounts during this period was accompanied by a large number of small banks going out of business in a relatively orderly fashion, and the number of registered or insured banks declining sharply from 287 in January 1962 to ninety-one at the end of 1967.

Insuring the Deposits of Cooperative Banks

During deliberations on the Bank's draft schemes for deposit insurance, fears were voiced in many quarters about the consequences for cooperative bank deposits of a scheme devoted solely to protecting depositors of commercial banks. The issue was first raised within the Bank in July 1960 by S.L.N. Simha, who however observed that cooperative institutions had made so little progress in raising deposits that there was 'no danger of any diversion' of their deposits to commercial banks. The consequences for cooperative banks' deposits of the proposed insurance scheme were also discussed following Mathrani's two letters to the Governor and a letter he wrote to the Deputy Governor, B. Venkatappiah, at the end of October 1960.

The reaction to the insurance scheme of the Agricultural Credit Department largely echoed Mathrani's fears. J.C. Ryan believed there was little chance of cooperative banks (including urban cooperative banks and apex and central cooperative banks) increasing their deposits if the insurance scheme was restricted to commercial banks; the expansion of cooperative credit, he feared, might consequently come largely to depend upon Reserve Bank finance. The Agricultural Credit Department was also concerned about the impact of insuring commercial banks' deposits on the 'integrity' of the cooperative movement. A sizeable portion of the surplus funds and reserves of cooperative societies were kept with central and state cooperative banks. Cooperative institutions already flouted the law requiring them to seek the permission of the Registrar of Cooperative Societies before lodging their funds in commercial banks, and once the latter's deposits were insured, this law, Ryan warned, would be 'more honoured in the breach'. He therefore proposed that if it was not feasible to include all cooperative banks under the scheme, a beginning might be made with a few selected state, central, and urban cooperative banks.

On the other hand, there was little prospect of cooperative banks' deposits being insured so long as the Bank had no statutory powers to control or regulate these institutions. This, in the event, was the Bank's view. Venkatappiah also told Mathrani informally that insuring the deposits of cooperative banks raised many complex issues that required to be considered carefully, and that a scheme for commercial banks should not be held up in the meantime. Besides, as the Governor informed L.K. Jha, the cooperative movement was already under so much 'State guidance and supervision' that insurance may actually turn out to be 'unnecessary'. But, he hastened to add, there was no need to take a 'final view just now'; better to watch the effects of the proposed insurance scheme on cooperative deposits and 'make up our minds later'.

Several members remarked on the exclusion of cooperative banks from the ambit of the Deposit Insurance Corporation Bill when it was moved in Parliament. The bill's passing into law did little to quieten the clamour for extending some form of deposit insurance to cooperative banks, and the issue figured prominently at meetings of the Standing Advisory Committee on Agricultural Credit in December 1961 and in February and June 1962, with several members echoing the views of V.L. Mehta that the Bank should 'speed up the examination of the type of protection that should be given to depositors in cooperative banks before the effect of the present scheme [of insuring deposits of commercial banks] spreads'.

There were essentially two approaches to insuring cooperative deposits. The first was to offer some form of depositor protection at the state level, rather than centrally, with individual state governments, who alone had powers to regulate cooperative banks, playing an important role in the arrangements. Earlier in 1959-60, some state governments had proposed guaranteeing the deposits of cooperative banks in the same way they guaranteed the debentures of central land mortgage banks, to help them mobilize resources. But cooperators generally looked askance at such measures, and the Committee on Cooperative Credit (V.L. Mehta Committee, 1960) rejected the principle of State guarantees which it said was not 'practicable' without 'much greater control' by governments over cooperative banks than was 'desirable'. Most state and central cooperative banks received substantial share capital contributions from state governments. Depositors were generally aware of this fact, the Mehta Committee noted, and concluded that State participation in equity was sufficient to 'inspire the necessary confidence' in depositors' minds. On the other hand, though many cooperators preferred the second approach, of having the Reserve Bank undertake, singly or along with the central and state governments, responsibility for protecting depositors of

cooperative banks, the Bank had no statutory powers to inspect and regulate the working of these institutions. It was also far from clear that state governments would easily relinquish these powers to the Bank. Hence, as pointed out in the previous chapter, the only consensus that emerged from the meeting of the Standing Advisory Committee in June 1962 was reflected in B. Venkatappiah's *opinion that whatever the arrangements to insure deposits of cooperative banks, these should be in line with those for overseeing, regulating, inspecting, and if necessary winding up, the affairs of cooperative banks.*

At the Standing Advisory Committee's suggestion, the Bank appointed a working group headed by the Deputy Governor, D.G. Karve, to examine the insurance of cooperative deposits in some detail. This group considered three alternatives, viz. organizing the insurance of cooperative deposits *centrally*, at the level of individual states, or through a combination of central and state-level agencies, but refrained from making its own preference explicit. The Standing Advisory Committee, on the other hand, felt it was impracticable, for reasons of its cost, to insure cooperative deposits at the state level. At the same time, although several ideas were floated in this regard, few in the Bank or outside were clear yet about the means by which the Deposit Insurance Corporation or some other central agency would protect depositors of cooperative banks.

In the meantime, despite the Mehta Committee *frowning upon the practice*, some state governments moved in the direction of guaranteeing the deposits of cooperative banks in their states. The pioneer in this respect was the Madras government, which decided in December 1961 to guarantee, up to some limit, three-year and longer fixed deposits of state and central cooperative banks offering interest of 5 per cent or more. Explaining this initiative, R. Tirumalai, an official of the Madras government, told the Standing Advisory Committee in June 1962 that the guarantee was a sequel to the 'acute shortage of medium-term resources ... for agricultural purposes'. The guarantee, he pointed out, had a positive impact on deposit mobilization by cooperative banks and the state government's action was 'justified by its results'. He also held out the possibility of the state government extending the guarantee to depositors of urban and other cooperative banks. The Bank did not favour such guarantees, and appears to have felt the Madras government's initiative would adversely affect its market borrowings. The effects of the guarantee were discussed during the Deputy Governor's annual meetings with officials of the Madras government in 1964 and 1965, when the latter confessed that the guarantee was introduced without a full appreciation of its implications. But the government also felt it could not be withdrawn without confusing

depositors and provoking a flight of deposits from cooperative banks to commercial banks.

Despite this experience, the state government soon approached the Bank with a proposal to increase guarantee limits (which were earlier set at Rs 125 lakhs for the state cooperative bank and Rs 30 lakhs for each central cooperative bank) in order to enable cooperative banks to mobilize larger resources for financing agricultural production. The Bank's Agricultural Credit Department opposed the proposal, arguing that the state government's action in guaranteeing deposits for three years and longer had caused a disproportionate growth in such deposits and induced cooperative institutions to lock up their resources in long-term or medium-term loans. In addition, the higher interest cost on these deposits eroded the profitability of cooperative banks in the state. The Standing Advisory Committee, which met in June 1965, also expressed itself against the state government's proposal to enhance guarantee limits.

The Madras government's example was quickly copied by some other state governments. But the Bank managed, on the whole, to check the enthusiasm of state governments for deposit guarantees from spreading too far. The Andhra Pradesh government, which had earlier decided to guarantee cooperative banks' deposits in the state, heeded the Bank's advice and withdrew its proposals in July 1963, while Mysore was persuaded not to renew its guarantee. *The Orissa and Bihar governments too were dissuaded from going down the path taken by the Madras government.*

Meanwhile, the Government of India's assurance to Parliament that it would soon bring forward legislation to extend deposit insurance to cooperative banks languished, since state governments were not keen to cede to the Bank powers to wind up or reconstitute cooperative banking institutions. In April 1965, S.K. Dey, the Minister for Community Development and Cooperation, wrote to chief ministers urging them to respond to the suggestions the Bank had made at the November 1963 conference and its draft amendments to various central enactments and the cooperative societies acts of state governments. The Bank too followed this up with letters to state governments explaining the amendments it proposed to the latter. Soon afterwards in September 1965, as seen in the last chapter, the Bank's efforts to separate the two issues and move towards regulating the banking activities of cooperative institutions without waiting for agreement on a mechanism for liquidating and amalgamating cooperative banks and extending insurance to their deposits bore fruit, with the Banking Companies Act being amended to make certain of its provisions applicable to cooperative banks. Spurred possibly by this legislation, chief ministers of three states wrote to the Government of India approving the deposit insurance scheme in principle.

But doubts endured. As the Bank anticipated, some state governments were uneasy about the diminution of their role in determining the future of cooperative banks. The Orissa government suggested that the Registrar should have the power to liquidate a cooperative bank even without the prior consent of the Bank, while the Madhya Pradesh government sought the power to entertain appeals against the supersession of a bank's board. The idea was also canvassed of entrusting arbitration to an 'independent third party', whenever the Bank and the state government differed over the future of a cooperative bank. The Governor was quick to scotch this proposal which, if accepted, might lead to the management of a cooperative bank using the arbitration period to water down its assets. He maintained that while there should be no legal obligation on the Bank to consult the state government before initiating action against cooperative banks, it would, in practice, take the local authorities into confidence before doing so. In any case, the Governor argued, a state government could hardly disregard the Bank's expert opinion on the soundness of any banking institution and the best means of safeguarding the interests of its depositors. Though some dissenters remained, in due course five other states and union territories indicated their agreement with the Bank's proposals, and after weighing their responses the Government of India decided to go ahead with the legislation to extend deposit insurance to cooperative banks.

The Deposit Insurance Corporation (Amendment) Bill, which, among its other provisions, vested in the Bank powers to order the reconstruction, amalgamation, winding up, or supersession of the management of cooperative banks, and increased the paid-up capital of the Deposit Insurance Corporation from Rs one crore to Rs 5 crores and the number of directors on its Board from five to eight, was introduced in the Lok Sabha in July 1967. It came up for consideration on 20 November 1968 and, for a piece of legislation that had been more than six years in the making, was passed in the Lok Sabha the very next day with surprisingly little ado. Requesting state governments to amend their cooperative societies acts in the manner suggested by the Bank, the Minister of State for Finance, K.C. Pant, assured the House that the Bank would always keep in mind the special features and needs of the cooperative banking system and act in close consultation with its institutions. The bill was adopted by the Rajya Sabha at the beginning of December 1968 and came into force from the end of the same month.

TRENDS IN INDIAN BANKING, 1951-67: AN OVERVIEW

Thanks to large public investments, rising incomes, structural changes in the economy, and the growth of the banking habit, Indian banking witnessed steady

expansion during these years (table 13). It was pointed out above that the number of banks in India fell sharply from 566 in 1951 to ninety-one in 1967. But the number of their offices rose from 4,151 in 1951 to 7,025 in 1967. This growth was even more impressive in the case of scheduled banks. In 1951, the ninety-two scheduled banks in existence had between them 2,647 offices, while the remaining 474 non-scheduled banks functioned out of 1,504 offices. The number of scheduled banks fell to seventy-one by 1967, but they now accounted for 6,816 offices, while the twenty non-scheduled banks still in existence had only 209 offices between them. Though more numerous at the beginning of our period than scheduled banks, non-scheduled banks accounted for a mere 4 per cent of total deposits and 6 per cent of the advances of Indian commercial banks in 1950. These proportions had fallen sharply to 0.7 per cent and 0.5 per cent respectively by 1967, deposits and advances of non-scheduled banks declining even in absolute terms from Rs 36 crores and Rs 29 crores respectively in 1951 to Rs 26 crores and Rs 13 crores in 1967.

The expansion of the branch network of Indian banks outpaced the rapid growth of population, so that the average population per branch fell from about 87,000 in 1951 to about 73,000 in 1967.⁵ There were however considerable inter-state variations, the union territories of Chandigarh and Delhi having a branch of a bank for 8,000 and 14,000 inhabitants respectively, while Tripura, also a union territory, had one branch serving as many as 2,77,000 of its population. Among the major states, the reach of the banking system extended farthest in Madras which had a population of 39,000 per office in 1967. Gujarat with 41,000 and Mysore with 43,000 people per office were not far behind. Kerala, Maharashtra, Punjab, Haryana, Himachal Pradesh, Pondicherry, and Goa, Daman & Diu were the other states or union territories with populations per bank office below or equal to the national average. On the other hand, Tripura, and among the states Orissa, where each office of a bank catered to the needs of 2,27,000 people, were the most under-banked areas of the country, followed by Bihar (2,18,000), Assam (1,99,000), and Jammu and Kashmir (1,26,000). However, to put Orissa's banking development during these years in perspective, it is useful to note that each office of a bank in the state served a population of about 1.2 million in 1951. In Bihar, in contrast, the number of people served by a branch of a bank fell only modestly from about 320,000 in 1951 to 218,000 in 1967.

Given the relative insignificance of non-scheduled banks, it is proposed to confine the remainder of the discussion of banking trends in this section to scheduled commercial banks.

⁵ The population per branch office of a scheduled bank in 1951 was 1,36,000.

Aggregate deposits of scheduled commercial banks in India rose rapidly from Rs 822 crores in 1951 to Rs 3,763 crores in 1967. The share of deposits of commercial banks to aggregate monetary resources climbed from 44 per cent in 1951 to 51 per cent in 1967. Despite the apparent incongruity of the stock-flow comparison, we may also note that bank deposits rose from 9 per cent of the national income to 12 per cent over the same period, and from 12 to 38 per cent of the gross savings of the household sector. The growth of deposits was accompanied by a broadly corresponding rise in the deposit accounts of banks from about 32 lakhs in 1951 to 140 lakhs in 1967. Although the proportion of personal accounts to total accounts fell, the share of personal deposits increased from 47 per cent to 57 per cent, while that of business deposits fell from 37 per cent to 25 per cent. Government and other deposits made up the remainder. This shift from business to personal deposits was mirrored in the composition of deposits as well. Demand deposits, which accounted for 55 per cent of total deposits in 1951, lost ground continuously to time deposits. As the former fell to just under 24 per cent in 1967, the proportion of time deposits increased from about 28 per cent in 1951 to over 55 per cent in 1959, before settling down at about half of the total at the end of our period.

Savings deposits, whose share of total deposits was in the region of about 16 per cent during 1951–56, declined in importance during the next four years, but thereafter registered continuous growth to reach a level of over a quarter of total deposits in 1967. While the shift from demand deposits towards time and savings deposits was stimulated by the increased spread between the interest rates offered on these types of deposits, the trend towards savings deposits after 1960 was due to a number of other factors as well. These included partly the banking uncertainty of 1960 (when as pointed out above the maturity structure of deposits generally grew shorter), growth of the banking habit among personal-account holders, the tightening of rules for time deposits, the liberalization by banks of rules governing savings accounts to make them almost as easy to operate as current accounts, and their growing popularity among personal-account holders wishing to store their transaction balances.

On the flip side, the growth in the deposits of the Indian banking system was not distributed evenly across the country, inter-state variations here mirroring those in the development of banking facilities. Deposit growth was most pronounced in a few advanced states such as Maharashtra, West Bengal, and Madras, and within them in the metropolitan centres of Bombay, Calcutta, and Madras. Other states such as Gujarat, Mysore, Punjab, Uttar Pradesh, and the union territory of Delhi also witnessed rapid deposit growth, while Madhya

Pradesh, Assam, Orissa, and Jammu and Kashmir were the laggard states. However, the wider geographical dispersal of the banking habit was also unmistakable, deposits in smaller towns and rural and semi-urban areas rising steadily during these years. Deposits at centres with populations below one lakh, for example, rose from Rs 126 crores, or 16 per cent of total deposits, in 1951 to Rs 815 crores, or 29 per cent of total deposits, in 1966.

Scheduled bank credit rose faster during our period than deposits, from Rs 585 crores at the beginning to Rs 2,727 crores at its end. Though the shift in the sectoral distribution of bank credit is somewhat overstated due to some categories of advances being reclassified during these years, it is difficult to ignore the rise in the share of industry in total scheduled bank credit from 34 per cent to 64 per cent. The share of bank credit going to commerce fell from 40 per cent to 19 per cent, while that of agriculture remained more or less steady at around 2 per cent. The credit-deposit ratio of scheduled banks fluctuated in the 1950s between 52 per cent and 71 per cent, but steadied in the 1960s around the upper limit of this range. To some extent, banks could afford to maintain a high credit-deposit ratio because of their access to Reserve Bank credit, the ratio of their investments to deposits falling more gradually than the rise in the former, from 38 per cent in 1951 to around 33 per cent in 1967. The cash reserve ratio of scheduled banks also fell from 11 per cent in 1951 to 7 per cent in 1967.

Despite the Bank's efforts, particularly after 1960, to persuade commercial banks to increase their capital and reserves, the expansion of the assets and liabilities of the banking system summarized above was accompanied by a mere 30 per cent rise in aggregate paid-up capital (from about Rs 35 crores to Rs 45 crores) and a doubling of reserves from Rs 26 crores to Rs 52 crores. In the upshot, the ratio of capital funds (paid-up capital and reserves) to deposits of scheduled banks fell from 9 per cent in 1951 to 3 per cent in 1967. To a large extent, this fall owed to the rising operational expenses of banks, particularly during the 1960s. The reported current earnings of scheduled banks increased some 7.4 times from Rs 45 crores in 1951 to Rs 335 crores in 1967. Higher credit-deposit ratios and lending rates were reflected in the share of earnings from loans and advances rising from 60 per cent of reported earnings in 1951 to 71 per cent in 1967. Earnings from investments in government securities, on the other hand, fell from 18 per cent to 12 per cent over the same period. The increase in current earnings of banks was more than offset, however, by that in their current operating expenses which rose nearly tenfold from Rs 31 crores in 1951 to Rs 298 crores in 1967. This rise was particularly sharp between 1961 and 1967 when the operating expenses of banks increased by a factor of three. Thanks to higher deposit rates, interest payments rose from 17 per cent of

earnings to 43 per cent between 1951 and 1967. After declining from 34 per cent in 1951 to 29 per cent in 1961, the share of establishment expenses rose on the back of an expanding branch network, additions to the workforce, and higher salaries to exactly a third of total earnings in 1967.

Thus, despite the impressive expansion of banking facilities, or perhaps because of it, the profitability of banking declined markedly during these years, pre-tax profits of banks falling from 29 per cent of reported current operating earnings in 1951 to 13 per cent in 1967. Even after allowance is made for the slight encouragement banks were given after 1960 to build secret reserves, there was an unmistakeable erosion in their profitability during our years. *But shareholders of banks who had bought their shares in 1951 or before had little reason to complain.* Dividends paid to shareholders went up from 19 per cent of pre-tax profits in 1951 to 22 per cent in 1956, and thereafter fell more or less steadily to 13 per cent in 1966, before rising to 15 per cent in 1967. But aggregate dividend pay-outs rose some 140 per cent from Rs 2.5 crores to Rs 6 crores over these years when, as pointed out above, aggregate paid-up capital had risen by only 30 per cent.

Table 13: Progress of Banking

	1951	1956	1961	1966	1967
1. Number of banks	566	423	292	103	91
(a) scheduled	92	89	82	76	71
(b) non-scheduled	474	334	210	27	20
2. Number of offices	4,151	4,067	5,012	6,637	7,025
(a) scheduled banks	2,647	2,966	4,390	6,416	6,816
of which—SBI and subsidiaries	643	850	1,436	2,076	2,219
—foreign banks	64	67	74	106	111
(b) non-scheduled banks	1,504	1,101	622	221	209
3. Paid-up capital and reserves	62	60	71	97	99
4. Ratio of paid-up capital and reserves to deposits	9	7	4	3	3
5. Aggregate deposits					
(a) scheduled banks	822	1,052	1,835	3,378	3,763
(b) non-scheduled banks	36	73	39	25	26
6. Aggregate advances					
(a) scheduled banks	585	745	1,277	2,434	2,727
(b) non-scheduled banks	29	43	25	15	13
7. Credit–deposit ratio	71	71	70	72	72
8. Classification of advances (% of total)					
(a) industry	34	37	51	63	64
(b) commerce	40	41	31	24	19
(c) agriculture (including plantations)	2	2	3	2	2
9. Total investments	328	395	652	1,154	1,233
of which—in Govt. securities (as % of total)	306 (93)	364 (92)	577 (88)	952 (83)	1,006 (82)

contd.

Table 13: contd.

	1951	1956	1961	1966	1967
10. Investment–deposit ratio	38	35	35	34	33
11. Cash and reserves	89	91	156	249	277
Cash ratio	11	9	9	7	7
12. Total earnings	45	65	123	291	335
13. Total expenses	31	51	94	255	298
14. Share of earnings from loans and advances to current operating earnings (%)	60	62	66	71	71
15. Share of earnings from investment in government securities to current operating earnings (%)	18	16	14	13	12
16. Share of interest on deposits to current operating earnings (%)	17	26	34	44	43
17. Share of establishment expenses to current operating earnings (%)	34	34	29	31	33
18. Pre-tax profit (% of current operating earnings)	29	21	23	14	13
19. Dividend to shareholders (% of profit before taxes)	19	22	16	13	15

NOTES: (1) All amounts in Rs crores; unless otherwise specifically mentioned, the figures relate to scheduled banks.

(2) The table is only indicative of general banking trends. Some figures may not be strictly comparable over time because of changes in classification and coverage. Intra-quinquennial variations may also be substantial in a few cases.

SOURCE: *Trend and Progress of Banking in India* and *Statistical Tables Relating to Banks in India*, various years.

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Memoranda to the Central Board and Committee of Central Board