

## APPENDIX C

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### The Palai Central Bank

The Palai Central Bank was incorporated as a public limited company in 1927 in the former state of Travancore. As other similar banks were at the time, this bank too, was included in the second schedule to the Reserve Bank of India Act in 1937 merely on the strength of its share capital and without a prior inspection or verification of its books. By all indications, it enjoyed rapid growth after becoming a scheduled bank, its deposits increasing more than tenfold from Rs 37 lakhs in 1936 to about Rs 382 lakhs twelve years later.

The affairs of the Palai Central Bank first came to the Reserve Bank's notice in 1948. But its powers of inspection were limited by the restrictive provisions of the Banking Companies (Inspection) Ordinance, 1946, which did not extend to the princely states, and all the Bank's officers could do at this time was to 'study the balance sheets' of the Palai Bank. Their study showed that while the bank had not 'indulged in any undesirable race ... to open ... branches', it did not 'conform to orthodox methods in regard to the investment of its funds'; nor had it made an attempt to 'strengthen its liquid position' to match the growth in deposits. Nearly two-thirds of its advances appeared to be unsafe or illiquid. The bank followed a generous policy on dividends, despite which its shares continued to be quoted below par, and had failed to build up sufficient reserves. Consequently, it was not in a position to 'meet losses arising out of its commitments, particularly the high level of its unsecured advances'. Verbal assurances the bank gave to the Madras office of the Reserve Bank and to the Chairman of the Madras Local Board had not been kept, and its actions subsequently did little to 'inspire confidence' in its 'ability and preparedness to eliminate ... undesirable features and conform to recognized practices in the conduct of ... business'.

The Palai Central Bank was, according to a Reserve Bank report, also poorly managed. Its management had remained in the hands of K. Joseph Augusti, about whose suitability and qualifications little was known, since 1932. The bank's resources had grown some eighty-fold during the intervening

years, and it was moot whether Augusti had the skills needed to lead an institution of the size to which the Palai Central had grown.

The dividend policy so far followed by the bank ... in combination with the poor level of its reserves and the high percentage of ... unsecured advances casts doubts whether the Managing Director is really alive to his duties and responsibilities and is capable of guiding the affairs of the bank along the right lines ....

The report noted that while it would be in the interests of its depositors to 'undertake a close examination' of the Palai Central Bank's affairs, this was not possible under the existing laws. On the other hand, since Palai Central's clean advances aggregated nearly four times its paid-up capital and reserves, the Reserve Bank should consider inspecting the bank 'after obtaining its consent' to determine whether it continued to be 'eligible for retention in the Second Schedule' of the Bank Act. In the meantime, the report proposed, the Reserve Bank of India should ascertain from the bank its liabilities and assets outstanding at branches situated in the former British India to gain some idea of the

extent to which its Indian Union branches have contributed to its deposits and secondly, whether a fair proportion of resources so obtained has been invested within the Indian Union for the benefit of depositors coming within the latter jurisdiction.

#### ATTEMPTING REFORM ...

No action appears to have been taken on the strength of this study. The first formal inspection of the bank under section 35 of the Banking Companies Act took place nearly three years later, in October–December 1951. The inspection report listed several major defects in the working of the Palai Central Bank. The bank's board of directors did not adequately oversee its working, and the Managing Director appeared to 'wield unrestricted powers of management'. He had sanctioned large clean advances to his relations, and to other directors and their concerns. The head office of the bank exercised poor control over the working of its branches many of whose advances were 'sticky and doubtful of recovery'. Advances 'showing undesirable features' constituted nearly 47 per cent of the total while unsecured advances alone amounted to nearly 40 per cent. The bank's directors, their relations, and firms in which they were interested accounted for about 13 per cent of its advances, and loans to them amounting to Rs 32 lakhs (or nearly 10 per cent of the total advances of the bank) had become sticky. Seven of the bank's twenty-four branches were

operating at a loss, three of these for the last fifteen years. The bank inflated its profits by adding to its income interest on accounts under litigation and sticky advances. It also offered high rates of interest on deposits and advertised aggressively to obtain them. As a result of 'unsound policies and methods of operation', the inspection report warned, the Palai Central Bank 'appear[s] to have lost not only its entire paid-up capital and reserves but also its deposits to the tune of Rs 3.95 lakhs'.

This report was considered by the Committee of the Central Board in October 1952. As the memorandum to the Committee recognized, the bank was liable on the basis of the inspection report to be excluded from the second schedule. But at the inspecting officer's instance, the Bank decided to invite the views of the Palai Central Bank on his findings and to defer a decision to exclude it from the schedule if its management appeared to be earnest about improving the bank's working. Although the Palai management agreed to follow the Bank's advice, there was little discernible progress on the ground. One year after the inspection, the liquidity ratio of the Palai Central Bank continued to fall, advances having 'undesirable features' had increased, and the bank continued to give large clean advances. Nor was there any change in the working of loss-making branches. The bank's overall earning capacity also appears to have suffered during these months.

The Bank however decided against 'drastic action'. According to a memorandum to the Committee of the Central Board, only a 'small portion of the deposits' was affected so far and exclusion from the second schedule may 'apart from creating a run on it, have serious repercussions on other banks in the Travancore-Cochin state' where the Palai Central occupied an 'important position'. Besides, there was no evidence of the bank's management having 'acted fraudulently' and it also appeared more willing now than in the past to 'act upon ... [the Bank's] advice or guidance'. These considerations and the relatively large size of the Palai Central—the 'fact [is that] that the depositors' stake in the institution ... [is] considerably high'—encouraged officials at Mint Road in October 1952 to put off for six months, a decision about the bank's exclusion from the second schedule should it agree to follow the Bank's directions. This course of action, the memorandum to the Committee argued, gave the Palai Central Bank 'a reasonable opportunity to improve its methods of operation', while by maintaining a close watch the Bank would be able to step in, if necessary, to prevent their 'further ... deterioration'.

The conditions the Bank imposed on the Palai Central Bank included appointing a Banking Adviser in informal consultation with the Bank. The Adviser would not be subordinate to Joseph Augusti, whose powers as Managing Director the Bank sought thereby to restrict, and would report to the board of

directors of the bank to whom he would furnish advice in writing 'on all important matters of policy'. The bank was also asked to desist from granting advances to its directors, their relations, or firms in which they held an interest, ensure that its books of accounts were maintained properly, bring down clean advances to a 'reasonable proportion of its total advances', and report to the Bank at monthly intervals its progress in implementing these reforms. Finally, the Reserve Bank reserved the right to demand any information about the bank and to depute its officers to verify the information supplied to it and watch over the bank's progress in implementing these conditions.

While the Palai Central Bank maintained that these conditions were either unnecessary or not in the interests of its constituents, it took violent exception to the last condition, viz. the appointment of an observer, two directors of the bank even calling at the Bank's office in Madras to voice their protest. They and the bank argued that Palai was 'practically a village with one street', and a visitor would 'naturally catch the public eye and become the subject for gossip'. Daily visits by the observer to the bank's head office could 'cause the talk to gain momentum'. The Palai Central Bank had grown in a small place such as Palai 'as no bank in a similar place in India had done'. This was entirely due to the confidence the public had in the bank's directors, and any suspicion that the affairs of the bank were under close scrutiny by the Reserve Bank would have 'unwholesome repercussions'.

Officials at the Bank thought these apprehensions unfounded. But they decided to meet the Palai Central Bank's objections halfway by stationing the observer at Kottayam, a town some seventeen miles from Palai, and leaving it to him to determine the frequency of his visits to the latter centre. But two of the bank's directors then called on the Deputy Governor, Ram Nath, to press for a reconsideration on the plea that they had already engaged a former officer of the Imperial Bank as an adviser. Following this, the Bank decided towards the end of January 1953 to postpone appointing an observer until July, and to rely in the meantime on monthly reports from the bank.

In July the Bank undertook a rapid scrutiny of the bank's accounts which revealed little improvement in its affairs. But the scrutiny also seems to have convinced the Bank that reforming Palai Central was going to be a long haul. Hence, while deciding to impose another condition, viz. that its directors, with the exception of the Managing Director, would not hold any office of profit in the bank, the Reserve Bank gave Palai Central until the end of 1954 to improve. The question of appointing an observer was also deferred till December 1953. In November 1953 the Palai Central Bank resumed its campaign against an observer. J.A. Frost, the aforementioned adviser, arguing that the move would have 'serious repercussions'. The Palai Central Bank's

deposits had grown steadily until his appointment. Thereafter, its rivals 'promptly made capital', quoting his arrival as evidence that all was not well with the institution. As a result, Palai Central had lost deposits of nearly Rs 40 lakhs since the middle of 1953, of which the Ernakulam branch, where his own office was situated, alone accounted for Rs 2 lakhs. Frost thought there was no justification for sending an observer. He himself attended all meetings of the bank's board. The bank had stopped practically all advances 'except against gold ornaments and ... deposits', and advances exceeding Rs 10,000 were now sanctioned only by the board. Directors of the bank had also begun to repay their loans, and the bank had filed nearly 150 suits to recover advances. He was currently preparing a manual which provided for tight head office control over the branches. The bank had a superintendent of advances and an inspector of branches, and hoped soon to appoint a retired official of the Imperial Bank as its chief accountant. Far from 'helping matters', the appointment of an observer Frost argued, would have 'extremely unfortunate repercussions'.

Officials at the Bank felt Frost's fears were exaggerated. But once again the Bank chose in the end not to test them, and decided in January 1954 to postpone a decision until July. In the meantime, the bank was allowed to open a branch at Madurai.

Predictably, the Palai Central Bank resumed its campaign in July 1954. Apart from its earlier arguments, the bank now pointed to the growth of its deposits and its lower credit-deposit ratio. It had cash on hand and with banks of Rs one crore against deposits of Rs 5.65 crores, and its investment in government securities totalled about Rs 1.14 crores. The bank also claimed to have made progress in recovering outstanding advances. Officials at the Reserve Bank conceded that the overall financial position of the Palai Central Bank was now 'slightly improved' and that it had begun to satisfy some of the conditions imposed earlier. The Bank therefore decided that the question of sending an observer 'no longer possessed the same urgency as it did before', and the expiry in December 1954 of the time granted to the Palai bank to remedy its functioning offered a suitable opportunity to review the situation.

This review, which took the form of a 'rapid scrutiny of the affairs' of the Palai Central Bank early in 1955 by O.R. Srinivasan, the Trivandrum-based Deputy Chief Officer of the Bank's Department of Banking Operations, revealed that although the bank had rectified most of the procedural defects noted in the earlier inspection report and restricted fresh advances, its financial position was now actually worse than in 1951. Even 'on the basis of a very liberal assessment of the real value of its assets', it was apparent that deposits to the extent of Rs 51.51 lakhs were at risk now as against

Rs 4 lakhs in 1951. Many advances which were unsecured and outstanding in 1951 had now reached a 'stage of complete stagnation' and been 'inflated in their book value to an alarming extent due to periodical applications of interest that is being booked to income ....' Advances amounting to Rs 89 lakhs out of total advances of Rs 343 lakhs were 'unrecoverable'. The bank also kept its records in a manner which did not easily reveal the true financial position of the borrowers, and 'in its desperate attempts to maintain the confidence of the public and collect more deposits without which it cannot survive', it showed 'unreal profits out of which dividend and taxes are paid and reserves ... built up'. The bank's board of directors refused to view the situation with the seriousness it deserved, and directors who were indebted to the bank appeared to 'find it embarrassing to sit in judgement over the debts of ... other borrowers'. Consequently, the board of the bank had not made 'earnest attempts' to evolve a 'planned programme' of recovering advances. The scrutiny report concluded by pointing out that 'however honest the intentions of the management', it had proved incapable of recovering or reducing frozen advances. 'A further deterioration in the solvency of the bank' was almost certain if its present management was allowed to continue or was given more time to implement the Bank's conditions. The scrutiny officer therefore recommended a 'detailed re-inspection' to better establish the bank's true state of affairs and determine the future course of action.

At first blush the Bank thought Srinivasan's report made a strong case to 'warrant' the bank's exclusion from the second schedule. But this step was not taken because it was likely to have 'far-reaching effects in the Travancore-Cochin State' where the Palai bank was the largest of five scheduled banks, two others among which were already in a 'vulnerable' position. Besides, the bank had not been entirely idle and had taken some steps to improve its affairs. Though incompetent, neither had its management done anything to 'jeopardize the depositors' interests further'. Hence the Bank decided in April 1955, 'as a special case', to grant the Palai Central Bank another year to remedy its affairs, and in the meantime to direct it to appoint a chief executive in place of the adviser (who it appears wanted to quit), desist from offering more than 4 per cent on any class of deposits, refrain from booking as profits unrealized interest on frozen and doubtful advances, and recover at least a quarter of the bad debts and half the doubtful debts classified by the scrutiny officer. It was also decided to invite Joseph Augusti for an interview with Ram Nath.

These conditions invited spirited opposition from the departing Frost. Summarizing the progress the bank had made since he was appointed to his present position, Frost told T.V. Datar, Chief Officer of the Department of

Banking Operations, in June 1955 that the affairs of the bank had actually improved since its inspection in 1951. The advances which the Bank's scrutiny officer identified as having 'undesirable features' were granted before 1948, and the bank's working had improved steadily since the new executive took office in 1949. Frost argued that the bank's immediate requirements were 'cheaper funds, larger deposits to provide high earnings without undesirably increasing the ratio of advances to deposits, and ... time to recover outstandings'. The latter was, however, best achieved through negotiating rebates in return for regular instalments, rather than 'summary legal action'. Such recoveries, Frost said, must 'necessarily ... be slow'.

The additional conditions the Bank wanted to impose on the Palai Central Bank, Frost maintained, were largely inspired by his letters to Joseph Augusti. But while he had advocated 'the surgeon's knife, the scrutinizing officer apparently preferred the hatchet', and it would be impossible for the bank to fulfil these conditions without eroding public confidence and bringing on a banking crisis. Instead of despatching an observer, Frost proposed, the Bank should undertake more frequent scrutinies of the Palai Central Bank. The latter should also be allowed to reduce the cost of its funds in a less obtrusive way than by lowering the maximum interest rates it offered on deposits. If the bank was prevented from booking interest on doubtful advances to income, it would be forced to show a loss. 'No possible advantage can result from this change.' Doubtful advances, moreover, were not always irrecoverable. Expressing himself satisfied with the present head office executive and its decision to engage two retired officers of the Imperial Bank, Frost claimed the set-up proposed by the bank was superior to the Bank's proposal to replace the chief executive.

*If in addition to the recent reduction in dividend, the appointment of a Reserve Bank observer, the lowering of deposit rates, and the declaration of a loss in the bank's working, a stranger, however well qualified, replaced a man of Mr. Augusti's standing in the small centres where the bank is established, the result would be disastrous. Nothing can be lost, and much gained by giving my suggestions a fair trial.*

The Managing Director of the Palai Central Bank also represented to the Bank in similar vein. Some directors of the bank called on Ram Nath late in June 1955 to protest against the plan to depute an observer as it would encourage the 'communist plan ... of fanning the flame of evil rumours' about the stability of the bank. At this meeting Ram Nath suggested 'amalgamating the bank with some other banking institution'. The directors rejected the

suggestion and sought more time to set their affairs in order. They promised gradually to reduce the interest the bank offered on deposits and pointed out in defence that a government-supported bank in the region and the Mysore government both offered 4.5 per cent on longer-term funds. The bank also argued against hastily classifying any of its debts as doubtful and showing 'imaginary losses' in its accounts. Then followed an exchange of letters between Mint Road and Palai after which the Bank decided in October 1955 to re-inspect Palai Central early in 1956 and in the meantime to relax many of the conditions the latter had taken objection to. The Bank retained the option to send an observer but did not, in the event, do so. The Bank also decided not to press for Augusti's replacement which, officials now agreed, might 'jeopardize the confidence of its constituents as he was a founder of the bank and had nursed it since ... inception'.

#### ... AND ENCOUNTERING RESISTANCE

The Palai Central Bank was inspected in February and May 1956 with reference to its position at the end of 1955. This inspection revealed that most of the major defects noticed earlier 'remained unrectified' or had worsened. The Managing Director, six of whose cousins held responsible posts in the bank, was incapable of taking energetic steps to improve its working. Many of the advances granted by the Manager of the bank's Madras branch, who also happened to be one of its directors, had turned sticky. He and his wife owed the bank nearly Rs 13.5 lakhs in the form of clean advances, and although he repeatedly flouted the head office's directions, it was unable to 'exercise effective control over him in view of his dual capacity ...'

Despite being in business for nearly three decades, the bank had meagre reserves. Its reserve for bad or doubtful debts was small even by normal standards. Nearly a third of the bank's deposits carried high interest rates of 4.5-5 per cent, and over 60 per cent of its advances were unsecured. There was a high 'concentration of risk' in the bank's advances, as nineteen borrowers, including some of its directors, accounted for nearly 44 per cent of the total. Nearly half the advances of Rs 34 lakhs owed by the bank's directors had been outstanding for over twenty-five years. Sticky and disputed advances and those having 'undesirable features' amounted to nearly Rs 270 lakhs, or more than three-quarters of all advances. The 'bank's income', the inspection report warned, was 'mainly derived from unrealized interest charged by it on sticky advances'. The estimated realizable value of the bank's assets amounted to about Rs 520 lakhs as against its total outside liabilities of Rs 659 lakhs, indicating that not only were its paid-up capital and reserves wiped out, its deposits also had been affected to the tune of Rs 139 lakhs.



There was, the report concluded, 'sufficient material' to suggest that the bank was 'conducting its affairs in a manner detrimental to the interests of its depositors'. It did not, besides, comply with sections 11 and 22(3)(a) of the Banking Companies Act and section 42(6)(a)(i) of the Reserve Bank of India Act. A note written in August 1956 and enclosed with the inspection report also detailed the bank's resort to 'objectionable methods of manipulation of accounts, creating fictitious assets which did not exist, and inflating incomes which did not really accrue'. These practices had been going on for several years, but after 1952 the bank was 'faced with the ... awkward problem of wiping out a huge intangible asset aggregating to Rs 16.96 lakhs' which was a 'legacy of past manipulations'. These 'assets' could 'no longer pass without notice', nor could the bank adjust them out of its 'normal earnings' since its income from advances, much of which was frozen, was declining. Hence, the note added, the bank had adopted the 'ingenious method of "creating" income for the above purpose out of certain "dead advances" ....' Despite the management of Palai Central refusing to cooperate with their investigations, the Bank's inspectors felt they had unearthed enough evidence to establish deliberate manipulation of the bank's books and to pin responsibility for it on individual officials.

The note ended with a strong indictment of the manipulations by the bank of its books which, it said, could not

by any standard be regarded as in the nature of a normal window-dressing permitted at times by convention. .... The *intention* behind these manipulations has clearly been to create false income and assets ... for the definite purpose of presenting a better and more satisfactory picture ... of the bank than would otherwise be warranted by *actual* results of its working known as such to the management. The elements necessary to prove guilt are intention, knowledge, and motive, and it has been amply borne out ... that in passing false entries for the purpose of its annual accounts and balance sheets, these have been present in this case. .... All these facts lead to the inference that the Board of the Bank on the whole has not been straightforward and has pursued policies which, by no accepted standards, ... satisfy the requirements of honest management. [Emphases in the original.]

Suggesting that these manipulations explained why the bank opposed the appointment of an observer, the note concluded that the Bank should not allow these 'highly objectionable manipulations' to 'pass ... without taking serious notice' of them.

For reasons that have been suggested in the main chapter and are referred to below, events thereafter appear to have moved rather slowly. A copy of the inspection report was sent to Palai early in January 1957. The bank's response came at the end of April 1957 in the form of a thirteen-page letter from Augusti. It is not clear whether Augusti was emboldened by the results of the recently concluded elections in the state to adopt a combative tone, but his letter questioned the judgement of the Bank's inspector who, he alleged, came from a region having 'little in common with the differing problems and features' of the Travancore-Cochin region, spent too little time in Palai to assess his bank's working in the 'proper perspective', and whose 'knowledge of practical problems that face a private joint-stock banker in day-to-day working' was 'meagre'.

He could not realize the difficulties and obstacles that have to be surmounted in piloting an institution through good times and bad, through war and peace, through periods of rise and fall of prices, through legal labyrinths, state enactments and political upheaval. He does not seem to have viewed the complexities of the problems involved in adapting and shaping an institution to suit standards and procedure which became applicable to it a generation after it was founded.

Alleging that the picture of the bank painted by the inspector was 'incorrect, contrary to facts, and ... absolutely misleading', Augusti said he had disposed of the members of the board in a 'slipshod way'. The report's assessment of every feature of the Palai bank was 'coloured and clouded'. The bank had made rapid progress since 1951 despite the 'restrictions, the difficulties and the vexations that arose from continued inspections'. Its deposits had grown from Rs 4.75 crores to nearly Rs 6.5 crores at a time when other banks in Kerala, including those enjoying government patronage, were losing deposits, the state was rocked by 'unrest and political instability' and 'continued onslaughts against capital and financial institutions', and Mint Road had refused to allow Palai Central—whose requests to do so had purportedly received 'assurances of sympathy from some of the highest quarters in the Reserve Bank and in the Ministry of Finance'—to open new branches. His bank, Augusti argued, could have shown better profits and paid out larger dividends if it had not been forced by the Reserve Bank to reduce its ratio of advances to deposits from 65 per cent to 54 per cent.

The letter ended by remarking on the 'widespread feeling throughout ... Kerala' that the 'peculiar economic conditions of the state' and the 'banking problems' arising from them were not

assessed in a proper light by the Reserve Bank of India authorities. One of the complaints heard during the recent elections was that the small banks in the state were being sacrificed. ... the cry of the small banks is a voice in the wilderness. ... unemployment and unrest are increasing due to the impediments put in the way of banking development and the consequent decline in business activities. The people here affirm that by discouraging small banks, the only means of obtaining rural credit are being withdrawn.

The Bank read Augusti's letter as a sign that the management of the Palai bank did not 'even now realize the gravity of the situation'. There was no argument in the letter that warranted a fresh or 'favourable consideration of the bank's case'. However, since any 'penal action against it at the present time might bring in its trail serious repercussions on the banking structure in Kerala' where the Palai Central Bank occupied a 'prominent position', the Bank decided at the end of June 1957, to give it 'one more year's time to improve its position', and in the meantime 'continue keeping its affairs under ... surveillance by imposing a fresh set of conditions'. It was also decided to summon one of the directors of the bank to impress upon him the need to reorganize the bank on 'sound lines', rectify its defects, 'explore the possibility of amalgamating it with some other banking company', and put right the bank's 'questionable transactions'.

The conditions imposed on the bank at this stage included better head office and board supervision of its branches, immediate appointment of a qualified and experienced chief executive officer, removal of the Madras manager, K. George Joseph, stopping all fresh advances to the bank's directors, their relatives, and their concerns, bringing down unsecured advances to a fifth of total advances, creating a 'specific reserve' equivalent to the unrealized interest on bad or doubtful debts credited to the profit and loss account, and taking steps to improve earnings and strengthen reserves. Finally, apart from securing monthly statements from the Palai Central Bank, the Bank reserved the right to call for any statement or information it required and to depute its officers to attend meetings of the bank's board and scrutinize its books. The Bank also warned that if any of these conditions were violated or the bank was found to persist with policies that were detrimental to the depositors' interests, it would pass 'without any further notice', orders under section 42(6)(b) of the Reserve Bank of India Act on the strength of the inspection report of December 1956.

These conditions, and the Bank's decision to defer action for twelve months if it accepted them, were communicated to the Palai bank in July 1957.

Predictably once again, the Palai Central Bank protested these conditions, in particular the one calling for Augusti's removal, as it would 'spread mistrust' about the bank and weaken its ability to improve its affairs. In letters to the Bank in October and December 1957, the Palai Central Bank argued that the appointment of an observer was also the 'surest way to undermine the credit of a bank', particularly one located at a small centre. The creation of a specific reserve to balance the unrealized interest on advances credited to income, the bank also said, would create an 'imaginary loss' and 'unwanted panic and trouble' for the institution. Pleading for a waiver of the proposed conditions, the bank said the Reserve Bank's 'sympathy and farsightedness' had already enabled it to rectify some of the features pointed out in the inspection report and strengthen its position. Its liquidity was also now being maintained at a very high level, but all these efforts to 'improve the working of the bank would be in vain if public confidence ... [was] ... shaken in the least'.

The Palai Central Bank's latest response clearly tested the patience of officials at the Bank. None of its arguments was new. They were, in fact, 'stereotyped and ... common to most of the banks in Kerala who often take shelter by laying ... emphasis on ... peculiar local conditions'. The bank refused to accept the conditions imposed upon it and was intent on pursuing 'dilatatory tactics'. Nor had the bank recently sent a director to meet Ram Nath or replied to the reminders sent to it in this connection. The tactics adopted by the management of Palai Central to evade the Bank's conditions and the recent 'upward trend noticed in its deposits', officials at Mint Road felt, indicated the need for 'some sterner action ... in the interests of ... depositors'.

The 'sterner action' the Bank now proposed was to take advantage of the amendments to the Banking Companies Act that came into effect in January 1957 to issue directions (section 35A), depute an observer (section 36) to the Palai Central Bank, and back the former up with the threat of refusing it a banking licence. These directions were issued at the end of January 1958 and the bank asked to comply with 'each of the directions' failing which it would attract a 'notice informing that a licence cannot be granted to it'. The Bank also deputed one of its officers, C.N. Sivabhusanam, to attend meetings of the board of directors of the bank and of the committees constituted by it, and to keep a close watch over the bank's affairs. Although the bank had no option now but to accept these directions and implement them, it continued to plead with the Bank to be allowed to retain Augusti as Managing Director and to appoint the Superintendent of Advances, K.M. George, as its chief executive. Officials in Bombay saw little merit in the suggestion which they felt promised no departure from the bank's 'old business policies'. But they had little choice in the matter. The banking situation in Kerala—in particular

the Travancore-Cochin region and the recommendations of the recent expert committee which dealt with the subject—constrained its options. The best hope in the circumstances lay in recovering as large a proportion of Palai Central's doubtful and sticky advances as possible, and officials at Mint Road were persuaded by a plea from the Trivandrum office that George's appointment might help achieve that objective.

Seeking also to keep the affairs of the Palai Central Bank under constant review, the Bank undertook another inspection of the institution in March–May 1958, with reference to its position at the end of February the same year. This inspection revealed that the bank's deposits had been affected to the extent of Rs 177.24 lakhs, as against Rs 139.13 lakhs at the time of the last inspection barely two years earlier, and that it was not in a position to pay its depositors in full as their claims accrued. Deposits and advances had also grown substantially during this period, the former mainly due to aggressive publicity campaigns and the bank's success in enlisting the support of some religious institutions. However, the bank had failed to implement most of the important directions and even violated some. Despite the directive against making advances to directors, their relatives, or their concerns, the bank had purchased cheques and drafts from concerns in which a director held a substantial interest. It had also continued to make fresh unsecured advances, which now amounted to nearly three-quarters of total advances as against about 60 per cent at the time of the last inspection. Most of the other major defects still remained to be rectified. Head office control and supervision over the branches was weak and ineffective, the bank's books of accounts continued to be in an unsatisfactory state, and its reserve remained 'small'. Twenty borrowers accounted for advances aggregating Rs 179.98 lakhs (or 42.7 per cent of the total). Advances having undesirable features and those in respect of which suits had been filed amounted to over three-quarters of all advances, and in the inspecting officer's judgement, Rs 208 lakhs (or nearly half the bank's advances) were irrecoverable. A 'major portion' of the bank's income was derived from 'unrealized interest on advances, a sizeable portion of which had become sticky'. It had been charging higher interest on certain decreed debts than those stipulated in the relative decrees, and was charging interest on certain advances in respect of which it had no legal remedy. Yet, the report pointed out, the bank continued to pay dividends.

The inspection report forced the Department of Banking Operations at last to acknowledge in September 1958 that there were good reasons to deny the Palai Central Bank a licence under the Banking Companies Act. But not knowing how deep the waters were, it refused to take the plunge. 'Drastic action', the department explained, was 'fraught with many risks' including 'adverse

repercussions on the entire banking structure of Kerala'. That was not the end of the Bank's dilemmas. Even a change in the bank's management, the department argued, might create problems. Although it had mismanaged the bank's affairs, the present board comprised 'influential persons', and removing them would 'lead to undesirable rumours'. Nor was it possible, because of the 'large depreciation' its assets had suffered, to amalgamate the Palai Central Bank with some other institution. On the other hand the Bank's regulators could not wish away the formidable challenge which the Palai Central Bank posed, and they decided to issue a fresh set of directions in the hope of bringing home to its management the seriousness of the situation, and achieving a 'speedy improvement' in its affairs. These directions included prohibiting the bank from declaring dividends until a reduction had been achieved in the size of its bad and doubtful debts and asking it to appoint four additional directors in consultation with the Bank; the latter largely so that the bank's board could no longer argue that it was prevented by its composition—all the directors were in debt to the bank—from reviewing the dues of its members!

By this stage the Governor, H.V.R. Iengar, was also in the picture. He remarked that the 'state of affairs' disclosed by the inspection report was a 'very sorry one'. But the action the Department of Banking Operations now contemplated

seven years after we first knew the bank is being mismanaged is likely to be criticized as being weak and ineffective and not in accordance with the interests of the depositors, in particular *new* depositors likely to be attracted by the advertisements of the bank.

The Governor conceded that in the end the Bank might be 'driven' to take the mild action suggested by the Department of Banking Operations, but he wondered whether 'as an opening gambit', a notice should not be issued to the Palai Central Bank asking it to show cause 'why a licence should not be refused' to it.

The Department of Banking Operations knocked back the Governor's proposal. It had been decided 'on grounds of policy, not to refuse licences to banks ... operating in Kerala'. Besides, the show-cause notice 'might leak out to the depositors and cause a scare among them', thereby ruining any hope of improving the bank's position or of 'reconstructing it on the basis of a scheme of arrangement'. Instead, the department proposed deferring a decision about what action to take against the bank until its directors had been sent for and acquainted with the findings of the Bank's inspectors. The Governor acknowledged the strength of Banking Operations' argument, but maintained that the Reserve Bank should tell the Palai bank when its directors

called at Mint Road that there was a case for 'descheduling the bank ... (and) ... refusing it a licence', and ask them to explain why this action should not be taken.

The directors of the Palai Central Bank called on Ram Nath two months later on 20 November 1958. In the meantime, the Bank directed the Palai bank not to declare a dividend until it managed to bring its bad and doubtful debts down to a reasonable level. Ram Nath pointed out to the directors that nearly a quarter of the deposits of their bank had been wiped out and wondered aloud why it should not be descheduled or refused a licence. The Palai Central Bank, the Deputy Governor declared, 'had the distinction of being the worst-managed scheduled bank in the whole of India'. In response, the directors alleged that 'some enemies of the bank' had conveyed 'false reports' about it to the Reserve Bank. The Palai bank, they contended, had progressed rapidly since the Bank first inspected it. It had not made any fresh mistakes, and the high proportion of bad advances was a legacy of the past. While the bank could not carry on business if it was denied a licence, even de-scheduling would force its closure. The latter 'will mean not only a serious setback to banking in Kerala but might even involve an economic crisis in South India'. In the end, the Bank told the directors of the Palai Central Bank to study the inspection report and to explain within a month why action should not be taken against their institution.

The Palai Central Bank came back with a prompt but partial response. While it acknowledged the defects pointed out by the Bank's inspectors, it was silent on why it should not be descheduled. But the Bank decided once again against any 'drastic action' because of its likely effects on the other Kerala banks. The Committee of the Central Board, the Department of Banking Operations also observed, had decided to 'go slow' in refusing licences to Kerala banks for another year. However, since the necessity remained in the meantime of alerting shareholders and the public to the 'seriousness of the situation, which the Board of Directors is not prepared to admit or appreciate', it should be prevented from declaring dividends.

The stoppage of dividend which it has been paying all along would have the effect of putting the public on guard that all is not well with the bank and this step is likely to bring about a check on the inflow of deposits to some extent, the department argued.

This direction was issued in November 1958.

Meanwhile, thanks to the earlier growth in its deposits the Palai Central Bank graduated from the 'C' class of banks to the 'B' class. The new

classification had little banking implication, intended as it merely was to determine the salaries payable to a bank's employees. Though the reclassification portended fresh trouble for the bank in the form of a higher wage bill, Palai's directors preferred to see it as a fresh affirmation of the strength of their institution. Consequently, the bank responded to the Reserve Bank's latest direction in February 1959 with a fourteen-page letter from Augusti which recalled its origins in a small village, its ability to withstand a succession of crises including the depression and the banking panic of 1937-38 in the region, and its growth to the status of one of the top twenty banks in the country and the largest bank in Kerala despite the presence of government-supported local banks in the state. Earlier restrictions imposed by the Bank, Augusti claimed, had only helped undermine the health of the institution and placed 'serious handicaps' in the way of its growth. Despite this, its deposits had grown rapidly. The Reserve Bank, according to Augusti, was also to blame for the large proportion of Palai's bad or doubtful advances. Left to itself the bank would have recovered these advances. But Reserve Bank intervention had had the effect of giving borrowers the impression that if they repaid their loans, 'no fresh advances would be allowed and their business and honour would be imperilled'. Besides, the bank was not

allowed to open any branches during the last nine years except one. We were continuously expanding over the 21 years prior to the [first] inspection. If we had only been allowed we would ... have grown to thrice the size of what we are. Our means of earning profits would have been enlarged. The old debts could have been considerably recovered and fresh advances on sound basis could have been granted.

Alleging that the Bank's licensing decisions were arbitrary, the letter cited instances of banks refused licences because of the way their affairs were conducted, 'repaying their deposit liabilities in full within weeks of the refusal of licences'. The liquid assets of the Palai Central Bank, the letter maintained, amounted to 47.6 per cent and 'all easily realizable assets' to 80 or 85 per cent of its deposits.

Augusti also objected to the restriction on dividends. The resulting saving of Rs 1.25 lakhs (at a rate of 5 per cent which was the dividend the bank paid out since 1955) would not improve the reserves significantly. Besides, it would take eight years by this method to make the bank's reserves equal its paid-up capital. The faster way to 'increase ... reserves, ... wipe off ... losses and to strengthen our position' was to 'increase ... earnings'. It was



important consequently to ensure that the bank's 'integrity' was 'left unimpaired' and it was allowed to increase the ratio of advances to deposits from the present level of about 53 per cent to 60 per cent or more. This 'cannot safely be done if there is a stoppage of dividend and consequent loss of prestige'. The letter ended with a plea for 'understanding and wisdom' from the Reserve Bank and a thinly-veiled reference to the political circumstances of the state.

The State of Kerala even now has vexatious problems which defy solution and are baffling to the supreme authorities in the country. We fervently hope that the Reserve Bank will ... help us in every way so that the discontent among the people of the State may not be aggravated [and] ... the integrity of the country ... [may be] consolidated.

Augusti's letter was followed a month later in March 1959, by one from George Thomas Kottukapally, the Member of Parliament from Muvattupuzha and a director of the Palai Central Bank, to the Governor. This letter was largely on the same lines as the longer one from Augusti, and pleaded in particular for relaxing the ban on dividends. Thomas also referred to the contemporary political situation in Kerala in rather more direct terms.

Conditions in Kerala ... are difficult and different from the rest of India. Under existing conditions we live in severe strain under a regime ideologically opposed to everything that we stand for. I fervently hope, as the supreme head of our entire banking system, you would view the position in all its implications and all its varied and comprehensive aspects and extend your support which a subsidiary institution deserves especially at a time such as we pass through in Kerala.

Referring to the 1938 banking crisis, Thomas remarked that it was

a sad thought for the historians of the time, that if the *Central Banking Institution* had moved during the TNQ Crisis the economic conditions of Kerala would have been different, and its political developments would not have taken the tragic turn [they have] taken today.<sup>1</sup>

<sup>1</sup> The abbreviation TNQ here refers to the Travancore National and Quilon Bank. The collapse of this bank is discussed on pp. 183-90 of the earlier volume of the Bank's *History*.

Soon after this letter towards the middle of April, the Governor gave George Thomas an interview in the course of which he refused to reconsider the Bank's decision on dividend payments by Palai Central. As an office note written in April 1959 explained the decision of six months earlier, the Palai Central Bank was

systematically giving publicity through advertisements about the services rendered by it to the public, and this may also be one of the main reasons for the steady growth of its deposits. The ... directive is therefore intended to safeguard the interests of its existing and future depositors.

#### A NEW APPROACH?

There matters largely rested during the remainder of the summer, though the Bank used this period to urge the Palai Central Bank to create a reserve against specific advances and to add four new members to its board. Three months after Iengar's meeting with Thomas, the Palai Central Bank decided in July 1959 to introduce a 'Cumulative Savings Scheme' differing little from similar schemes introduced by other banks.

On past form, the Reserve Bank might have been expected to stop the scheme. Apart from leaning on the Palai bank to improve its affairs, the Bank's efforts had earlier been to protect the interests of the wider public by discouraging its members from placing fresh funds with this institution. There were limits to the extent to which new depositors could be discouraged without encouraging existing depositors to flight. Consequently, the Bank never formally asked Palai Central not to take fresh deposits. However it attempted to make it more difficult for the sick bank to attract new deposits by not allowing the latter to open new branches, advertise widely for deposits, offer high interest rates, and most recently, pay out dividends. During these years, the Palai bank had applied to the Bank several times to be allowed to take the new deposits route to rehabilitation, but always in vain. As recently as March 1959, when George Thomas made a similar request, the Bank had thought his argument 'strange!'

In August 1959, however, the Bank, for reasons that remain a mystery, turned its back on the earlier approach and supported the Palai Central Bank's plea to be allowed to attract deposits under its new scheme. Remarking on the request, an official pointed out that the bank's earning capacity was 'already low', and a 'substantial portion' of its existing advances were difficult to recover.

Hence, the chances of its retrieving its position will be slim if it cannot successfully augment its earning capacity and build up adequate surplus as to be in a position to write off, in due course, the bad debts. As a significant portion of its existing resources is practically locked up in sub-standard or irrecoverable advances, the bank cannot but make efforts to increase its resources as a necessary prelude .... Thus, although there is an inherent danger of permitting it to introduce schemes intended to attract further deposits, this is an unavoidable step if the bank is to rehabilitate itself.

The note went on to remark that the Reserve Bank so closely oversaw the working of the Palai Central Bank that the 'scope for any further abuse of funds or frittering away of resources by the bank' was 'limited'.

In the circumstances and as it is not our intention to de-schedule the bank or refuse a licence to it before giving it the maximum opportunity to rehabilitate itself, it does not appear desirable for us to object to the bank's proposal ....

Somewhat contradictorily, the note also argued that the

sudden non-declaration of dividend on shares by the bank for 1958, pursuant to the direction issued by us, would have already put the public on guard to some extent in regard to the real financial position of the bank. Consequently, it is doubtful whether, in practice, any significant response to the new scheme of deposits will be forthcoming.<sup>2</sup>

The course of action proposed in the office note was hotly debated within the Bank, the Executive Director, C.S. Divekar, observing that he was not convinced by the 'reasoning' behind it. The Palai bank, he said, was

on the brink and for some time to come it should not go in for additional commitments but concentrate on setting its house in order. The R[eserve] B[ank] would be perfectly justified in descheduling them but having decided not to precipitate a crisis, let us not be parties to ... unwary depositors being trapped by them.

<sup>2</sup> In the event, despite the ban on dividends, the bank's deposits increased from Rs 855.56 lakhs at the end of December 1958 to Rs 968.77 lakhs at the end of December 1959. This, according to a memorandum to the Bank's Central Board in February 1960, belied the Palai Central Bank's contention that the 'stoppage of dividend ... will jeopardize its reputation'.

But a meeting with the Chief Officer of the Department of Banking Operations appears to have set Divekar's reservations at rest, for the Bank decided to allow the Palai bank to introduce the new deposit scheme while keeping a 'watch over the amount of deposits' collected under it.

Whether and how far the Reserve Bank allowed extraneous considerations, such as the surcharged social and political situation in Kerala, to affect its judgement on this question must remain a matter for conjecture. But it is evident from reports in the local press that the Palai Central Bank was not above the contemporary political fray in Kerala. We have already noted that a Congress member of Parliament from Kerala was a director of the Palai bank which also orchestrated protests by the region's banks against the state government's agricultural debt relief legislation. These protests culminated in a decision taken in May 1959 at a meeting of bankers hosted by the Palai Central Bank, to boycott the state government's loan programme that year, and force its abandonment. There were reports in the state's political press that the bank held the deposits of the state Congress party, bankrolled the 'liberation struggle' against the United Front government, and that its resources had been eroded in consequence.<sup>3</sup> Such charges cannot be verified. But we may note in passing for what it is worth, that the Bank's decision to relax its long-standing policy of preventing the Palai Central Bank from actively seeking fresh deposits coincided with a period of heightened social and political strife in Kerala.

Whatever the other pressures and motivations, there were limits to how far the Reserve Bank could backtrack on the course it had pursued for the past many years. It will be recalled that in January 1958 the Bank directed the Palai bank to create a specific reserve or make a provision equivalent to the interest charged to accounts considered by the Reserve Bank to be bad or doubtful of recovery. The bank then set up an 'Interest Deferred Account' which accumulated Rs 4.05 lakhs during 1958. But rather than show a loss (of some Rs 37,000) in 1958, the directors of the Palai bank preferred to violate the Bank's direction and transfer the amount in the 'Interest Deferred Account' to its profit and loss account. This enabled the bank to show a profit of Rs 3.78 lakhs for 1958, but also necessitated a provision of Rs 2 lakhs towards taxes. Asked by the Bank to explain its conduct, the management of the Palai bank argued that if it was prevented from taking credit in the profit and loss account for interest on all the debts the Reserve Bank's inspectors considered bad or doubtful, the balance sheet for 1959 would end up showing

<sup>3</sup> A malicious report even claimed that forged currency notes detected in circulation in the Coimbatore region were kept in safe custody at one of the bank's branches.

a loss of Rs 16 lakhs. This 'disclosure all of a sudden' it argued, 'might cause a panic among its depositors and result in a crisis'. But it was not only the Palai bank which was caught in the cleft-stick. So was the Reserve Bank, which sympathized with the fears voiced by the management of the Palai Central Bank. But it could not relax the directive relating to special reserve provisions without seeming to 'acquiesce in the manipulation resorted to by the [Palai Central] bank'. Since 'either course was fraught with embarrassing consequences' the Bank decided to take the matter to the Southern Local Board and also hold a new round of discussions with representatives of the Palai Central Bank.

#### THE FINAL WEEKS

It was a chastened group of directors who came to Madras in December 1959 to discuss the crisis facing their institution. Willing at long last to concede the enormity of the crisis facing the Palai bank and to take urgent steps to restore the position, they were however anxious that the 'implementation of the directions issued by the Reserve Bank should not directly or indirectly result in its closure'. But the management's reformed attitude had come too late to make any appreciable difference to the future of the Palai Central Bank or the fortunes of its depositors. After a careful review of the latest discussions and the bank's position, the Southern Local Board concluded that 'the bulk of the bank's income consisted ... of interest on its unrealizable advances', and that it would not be able to show any profit 'for several years to come'. Hence there was 'no question of any relaxation of the direction prohibiting the payment of dividend'. The Local Board also decided that the bank's accounts should be inspected 'immediately' to 'arrive at the exact figure of unrealizable advances'. More fatefully, the Palai Central Bank was asked to retain the interest accruing on such advances in an 'Interest Deferred Account' and show the resultant loss in its balance sheet for 1959. In addition, the Local Board insisted that the bank should quickly carry out the directive to appoint four additional directors, appoint an 'independent and suitable' chief executive, stop paying Joseph Augusti (who had earlier been divested of all his powers) a monthly salary, and cut down its administrative costs by retrenching the senior management of the bank, closing down unremunerative branches with 'meagre deposits', reducing deposit rates in stages, and slashing expenditure on advertisements.

The scrutiny which followed in January 1960 revealed that out of total advances of Rs 528 lakhs, advances to the tune of Rs 221 lakhs would have to be considered 'definitely as irrecoverable'. Of the remainder, Rs 4.73 lakhs were 'doubtful of recovery', and advances aggregating



Panicky depositors at the Delhi branch of the Palai Central Bank

Rs 121.08 lakhs were 'either frozen or sticky'. According to the inspecting officer, this meant that the Palai Central Bank would have to show a loss of at least Rs 13.73 lakhs, and possibly of Rs 15.07 lakhs for 1959. The condition of the Palai Central Bank was brought to the notice of the Bank's Central Board in March 1960, following which the earlier directions were reissued. While the bank dallied in appointing independent directors, it was not until April 1960 that it agreed to appoint an independent chief executive officer. This appointment came about in July 1960, when

T.R. Sivaraman, the agent of the Cochin branch of the State Bank of India, took over as the General Manager of the Palai Central Bank. On 21 July, the Bank sent Palai bank a report on the scrutiny of its advances, and gave it a month's time for explanations and a year's time to remedy its many defects. But the final denouement involving the Palai Central Bank had begun to unfold, and neither these measures nor the Bank's intentions could do much to arrest or deflect the course of events already under way.

From all accounts, the Palai Central Bank began suffering a run on its deposits at least from 24 June 1960. The proximate cause of the run was the publication the previous day of the annual accounts of the bank for 1959 showing a loss of some Rs 14.5 lakhs. The run on the Palai Central Bank was also accompanied by a smaller run on the South Indian Bank, but this appears to have been largely because other smaller banks in the region anticipated a rush for withdrawals and drew down their deposits in this institution to cope with it. According to Finance Minister Morarji Desai's statement in Parliament some days after the collapse of the bank, withdrawals increased steadily from Rs 12 lakhs during the week ending 1 July 1960 to Rs 17 lakhs a week later, Rs 20 lakhs during the week ending 15 July, and Rs 23 lakhs, Rs 29 lakhs, and Rs 35 lakhs during the weeks ending 22 July, 29 July, and 5 August 1960 respectively. The Palai Central Bank's deposits fell by nearly a sixth between 24 June and 8 August 1960.

The board of the Palai Central Bank met on 30 July 1960 to consider fire-fighting measures, and decided to send Sivaraman to Bombay to apprise the Reserve Bank of recent developments and request to be allowed to open a branch or two as a confidence-building measure. In May 1960, when the Bank first learnt of Sivaraman's impending appointment, it had hoped to invite him for an interview soon after he took up his new position to discuss the shape in which to consolidate the various directions issued to the Palai Central Bank over the years, and the reorganization of the working of the bank. This meeting now came about in circumstances of crisis, and in discussions with the Governor and senior officials of the Bank in the first week of August, a grim Sivaraman acknowledged that the Palai Central Bank was beyond redemption and that it was best taken into liquidation as soon as possible. The bank, Sivaraman disclosed, was left with a cash balance of Rs. 50 lakhs and reserve borrowing of Rs 100 lakhs against government securities.

#### LIQUIDATING THE PALAI BANK

Following Sivaraman's report, the Bank came to the conclusion that the Palai Central Bank was not in a position to pay its depositors in full and that its

continuance would be prejudicial to their interests, and on 8 August 1960 moved an application in exercise of its powers under section 38 of the Banking Companies Act before a judge of the Kerala High Court at Ernakulam seeking the winding up of the bank. After the High Court admitted the application and passed an interim order appointing a provisional liquidator, the General Manager of the bank called a meeting of its board the same afternoon to apprise it of these developments. (According to some press reports critical of Sivaraman's role, he had called a meeting of the board to coincide with the anticipated receipt of word from Ernakulam about the admission of the Bank's application.)

The Bank's action in seeking the liquidation of the Palai Central Bank predictably raised something of an outcry in the press and in Parliament. The front pages and editorial columns of Kerala's newspapers appear to have had space for little else for a few days in August. Some newspapers attacked the Reserve Bank for having waited too long before acting, others attacked it for acting without sufficient cause, while those steering a middle course held the Bank guilty of having done too little for too long and then wielding the hatchet without warning. Articles by the distinguished economist, K.N. Raj who was no stranger to the Bank, and A.D. Gorwala, Chairman of the Committee of Direction of the All-India Rural Credit Survey, also criticized the Bank for allowing the Kerala bank to beguile new depositors. If the Bank's handling of the Palai Central Bank typified its policy with respect to other banks, Gorwala thundered,

there cannot but be grave doubt about the state of the whole banking system. Much may need to be done, much set right, and the first step towards correction must be a thorough and impartial investigation into the affairs of the Palai Bank and the Reserve Bank's part in them.

The events of 8 August also reverberated through Parliament which was in session at the time. The Parliament discussed the bank failure more than once during the next few weeks. Though not all members who participated in these discussions were critical of the Bank, it once again faced the charge of allowing matters to drift until only extreme measures were possible. In public and in Parliament, the Finance Minister whom Iengar had 'informed' by telephone before taking action against the Palai Central Bank, defended the Reserve Bank forcefully.

If action had been taken earlier, it might have been open to the criticism that sufficient time and opportunity had not been provided



for those controlling the bank to set their house in order. If it had been deferred, there was every chance of preferred creditors and those with demand liabilities getting away with what was readily available, leaving the other creditors to face a dead loss. One has to balance nicely the various conflicting considerations and with full knowledge of all the factors involved, I have little doubt that the action taken by the Bank and the timing were appropriate,

the Finance Minister told the House. He was also fulsome in the Bank's praise, and spoke of the 'admirable manner' in which it was 'doing its work'.

Privately, however, the Finance Minister conveyed to the Bank his reservations about its handling of the Palai affair. Writing to the Governor two days after the bank closed its doors, Morarji Desai invited Iengar's attention to the criticism the government faced in Parliament and asked to know why the Bank had allowed the affairs of the Laxmi Bank and the Palai Central Bank to drift before deciding eventually to wind them up. Exhorting the Bank to ensure against such failures in the future, the Finance Minister wondered

whether some more positive steps cannot be taken, on the basis of inspection reports, as soon as there is an indication that the banks concerned have not been functioning properly. The Reserve Bank has now a wide range of powers under the Banking Companies Act, including power to give directions relating to a number of matters. Perhaps those powers might be more freely used.

While defending the Reserve Bank as 'one of the best central banks in the world' maintaining a 'high level of efficiency', the Prime Minister, Jawaharlal Nehru, was reported to have acknowledged that it may have made a 'mistake' in closing down the Palai Central Bank.

Defending the Bank's action, the Governor recalled the representations received from the Kerala Bankers' Association and the Travancore-Cochin Banking Inquiry Commission to 'go slow' on refusing licences to banks in Kerala and pointed out that if the Bank had taken the action it had now taken in any of the previous three years, it would have been subject to even greater criticism. 'This has been the considered judgement of my colleagues and myself in the Bank.' However, Iengar conceded, 'someone else could have exercised his judgement differently'.

The Bank issued a press statement on 9 August 1960 explaining the reasons for its action against the Palai Central Bank. Thereafter, however, the Bank had said nothing in public on its own behalf. While the onus of defending it in Parliament fell, naturally enough, on the government of the day, the Bank's case threatened to go unrepresented in the press. Besides, public reaction to the August

events was intense and widespread and so little appreciation existed of the Bank's point of view, that the Governor chose to devote his Presidential address to the annual general meeting of the Indian Institute of Bankers to placing in perspective the relative roles and responsibilities of the Bank and of banks' managements in ensuring the soundness of their institutions and of the banking system.

The Reserve Bank has been given pretty wide powers to inspect, give advice, and issue directives. All this, however, is no substitute for operational responsibility .... I do not suppose any one suggests that the Reserve Bank should carry out these responsibilities over nearly 4,000 branches in the country; apart from the sheer physical difficulty, that would be taking over a direct and continuous administrative responsibility which rests on commercial banks. *The Reserve Bank's powers are not ... a substitute for the efficiency and integrity of the managements themselves* .... In the final resort, if a management does not listen to advice and chooses to be recalcitrant and it is felt that continued pressure would be useless, the Reserve Bank would have no option but to close down [the bank] in the interests of the depositors. But this decision involves a delicate balancing of several factors, some of them operational, some psychological .... [Emphasis as in the original draft of the speech.]

It was 'easy enough to be drastic'. But greater wisdom lay in 'nursing' a bank to bring it to a 'healthy state' if there was 'any reasonable hope of doing so'. Pointing out that this had in fact happened in a number of cases, and that nursing a sick bank back to health was a 'time-consuming process', the Governor averred that 'persuasion and pressure applied persistently over some years' had resulted in many a bank 'reforming its ways and putting its house in order'. But such reform took 'patience and time ....'

The next stage of the Palai Central Bank episode unfolded in the law courts. Citing two grounds, namely that it was mala fide and that section 38(3)(b)(iii) of the Banking Companies Act offended Articles 14 and 19 of the Constitution, sixty-six creditors of the Palai Central Bank opposed the Bank's application to wind up the institution. The plea of mala fide was soon withdrawn by the petitioners, and in December 1960 Justice Raman Nayar of the Kerala High Court upheld the constitutional validity of section 38 and allowed the Bank's application to wind up the Palai Central Bank. Joseph Kuruvilla Vellukunnel, a former director of the Palai Central Bank and a contributory, appealed against the judgement in the Supreme Court where he was joined by another contributory and depositor who filed a separate writ under Article 32 of the Constitution. By a majority judgement delivered in

March 1962 by the Chief Justice, B.P. Sinha, and Justices M. Hidayatullah and J.R. Mudholkar, the appeal and writ petitions were dismissed, the Court holding that sections 38(1) and (3)(b)(iii) of the Banking Companies Act were neither discriminatory nor unreasonable and violative of Articles 14 and 19 of the Constitution. Nor were these provisions, since they were manifestly in the public interest and protected by Article 302, *ultra vires* of Article 301 of the Constitution. In their minority judgement, Justices J.L. Kapur and J.C. Shah felt the High Court order should be set aside as section 38 imposed unreasonable restrictions on the right of a bank to carry on business without making adequate provision for subjecting executive actions under it to judicial review.

Back in the High Court, the liquidator moved a plea in August 1961 for publicly examining the directors and the auditor of the Palai Central Bank under section 45(G) of the Banking Companies Act on the ground that their actions and omissions had led to the bank and its depositors losing money. After the court allowed the appeal, the liquidator initiated malfeasance proceedings against the bank's directors and auditor and to recover Rs 288 lakhs from them. The directors denied personal liability. The Court exonerated some directors of the bank and directed the others and the auditor to pay Rs 288 lakhs. But the liquidator failed to recover any part of this amount. The main proceedings to liquidate the Palai Central Bank also dragged on for nearly three decades, the High Court's final orders dissolving the bank coming only in December 1987, i.e. twenty-seven years and four months after the Bank moved its application. The real losers, both due to the bank failure and the prolonged liquidation proceedings, were the unfortunate depositors of the Palai Central Bank who managed in all to recover some two-thirds of their 1960 deposits. In real terms, of course, depositors' losses were much greater.

*Additional Unpublished Sources*

G.8	Governor's Correspondence with Government of India, Ministry of Finance
DBO.81(A)	Palai Central Bank Ltd. (in liquidation)
Liq.4(163)	Palai Central Bank Ltd. (in liquidation)
C.73(D)	Palai Central Bank Ltd.
B.2.3030	Palai Central Bank (Appeal and Writ Petition Filed in Supreme Court)
Ins.22(B)	Supreme Court Judgement in Palai Bank Case
Ins.22(B)(4)	Palai Central Bank Ltd.—News Items

*Memoranda to the Central Board and Committee of Central Board*