
To Whom to Lend, How Much and How

BILLS REDISCOUNTING SCHEME

We have seen how, after India became independent and acquired a democratic government, pressures arose from the political parties to increase the availability of credit to the less well-off. The 1960s were dominated by the debate over the adequacy of 'social' control of banks, which would force banks to extend credit to the less well-off, and the need for outright nationalization, which would enable the government to make absolutely sure that credit went where it wanted it to go. The matter was resolved in July 1969 when, for purely political reasons, Prime Minister Indira Gandhi decided in favour of nationalization. With this started a new era in Indian banking.

But expanding credit delivery required two things: vehicles of delivery, namely, branch expansion, which was discussed in Chapter 2; and more loanable funds, which we will discuss now. As an immediate solution, the Reserve Bank turned, as it had done once before in 1952, to an old practice capable of delivering quick results: commercial bills and the Bill Market Scheme. It was for more-or-less similar reasons that the scheme had been restarted in 1952 after going into decline during the decade preceding independence. Its purpose was to provide banks with a mechanism to obtain advances from the RBI against specially created bills of a self-liquidating character. But by 1958 the scheme had fallen into disuse. (See Volume 2 of the history of the Reserve Bank of India for details.)

In 1964, when the issue of credit expansion was once again being discussed, Governor Bhattacharyya took the initiative and the general question of creating a bill market based on genuine bills was examined by the Department of Banking Operations and Development (DBOD). The Department took the stand that the arrangement of obtaining manufactured bills, at Governor Bhattacharyya's initiative, as security for advances under the Bill Market Scheme was working well, and that the objective of

relieving monetary stringency during the busy season was being met. It also felt that the Bank could exercise qualitative control on expansion of credit by commercial banks.

Having said that, however, the Department allowed that as a beginning the banks could start the acceptance business. This, in turn, could form the basis for the creation of a supply of prime bank bills, which, in due course, could be made eligible for rediscount with the Reserve Bank. But there was a problem. The offer of rediscounting facilities by itself would not encourage an open market in bills. So the idea of establishing an institution to act as a dealer in bills and as an intermediary between banks was mooted. This proposal envisaged several advantages. One was better deployment of the day-to-day surplus of deposits in the call market in granting call loans to the discounting institution against the security of packets of bills. This would link the call market to bills representing specific trade transactions and ultimately help the Bank in exercising greater influence on the call money market through its rediscount policy.

M. Narasimham was Director of the Banking Division at the time and he felt that use of the trade bill as a credit instrument called for a change in banking procedure. But the initiative for this change would have to come from the banks themselves. This meant that the existing Bill Market Scheme would have to continue until the volume of genuine trade or institutional bills increased sufficiently. V.G. Pendharkar, Economic Adviser, agreed with this argument and observed that for control by the central Bank it was not 'absolutely essential' to have a genuine bill market. He also pointed out that control of short-term fluctuations in the supply of credit could be effected in several ways. One of these was through the use of bills. However, under the prevailing conditions he did not think trade bills would become significant as a method of financing borrowers. B.D. Joshi, who was the Executive Director, felt that unless acceptance and discount houses were established, the scope for development of bills could not be exploited. He therefore suggested a discussion with representatives of the Indian Banks' Association and some prominent bankers. B.K. Madan was the other Executive Director and he too foresaw 'real' difficulties in resuscitating the genuine bill market. As a result of these views no particular action was taken.

In 1969, left with few options and as a result of a letter written by T.A. Pai on 19 May to Deputy Governor B.N. Adarkar, the Reserve Bank sought to breathe fresh life into the Bill Market Scheme. Pai, who was the chairman and managing director of Syndicate Bank, asked for two things: a review of the existing Bill Market Scheme and redesigning it so that a genuine bill market could be created. He said that the Bank should allow

banks to offer inland usance bills up to 90 days for rediscount instead of the present practice of making advances to banks against the security of 'manufactured' or 'specially created' bills. Pai also pointed out that the banks had been financing manufacturers' and wholesalers' accounts receivables, and the most convenient way of doing it was to draw a bill against acceptance to be discounted by the Reserve Bank. In his view, the creation of such bills would help monetary management and impart flexibility to the credit mechanism if the bills were made eligible for rediscount by the Bank. Finally, he said, such bills satisfied the conditions laid down in Section 17(2)(b) of the Reserve Bank of India Act, as one of the signatures on the bills had to be that of the licensed scheduled bank and the creditworthiness of the manufacturer or wholesaler (being the second signature) could be verified. Drawing attention to the Bills Rediscounting Scheme of the Industrial Development Bank of India (IDBI), which provided that banks should retire bills three days in advance of maturity, Pai suggested that a similar procedure could be adopted in respect of the proposed bills and that the scheme as suggested could be introduced on merits.

Adarkar was aware of the need to do something quickly. He saw no difficulty in the RBI rediscounting bills, provided the banks took over the bills for collection just before maturity. So he instructed the DBOD to examine the matter quickly. DBOD considered the proposal from two angles: one was the possibility of better control over bank credit, and the other was the rediscounting of bills as a better method of refinance than the existing Bill Market Scheme.

DBOD, in a note, wrote that it was not necessary for the Reserve Bank to rediscount trade bills because adequate control was already being exercised under the existing scheme. It reasoned that once the bills were rediscounted with the Bank, RBI would not have an opportunity to ascertain whether the bills had arisen out of genuine trade and commercial transactions, and further, that the banks might not find it attractive to offer trade bills to any appreciable extent when it was much easier to obtain refinance under the Bill Market Scheme. Concluding that there was no need to provide facilities for rediscounting of trade bills, it offered, by way of a concession, to discuss the question with a few bankers, 'if considered necessary'.

But Adarkar was adamant. He pointed out that the DBOD had not taken adequate note of the advantages of trade bills in helping small traders to avail of credit offered by local banks instead of depending on credit from big wholesalers in the towns. L.K. Jha, who was the Governor, asked if it was a matter suitable for study by the Banking Commission or some other ad-hoc body. On 11 August, Adarkar sought the advice of the Secretary,

M. Narasimham, expressing the view that if the Reserve Bank encouraged the growth of a bill market and, in due course, the establishment of discount houses, it would have made a significant contribution to the development of the money market in India, and that a proper bill market would help to bring about better distribution of credit not only between different stages of distribution but also between different banks and other suppliers of credit, e.g. discount houses.

On 12 August, Narasimham and Adarkar met and discussed the issue. It was decided to constitute a Study Group comprising R.K. Talwar (State Bank of India), T.A. Pai (Syndicate Bank), Nariman (Union Bank), Laxminarayan (Indian Bank) and R.B. Shah (Bank of Baroda), with M. Narasimham (RBI) as Member Secretary. The Governor approved the proposal in principle on 13 August, but also suggested postponement ('the question is one of timing') because of the many urgent problems pending before the banks' chairmen. That was done and a few months later, in December, the idea was revived, this time successfully. The Bill Market Study Group was constituted on 22 January 1970 with a change in the originally proposed membership. The final composition of the Group was somewhat of a climb-down as the level of members was far lower than that envisaged earlier.

On 20 February 1970, a letter informed the members that the Study Group proposed to study:

- (i) the efforts necessary to enlarge the use of bills of exchange as an instrument of credit and for the creation of a genuine bill market in India;
- (ii) the factors inhibiting the growth of a bill market in the country;
- (iii) the method to get over the impediments;
- (iv) the steps necessary to increase the supply of genuine trade bills; and
- (v) the institutional set-up necessary for the purpose.

The Group held its first meeting on 3 March and met three times in all. The final report was signed in the first week of May 1970. A copy of the report was forwarded to scheduled commercial banks on 17 July 1970.

Based on its recommendations, the Reserve Bank issued a circular on 28 August advising that a Scheme of Rediscounting of Bills of Exchange under Section 17(2)(a) of the RBI Act would be introduced from 1 November. The rediscounting facilities were to be made available at the Bank's offices at Bombay, Calcutta, Madras and New Delhi. The salient features of the scheme were as follows.

- (i) Only genuine trade bills, i.e. evidencing sale and/or despatch of goods, were eligible.
- (ii) Bills of exchange arising out of sale of commodities covered by selective credit control directives of the Reserve Bank, as also bills pertain-

ing to supplies made to government departments, were not covered by the scheme.

- (iii) Accommodation bills were outside the purview of the scheme.
- (iv) To be eligible for rediscount by the Reserve Bank, a bill of exchange should be drawn on and accepted by the purchaser's bank, and, where the latter was not a licensed scheduled bank, it should, in addition, bear the signature of any licensed scheduled bank as acceptor.
- (v) In view of the absence of discount houses or acceptance houses in the country, the purchaser's bank should satisfy itself as to the ability of the purchaser to meet the bill on the due date and ensure that the bills were accepted by banks on behalf of 'first-class parties' only.

Anticipating that the scheme would experience teething troubles, the Reserve Bank advised that

there may be resistance on the part of buyers of goods to accept bills drawn on them by the sellers or to ask their bankers to accept such bills on their behalf, as this process would bind them to make payment for the purchases on the stipulated dates. In view of the merits of the scheme, we suggest that the banks might persuade their borrowers to avail themselves of finance necessary for sale of goods on credit by way of discount of bills of exchange. The banks may ensure that not only bills drawn by bigger concerns on the smaller ones were financed through bills but also those drawn by smaller concerns on the bigger ones. In order to promote the development of the Bill Market, the banks may discourage giving credit in respect of sale of goods against book debts.

Commercial banks were asked to forward their applications for the grant of total limits under the new scheme based on their estimates of requirements of rediscounts for the year 1 November 1970 to 31 October 1971, and the Bank agreed to fix the limits on a flexible basis as the banks might find it difficult to make a realistic assessment of their rediscount requirements under the new scheme at the initial stage. These estimates could be revised once more accurate data became available.

The RBI, however, decided to continue the existing Bill Market Scheme in which advances were granted under Section 17(4)(c) of the RBI Act to enable commercial banks to meet the credit requirements of the priority sector. These facilities were available in respect of the banks' short-term lending to agriculture, including credit granted to primary cooperative societies in selected states as well as short-term lending to small-scale

industries covered by the Credit Guarantee Organization and advances to banks for food procurement and distribution of fertilizers. In March 1973, refinancing arrangements in respect of defence packing-cum-supply credit were withdrawn.

The scope of the Bills Rediscounting Scheme was expanded in February 1971 by including, in addition to bills drawn on and accepted by the purchaser's bank, the following:

- (i) a bill drawn on the buyer and the buyer's bank jointly and accepted by them jointly,
- (ii) a bill drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank which opened the letter of credit,
- (iii) a bill drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and a declaration in the prescribed format by the bank endorsing the bill.

In early April 1971, the State Bank of India (SBI) suggested a scaling down of the minimum amount of a single bill offered for rediscount from Rs 10,000 to Rs 5,000. This was because it had received representations from its constituents that they were unable to avail of the discount facilities to the full because of the nature of their distribution network and the prevailing trade practices; both these made it difficult for them to avoid drawing of bills for amounts less than Rs 10,000. For example, in the textile industry, where despatches were usually in small lots, most of the bills covering sale of cloth were for values less than the minimum stipulated under the scheme. SBI suggested that while lowering the bill amount would lead to a sizeable increase in the number of bills discounted/rediscounted and consequently to higher administrative costs, it was necessary because a large segment of internal trade would otherwise not be covered by the new scheme. This, in turn, would necessitate the grant of credit by commercial banks either in the form of cash credit against receivables or usance bill limits outside the scope of the scheme. As the suggestion was obviously sensible, Hazari approved it as did the Governor. Yet, surprisingly, the minimum value of bills offered at any one time by a bank for rediscount by the Reserve Bank remained unchanged at Rs 10,000!

Even though bills pertaining to supplies made to government departments were not covered under the scheme, in July, the RBI, with a view to 'further enlarging the scope of the scheme', made eligible for rediscount with it the bills of exchange arising out of sale of goods to government departments and quasi-government bodies as well as statutory corporations and government companies, provided such bills conformed to the

conditions of the scheme. But in spite of this and other initiatives to expand and reorient the scheme, it received very little response. As early as 28 November 1970, DBOD was noting that some of the nationalized banks, for unknown reasons, had not yet applied for limits under the scheme. The Reserve Bank then requested its officers and those of IDBI on the boards of nationalized banks to discuss the matter with the respective banks and ask them to refer any difficulties to the RBI.

A proposal to include export bills carrying long usance up to 180 days was examined by the Bank but was not found acceptable for various reasons. These bills were discounted by banks in India, after which they were forwarded to foreign correspondents for acceptance. On acceptance, the bills had to be retained abroad till maturity for payment. Further, Indian banks obtained refinance from the Reserve Bank against these bills on the basis of their declaration under the Export Bills Credit Scheme (Section 17(3A) of the RBI Act) at a concessional interest rate of 4.5 per cent per annum or at the rate linked to the respective bank's net liquidity ratio. In July 1971, Governor Jagannathan considered extending the scope of the Bills Rediscounting Scheme to all institutions—financial and otherwise. However, it was decided that transactions should be limited for the present only to financial institutions and that the question of widening it could be considered only when the Bill Market Scheme developed sufficiently well. In fact, in March 1973, when some banks were found permitting non-financial institutions to deploy their surplus funds in the new Bill Market Scheme, the RBI advised them that they should not rediscount bills of exchange or allow taking up of such bills by agencies other than Life Insurance Corporation (LIC), Unit Trust of India (UTI), the general insurance companies and other financial institutions approved by the Bank. Increasingly, it was becoming clear that the scheme was an idea whose time had gone. But efforts to keep it alive were not given up.

In December 1970, the Reserve Bank requested the Director General of Supplies & Disposals (DGS&D) to evolve a procedure for bringing bills drawn by suppliers to government within the purview of the Bills Rediscounting Scheme. But, as is often the case in such matters, the DGS&D was not very helpful. They took eight months to respond and then said that the existing payment mechanism did not give any scope for drawing bills of exchange facilitating payment on a future date unless it was drastically altered to a system of deferred payment. It also pointed out that the traders were likely to resist any change, and that the system of bills of exchange, even if it could be fitted into payment for government purchases through DGS&D, was unlikely to be an improvement over the present system.

THE EFFORT INTENSIFIES

The Bank, being keen that the Bills Rediscounting Scheme should succeed in giving a fillip to the growth of the bill market, wished to leave no avenue unexplored. The Thakkar Committee had pointed out how delays in payment of bills by the government imposed a considerable strain on small-scale entrepreneurs. So, in March 1971, the RBI wrote to the Department of Banking in the Finance Ministry proposing that public sector undertakings should take the lead by arranging acceptance of bills drawn on their banks in regard to the supplies of goods made to them or, alternatively, agree to opening of irrevocable letters of credit in favour of their suppliers whenever required.

Meanwhile, it turned out that Tata Engineering and Locomotive Company Ltd (TELCO) and Air India were reluctant to have bills drawn on them or to accept bills in respect of purchases made from their suppliers. So, in June, Hazari asked the Credit Planning and Banking Development Cell of the Secretary's Department to make informal enquiries about these two firms. It transpired that TELCO was not in the practice of accepting liability on purchases not paid for until the goods were inspected and accepted by it. Furthermore, the company normally availed of buyers' credit of about 30 to 45 days or more against purchases. However, its bankers, Central Bank of India and Bank of India, were in the process of negotiating with the company for introducing a system of usance bills of short duration being drawn on it by its suppliers. Air India's purchases mainly related to fuel from the Indian Oil Corporation and some other oil companies in the private sector and it usually enjoyed credit for about 30 to 60 days from the suppliers. The airline had not given any serious thought to settlement of claims on the basis of bills drawn on it.

Hazari wrote semi-official letters during April and May 1971 to the chairmen of leading public sector enterprises seeking their cooperation in the development of a genuine bill market in India, where bills could be purchased and sold according to the requirements of the institutions concerned. The chairmen were advised that although it was not the intention of the Reserve Bank to replace the entire system of lending by way of cash credit with the proposed system of bills of exchange, the Bank felt it necessary for some short-term finance that was provided by banks for sale of stocks through cash credit against the collateral of book debts to be disbursed in the form of discounting of bills of exchange.

The RBI was hopeful that the public sector undertakings would provide a substantial source of eligible bills for the market and thus give an impetus

to popularizing the bill as an instrument of finance. But, once again, the responses were unenthusiastic. Basically, the public sector enterprises said that they were not convinced about what the Bank was asking them to do because of their diverse operational structures and varied perceptions about the practical utility of the revised bill scheme.

In a meeting with Jagannathan in late June, R.K. Talwar, SBI chairman, had asked whether the restriction that was applicable to the purchase of participation certificates by financial institutions would be equally applicable to bills. Hazari, who was present at the meeting, had responded that there would be no such restriction. Talwar, in a strongly worded letter written on 9 July, argued that the bill market by itself was not going to add to the volume of funds in the banking system. He opposed any arrangement whereby parties with surplus funds in the 'specified centres' could divert deposits from banks to purchase bills from banks and thereby earn a higher rate of return than permitted by the deposit rates directive of the Reserve Bank. 'In our social set-up,' Talwar observed, 'I would submit that it is the large body of small depositors that need the opportunity for a better return and not the large business houses or other wealthy parties with substantial idle funds.'

He also cited instances where parties were able to buy bills with maturities of between 90 to 180 days from other banks, namely, some of the foreign banks, at rates up to 7.5 per cent or even higher. This, he wrote, did not in any way augment the resources of the banking system but instead impacted on the system's liquidity requirement under the law or in terms of the RBI's directives. He concluded by saying that he had returned (from the meeting) with the impression that the Governor was going to have this aspect thoroughly examined and he 'requested' that this might be done early. The next day, Jagannathan noted that the matter would be discussed after he and Hazari returned from Calcutta. But it is not clear whether this was done or whether Talwar received a reply.

For some reason that will probably never be known, C. Chittibabu, MP, tabled a question in the Lok Sabha, on 18 June 1971, on the inter-bank call money market. He wanted to know if the LIC and UTI were diverting their deposits with banks to the inter-bank call money market, and whether this withdrawal affected the liquidity ratio to be maintained by the banks and also deposit mobilization by the banks. Y.B. Chavan, who was Finance Minister at the time, replied that from 3 June 1970 onwards, the Reserve Bank of India had permitted the LIC and UTI to receive interest on call and short notice deposits made by them with banks at rates ruling in the inter-bank call money market. He added that their withdrawal of deposits

would not affect the liquidity ratio to be maintained by banks.

To another query, the Minister replied that as scheduled commercial banks could secure call and short notice deposits from LIC and UTI in the inter-bank call money market, the quantum of deposits with banks was not adversely affected. Banks, however, had to pay interest to LIC and UTI at inter-bank call money market rates, which were generally higher than the rates admissible on savings and short-maturity deposits. He also clarified that the entire issue was one of adjustment in income and expenditure between two wings of financial bodies, viz. scheduled commercial banks on one side and long-term financial institutions on the other.

A. Bakshi, Secretary in the Department of Banking, wrote to the RBI Governor on 19 June that some of the banks had strong feelings on the subject and that Parliament was also becoming 'curious' as well.

At a meeting with Talwar on 26 June 1971, Jagannathan opined that funds placed in the call money market did not amount to diversion of funds from bank deposits but were an addition to the resources of the market. RBI took the view that LIC and UTI need not be debarred from operating in the call money market, provided they agreed to a reasonable maximum rate of interest at which such funds could be placed. Talwar's reaction was that this amounted to the two institutions being treated as preferred entities and earning a higher rate of interest on surplus funds than was permissible to the general public under the RBI's interest rate regime, but 'if the authorities had made up their mind, we had nothing more to say'. He suggested that the matter might be discussed again after the maximum rate of interest had been determined.

A question also arose over the rates of discount charged by banks. B.N. Adarkar, who had been a Deputy Governor of the Reserve Bank and who had later become custodian of the Central Bank of India, sought clarification from Hazari. He said that the rates charged by commercial banks for discount of bills accepted by the Bank as well as for issuing the acceptances differed widely. He requested that the Bank should ascertain the facts from different banks and guide them as to the rates of discount and acceptance commission to be charged on this type of business. The Bank looked into the request but, eventually, Hazari decided not to respond to Adarkar's letter. The reasons were as follows.

No ceiling had been imposed on discount rates or acceptance commission, and, irrespective of what the banks charged by way of discount or acceptance commission, the RBI discounted the bills at the Bank rate. Moreover, none of the bills tendered to the Bank for rediscount had been accepted by a bank other than the discounting bank and mostly the same

bank that had discounted the bill had also accepted it. A quick study of the bills rediscounted with the Bank at its Bombay office revealed that the banks did not charge uniform rates of rediscount on such bills, and that the discount rates varied widely from bank to bank and even from customer to customer in the same bank. The scheme having been introduced in November 1970, it was considered too early for banks to decide upon a firm policy in regard to the discount rates or acceptance commission that should be charged by them. It was also observed that when a bill was accepted by a bank it became a bank bill and the rate of discount to be charged by the discounting bank on such bills should not ordinarily exceed a reasonable limit, say, 2 to 3 percentage points above the Bank rate. But none of the banks had so far discounted a bank bill in the strict sense of the term. Therefore, the Bank was not inclined to intervene in the matter and decided to review the position at a later date, when the scheme achieved a fair degree of success. So Adarkar's query went unanswered.

Another question that arose was about what would happen to cash credit. Ever since the Bill Market Scheme had been revived, the RBI had been trying to persuade banks to change from cash credit to loans and advances. This led to the Executive Committee of the Maratha Chambers of Commerce and Industries, Pune, writing to ask what would happen to cash credit. The Bank explained that the intention was to curb, as far as possible, certain unhealthy practices that had crept into the cash credit system. But it reassured the Chamber that the system would not be done away with altogether, that the change would be brought about gradually, and that, where practical considerations warranted, cash credit facilities would continue.

Early in 1971, Andhra Bank had suggested that bills of exchange accepted by state financial corporations (SFCs) and the Industrial Credit and Investment Corporation of India (ICICI) should also be made eligible for rediscount by the Reserve Bank. But, under the State Financial Corporations Act, 1951, SFCs were not authorized to accept the bills. So the question of rediscounting bills accepted by them was ruled out. ICICI, when asked, said that its Articles of Association permitted it to engage in all activities connected to financing of bills and envisaged two situations where it could help: first, by accepting bills on behalf of its constituents who were the purchasers of goods; second, by endorsing or discounting bills drawn by sellers where they had to carry a heavy load of working capital financing as part of normal business requirement. It wanted to know if the Bank would be willing to provide rediscounting facilities for bills accepted and discounted by it.

In July, DBOD wrote back that ICICI was not a banking company and so bills accepted or discounted by it could not be directly rediscounted by

the Reserve Bank and such bills would have to come to it through eligible banks. The alternative was to amend the Act. Even so, argued DBOD, the Bank would have to take a decision on rediscounting of bills discounted by ICICI, which was a term lending institution and not intended for short-term-lending by way of discounting short-term bills. While there was no objection to the Bank rediscounting bills accepted by ICICI, the issue for consideration was whether it would be in order for the banks to directly rediscount the bills that had been discounted by ICICI.

It was decided to ask the Economic Department, which did not see any objection to ICICI accepting bills on behalf of its customers, which could be discounted at finer rate and later on. ICICI could sponsor a specialized acceptance house for conducting this business. In any case, even if ICICI were permitted to discount bills of medium maturity, IDBI, rather than the Reserve Bank, could rediscount bills of that type because it was already rediscounting bills/promissory notes covering sale of machinery on a deferred payment basis. This arrangement could be extended to cover medium-term bills discounted by term-lending institutions.

The director of the Banking Division of the Economic Department agreed that ICICI might not take up discounting of bills of medium-term maturity but pointed out that the possibility of its seeking refinance from the Reserve Bank was not strong since it had surplus investible funds. It was also stressed that one of the objectives of the scheme was to replace cash credit as far as possible, rather than to serve as a substitute for long-term lending. Eventually, DBOD concluded that ICICI could offer eligible bills for rediscount by the Reserve Bank only after suitable statutory amendments had been carried out. DBOD also suggested that, as a matter of policy, the Bank should not, for the present, rediscount bills for any institution other than eligible banks so long as there was excess liquidity in the banking system and the Bank did not possess any powers of supervision and control over the functioning of ICICI. Jagannathan and Hazari agreed with this assessment and ICICI was suitably advised.

After an initial phase of decline during July and August 1971, the outstanding level of bills rediscounted with the Reserve Bank stood at Rs 25 crore at the end of September 1971. With the progress of the busy season, banks began to avail of rediscounting facilities and, by the end of March 1972, the level of outstanding was Rs 42 crore. As mentioned earlier, refinance facilities under the old Bill Market Scheme were continued to enable banks to meet the credit needs of the priority sectors, especially in respect of short-term lending to agriculture, credit to primary cooperative societies in selected states, and short-term lending to small-scale industries

covered by the schemes of the Credit Guarantee Organization. Refinance in respect of bank advances for food procurement and distribution of fertilizers also were made available after June 1970. The requirement of having to lodge eligible bills with the Reserve Bank for availing of rediscount facilities and then taking them back three working days prior to their maturity was found to be irksome, as banks were prevented from rediscounting the bills for the full period of their usance. Further, the bills that were discounted by banks in their mofussil branches could not be offered for rediscount. So, with a view to avoiding delays and to reducing the work involved in delivering the bills to the Bank and taking them back, from November 1971, the Bank waived the requirement of actual lodgment of bills of individual face value of Rs 2 lakh and below, and authorized banks to hold such bills as its agent. The discounting bank would have to retire such bills three days before the date of maturity. In view of this relaxation, the minimum face value of a single bill was abolished.

Rediscounting facilities were extended to five more offices of the RBI (at Hyderabad, Patna, Nagpur, Kanpur and Bangalore) in November 1971. A bill of exchange drawn on and accepted by ICICI on behalf of its purchaser constituents singly or jointly was made eligible for rediscount under the scheme from April 1972, provided it was offered to the Bank by an eligible scheduled commercial bank. The resource position of banks during 1972–73 was comfortable and this was reflected in the low level of bills rediscounted with the Bank. In its *Report on Trend and Progress of Banking in India* for that year, the RBI hoped that as banks were prepared to lend against bills rather than book debts or inventories, this scheme should become an important means of rediscounting. In 1973–74, the scheme gained ‘remarkable’ momentum, largely due to the tight resources position of banks.

Efforts to promote the bill of exchange as an instrument of credit were continued in the subsequent years but within the framework of a restrictive credit policy. Consequent to the exceptional credit stringency that prevailed during 1973–74, bills rediscounted under the scheme shot up and by the end of June 1974, total limits of Rs 365 crore had been sanctioned to banks. However, the Reserve Bank imposed some restraint on the rapid increase in utilization of the rediscounting facility, in the context of the tight credit policy in vogue. It allowed the enhancement of limits sought for by banks only on a selective basis and, that too, generally up to the end of June 1974. Further, the minimum rate of discount fixed for bills eligible for rediscount was raised from 8 per cent to 9.5 per cent in November 1973. From 17 June 1974, the minimum rate for bills rediscounted at the instance of drawees was raised to the same level as the prevailing minimum

lending rate, viz. 11 per cent. The minimum rate of discount in respect of bills discounted for drawers remained at 9.5 per cent.

When the slack season of 1974 began, the Reserve Bank directed banks to reduce bills rediscounted so as to bring the limits to about 40 per cent of the existing level for the banking system as a whole. This resulted in a return flow of funds to RBI. The banks were advised that rediscount limits would henceforth be sanctioned on a six-monthly, not annual, basis. Even though the Bank continued to announce its preferred position of promoting a genuine trade bill market and the use of bill financing in preference to the cash credit system as an objective of long-term policy, it was concerned at the instances of misuse of bills for circumventing the rigours of credit control. The Bank made a distinction between drawees' bills and drawers' bills, with a higher minimum rate for the former. It also stipulated, in June 1974, that the rate of interest on drawees' bills should be on par with the rate of interest on cash credit accommodation extended to the same borrower, thereby preventing bill finance for inventory purchase being cheaper than that under the cash credit system.

Banks were granted basic bill rediscount limits equal to 10 per cent of their inland bills purchased and discounted as at the end of September 1976. The Reserve Bank announced in May 1977 that limits aggregating Rs 133 crore would not be valid beyond the end of June 1977 and additional rediscount accommodation would be sanctioned at its discretion after detailed discussion with the banks concerned. The rates of rediscount in respect of these limits ranged between 10 and 12 per cent, depending on the size of the limits. Additional limits sanctioned during the year ended March 1977 were lower, at Rs 96 crore, as compared to the previous year (Rs 137 crore). The bill rediscounting facility to banks was placed on a discretionary basis from June 1977. In spite of restoration of normal conditions in the banking sector, the bill rediscounting limits at Rs 118 crore in June 1979 were lower as compared to Rs 187 crore in June 1978. Gradually, the Bank reduced the availment of funds under the scheme; during the year 1981–82 (July–June), no fresh limits were sanctioned to banks and there were no outstandings after October 1981.

The RBI had been trying to persuade banks to change from cash credit to loans and advances. However, due to practical considerations, cash credit facilities continued. It was perceived advantageous both to the seller and the purchaser if a bill of exchange was used more for settlement of trade transactions as also as an instrument of credit in that connection, thereby helping the creation of a genuine bill market in the country.

CREDIT AUTHORIZATION SCHEME
AND INVENTORY NORMS

It is one of the features of the management of anything—from a small factory to monetary policy—that crises, small or big, lead to special measures involving discretionary permissions as a way of dealing with immediate problems. This is not a matter for concern. But what is a matter for concern is what happens to such special measures once the crisis is over; how quickly does the system revert to automaticity from discretion? The Credit Authorization Scheme (CAS) of 1965 provides an illuminating example. It marked the beginning of credit regulation and it held sway for over two decades. This section traces its course.

During the 1965–66 peak season, there was severe stress on the economy that culminated in worrying inflationary pressures. The Reserve Bank thought it would be prudent to restrain credit and that there was an imperative need to preserve a ‘reasonable balance between aggregate monetary flows and the availability of real goods and services’. So a set of regulatory measures were adopted in the credit policy announcement for the busy season of 1965. It advised all scheduled commercial banks that, ‘in order that the growth of bank credit may be more closely aligned to the requirements of the Plan and as an additional measure of credit regulation’, they would be required to obtain the Bank’s authorization before sanctioning any fresh working capital credit limit (including commercial bill discounts) of Rs 1 crore or more to any single party, or any limit that would take the total limit enjoyed by such a party from the entire banking system to Rs 1 crore or more on secured and/or unsecured basis.

Between 1965 and 1981, in keeping with the changing profile and needs of the economy, the scheme was significantly modified. The 1982 review committee categorized the changes into four distinct phases.

The first phase lasted till 1970. The Bank’s role, in this phase, was confined to satisfying itself, through a brief scrutiny of the banks’ applications, about the purpose of the advances and, in the process, monitoring the facilities allowed. The idea was to exercise a measure of restraint on bank lending to large borrowers so that they did not pre-empt the available resources. The emphasis was on preventing excessive lending to large units or business groups taking advantage of their close links with particular banks. There was, however, no method either of precisely assessing the credit needs of borrowers or ensuring the end-use of the funds by them.

During the second phase, from June 1970 to mid-1975, the RBI sought to introduce a more organized approach towards assessment of the credit

needs of large borrowers. It also sought to streamline banks' decision-making on the proposals. It prescribed, for the first time, a set of forms in which certain essential data were to be obtained by the banks from borrowers seeking credit facilities covered by CAS. This modified mechanism enabled the banks to critically appraise the borrowers' credit requirements, and worked towards prevention of stockpiling and diversion or siphoning of funds for intercorporate investments or for lending to sister concerns.

The third phase commenced with the acceptance by the Reserve Bank of the recommendations of the Study Group to Frame Guidelines for Follow-up of Bank Credit (Tandon Committee) in mid-1975. There had been a steep rise in the demand for bank credit that was clearly unrelated to increases in production. Meanwhile, inflation reached unprecedented levels during 1973–75. So it became necessary to correlate the credit demand to business/production plans, as also the borrowers' own resources. The latter included long-term funds at their disposal. As a result there was a perceptible shift from a 'security-based' approach to a 'need-based' approach towards bank credit. The Tandon Committee recommendations proposed assessment of the credit needs of borrowers on the basis of certain norms linked to holdings of inventory and receivables, and working out the maximum permissible quantum of bank credit on the basis of prescribed methods besides supply of follow-up information by borrowers to banks. This phase lasted till about the end of 1980. Concepts like net working capital and acceptable minimum current ratio were adopted, and the role of a bank in financing working capital needs was defined in clearer terms.

Phase four commenced in December 1980 with the adoption by the Reserve Bank of most of the recommendations of the Working Group to Review the System of Cash Credit (Chore Committee). This sought not only the continuation but also a strengthening of the discipline introduced during the third phase. A brief note recorded by Governor L.K. Jha, on 29 June 1968, set the tone.

It has been represented to me that the requirement that advances exceeding Rs 1 crore should receive the prior approval of the Reserve Bank should be waived in the case of packing credits for export. The point made was that these are short-term advances for an unquestionably good purpose and even the few days that may be necessitated in getting RBI clearance may well be vital for the execution of an overseas contract.

The larger point was clear, namely, that the rules would be changed if they were getting in the way.

The DBOD (Credit Authorization Scheme) objected. It wrote that banks usually applied for authorization of packing credit limits along with other credit limits such as cash credit/overdrafts/loans, term loans, bills purchase/discounting facilities, etc., and that banks sanctioned packing credit either against the security of stocks or on a clean basis. Further, although advances under packing credit limits were granted for periods not exceeding 180 days, such limits were usually sanctioned for a specific period, say, six months or one year, on a regular basis. The requirements for finance were estimated on the basis of past export performance and expected business in the ensuing year well in advance, and credit limits were sanctioned accordingly. These facilities were not generally availed of immediately after sanction but were utilized according to the borrowers' requirements over the period covered by the sanction. DBOD, therefore, insisted that the few days involved in obtaining the Bank's authorization were of no material significance and that, in cases where the banks approached for sanction of additional/fresh limits for financing urgent export commitments, authorizations were accorded expeditiously and at times even on the very day of the receipt of the application. The DBOD's note concluded that the existing procedure might continue. This was clearly a case of a regulator not wishing to give up power. But Adarkar was not convinced. He wrote back that 'despite what has been stated in the note above, I think we should exempt packing credit advances from the procedure for prior authorization of limits of Rs 1 crore or more. I would also recommend similar exemption for post-shipment advances for exports.' This was approved by the Governor in July and instructions were issued. Later, with effect from July 1974, pre-shipment advances above Rs 5 lakh were brought under CAS, in the wider perspective of addressing inflationary pressures.

THE ISSUE OF COMMON DIRECTORS

There was another ticklish issue that had been festering for long, which had to be resolved. This was the issue of common directors between banks and borrowers. In 1968, when the Banking Laws (Amendment) Bill, 1967, was being considered by Parliament and the Select Committee, the question of approving credit facilities during the interim period to big business houses—many of which had common directors with the financing banks—came to the fore. Under clause 5 of the Bill, which sought to amend Section 20 of the Banking Regulation Act, 1949, banks could not, after the amendment came into force, grant any loans or advances to, or give or renew any guarantee on behalf of any company of which any of the directors of the

banking company was a director, managing agent, etc. Meanwhile, the DBOD, while dealing with applications received from banks under the CAS where the banking company and the borrowing institution had common directors, started stipulating that the increased facility allowed should be liquidated before the amended Act came into force or within a short period of, say, two months thereafter. Some of the cases that came under this category were Punjab National Bank's advances to the Delhi Cloth and General Mills Co. Ltd and to Mukand Iron and Steel Works Ltd; and SBI's advances to Rallis India Ltd, Andhra Pradesh Paper Mills Ltd, Gobind Sugar Mills Ltd, etc.

This measure gave rise to differing interpretations from the banks. SBI sought clarification on two points. It wanted to know whether the Reserve Bank stipulation regarding recovery of the increased facility granted before the amending Act came into force or within a short period thereafter, without availing of the grace period that might be provided in the Act, would still be applicable if the director in question vacated that post either in the bank or in the borrowing company. It further pointed out that the amending Bill as introduced in the Parliament—to which certain further amendments were being considered but had not yet been finalized—stipulated that where any loan granted before the commencement of the said Act was such that the loan could not have been granted if it were in force on the date of granting the loan, then steps should be taken to recover the loan within the period stipulated for repayment or within a period of three years from such commencement, where no period had been stipulated for repayment of the loan. The amending Bill further provided that if the loan was not repaid within the specified period/grace period, the concerned director of the bank would cease to hold that post.

SBI argued that the provision implied that if the concerned director ceased to be a director of either the borrowing company or the bank before commencement of the amending Act, the advance in question need not be repaid. In response, DBOD said that the specific stipulation made by the RBI in its authorization letters was not based on strict legal grounds but intended to ensure compliance with the spirit of the proposed provisions.

The second query presumed that the above stipulation contemplated only the recovery of such amount drawn as would be in excess of the limit in force prior to the sanction of the additional limit, with which the DBOD was also in agreement.

The points raised by SBI were referred to the Legal Department for comments. Concluding a detailed interpretation of the specific provisions of the proposed Bill in respect of the first point, the Legal Department wrote:

The State Bank and the borrowing company had a common director. In these circumstances Reserve Bank, while granting permission for increase of the limit beyond Rs 1 crore, stipulated that the banking company should undertake 'to liquidate the increased facility' not later than two months after the date when the amendment Act comes into force, instead of seeking to avail of the three years otherwise permissible under Section 20(2) as proposed to be amended. As the stipulation was made in the light of Section 20(2), it is clear that it has reference only to the facts as they stood on the date on which the further facility was granted by the State Bank of India to each of the borrowing companies; and, changes in those facts subsequent to that date are irrelevant. Consequently, if, on the date when the increased facility was granted, there was a common director between the State Bank and the borrowing company, the stipulation applies; and it continues to apply to such facility, unaffected by the fact that, subsequent to the date when such facility was granted, the common director may cease to be such. The position holds good even if the common director ceases to be such before the date of commencement of the amendment Act (so long as such cessar is after the grant of the facility in question.).

As regards the extent of the credit facility to be recovered, the Legal Department ruled:

By the stipulation made by the Reserve Bank and accepted by the borrowing bank, this period of three years was, by agreement, reduced to two months. It will thus be seen that the stipulation for recovery within the specified period relates to the recovery of the loan which could not have been made, if the amended section had been in force. Consequently, 'the increased facility' referred to in paragraph 2 in the letters to the State Bank mentioned above, applies to the entire amount of the increased facility granted by the State Bank to each of these companies, in pursuance of the increase of limit permitted by the Reserve Bank. There is no warrant for construing it as limited to the amount of the facility in excess of such limit, as could have been granted by the banking company at the time when it applied to the Reserve Bank for increasing the limit.

The State Bank of India was accordingly advised on the matter.

Various other references were made by banks in relation to the Banking Laws (Amendment) Bill that was being examined by the Select Committee. Most of these cases had to be referred to the Legal Department. In an interesting interpretation of the legal implications of the amending provisions under Section 20 of the Act, in February 1968 the Legal Department held that in light of the definition then proposed of the expression 'director' as including a member of any board or committee constituted by a banking company for the purpose of advising it in regard to the management of its affairs, and as the powers of members of the local board of the State Bank were not limited to advising the State Bank in regard to the management of the affairs of the bank but extended to managing a certain part of the affairs of the bank, they were not considered to fall within the definition then proposed of the term 'director'.

However, the definition of 'director' finally proposed by the Reserve Bank included members of advisory committees as also members of bodies entrusted with the management of the whole or any part of the affairs of banks. But the Select Committee had stopped with the words 'in regard to the management of its affairs'. The result was that the later part of the definition, dealing with a member of a committee constituted for dealing with the whole or part of the affairs of the banking company, was left out. Further, according to the Legal Department, the wording 'director means' (and not 'includes') had resulted in the anomalous connotation. The Legal Department, in its note dated June 24 on the subject, concluded:

No doubt it may be argued that as the revised definition defeats the object with which the section was in the Act, and for which it is now being amended, the term 'means' shall be read as connoting 'includes'. Where the language of a statute, in its ordinary meaning and grammatical construction, leads to a manifest contradiction of the apparent purpose of the enactment or to some inconvenience or absurdity, hardship or injustice, presumably not intended, a construction may be put upon it which modifies the meaning of the words, and even the structure of the sentence. (Maxwell—11th Edition—page 221). Hence the definition may have to be construed, so as to avoid leading to an absurd result, as saying that in addition to members of boards or committees exercising executive functions, members of boards or committees set up for tendering advice are also to be regarded as directors. On such interpretation, a member of a

Local Board of the State Bank would also be 'director' under the revised definition. In the circumstances aforesaid, a member of the Local Advisory Committee of a bank as also a member of a Local Board of the State Bank would be regarded as a 'director' within the meaning of Explanation(b) to Section 20(4) (as proposed by the Select Committee).

The Reserve Bank later issued a circular based on the above interpretation. As a result, when banks forwarded applications for CAS approval they had to, in addition to providing information as to whether any director of the bank was interested in the borrowing concern, also indicate whether any member of the bank's local board/advisory board/local advisory committee was interested. In a consequential development in January 1969, SBI forwarded a list of several of their directors/local board members who had tendered their resignations from the respective forums. These were accepted. SBI requested that as these directors/members were interested in the companies to which advances were granted under Reserve Bank authorization, the cessation of their association with the bank in these capacities should pave the way for withdrawal of the Bank stipulation regarding premature repayment of the loans and advances. This was in the context of the proviso to Section 20(2) of the Banking Regulation Act, 1949, as proposed to be introduced by the Banking Laws (Amendment) Act: that the subsection did not apply if and when the director concerned vacated the office of the director of the banking company, whether by death, retirement, resignation or otherwise. The Bank responded positively and after obtaining legal opinion on the matter, took decisions in individual cases.

Another reference made to the Legal Department related to the nature of bills purchased and discounted transactions vis-à-vis the term 'loans and advances'. The question whether purchase/discount of bills by a banking company would be prohibited, in terms of the proposed amendment to Section 20 which, *inter alia*, precluded a banking company from granting loans or advances to a company in which any of the directors of the banking company was director, managing agent, manager, employee or guarantor, or in which he held substantial interest, was examined by the Legal Department in February 1968. It held that the purchase or discount of bills simplicitor might not amount to making of a loan or advance because the transaction in each type of case would give rise to different types of obligations and rights, and that if the transactions were really discounts or purchases, they could not at the same time be loans or advances. Accordingly, DBOD treated purchase/discount of bills as not covered by the term 'loans

and advances' used in Section 20(1)(b) of the Banking Regulation Act under amendment.

THE ISSUE OF DEFINITIONS

Definitions could also become a problem sometimes. There was, for example, a proposal to define the term 'credit facilities', which was intended to be used in place of 'loans and advances'. The idea was to cover purchase, negotiation and discount of bills of exchange. But it was subsequently decided to leave out bills for the time being and to make the definition more flexible by providing that the term would include such other credit facility as the Reserve Bank might, from time to time, specify. So the Select Committee did not replace the term 'loans and advances' with the term 'credit facilities'. It also did not make any specific reference to bills purchase/discounting facilities in Section 20 of the Act but added a clause providing that if any question arose whether any transaction was a loan or an advance for the purpose of Section 20, it should be referred to the Reserve Bank, whose decision shall be final.

Here it is worthwhile recalling the interpretation contained in the Legal Department's note on the nature of bills purchased/discounted facilities. It had held that when a bill of exchange was purchased or discounted in the real sense of the term, there was no relationship of debtor and creditor between the party and the bank (the obligation of the party arising only in the event of dishonour of the bill by the drawee). No doubt, in the event of the bank being unable to realize the amount from the drawee, it would have recourse against the customer, but this still did not involve the making of a loan or advance by the bank to the customer, which was prohibited by Section 20 of the Banking Regulation Act.

In 1969, a series of exemptions were afforded under the CAS on various grounds. A note recorded by Adarkar on 24 January 1969 pointed out: 'In view of the importance of fertilizer distribution and in fact that delay in authorization may result in fertilizer not reaching the cultivator in time, we should urgently examine the desirability of exempting limits for fertilizer distribution from prior authorization procedure.' The decision was conveyed to banks through a DBOD circular dated 27 January 1969. Later, in April 1969, instructions exempting 'credit limits against fixed deposits' were also issued to the banks.

A couple of piquant issues came to the fore when some banks sought the Reserve Bank's clearance for advance proposals even before they were placed before their own boards of directors. The Bank's stand was made clear on

two major issues: first, while it was for the Bank to approve of or disagree with the board's decision, it was not for it to assume any primary responsibility for processing the proposal: second, the Bank would not to assume responsibility for the safety of the advance. The matter was discussed at the conference of regional heads of DBOD in November 1968, where Adarkar indicated that the Bank's clearance should be sought by banks only after the advance proposals had been approved by their own boards of directors. However, this stand had to be diluted in the case of the SBI and its subsidiaries in view of their internal regulations and well-set procedures for sanctioning of advances, and on the assumption that the proposals were initially approved by the SBI at the level of managing directors. In the case of these banks, while conveying the Bank's authorization, it was specified that the same was subject to the proposal being sanctioned by the competent authorities of the banks.

In the monthly list of cases put up to the Governor in March 1969, Adarkar pointed out that the question of exempting certain categories of credit facilities should be examined so as to minimize the workload under the CAS. After a detailed examination of various credit facilities/practices, a circular was issued to banks in May 1969 exempting the following from the purview of CAS.

- (i) Transfer of limits from one bank to another not involving any increase.
- (ii) Extension of time for limits sanctioned for a temporary period and authorized by the Reserve Bank earlier (provided the proposed extension of time was only up to an aggregate period of one year from the date of original sanction of the limit and such extensions did not conflict with the provisions of the Banking Regulation Act, 1949, especially Section 20).
- (iii) Advances to state governments, the Food Corporation of India and state cooperative banks for financing of food procurement operations.
- (iv) Advances granted to state electricity boards and public sector undertakings, and those granted against guarantees of the central and state governments.
- (v) Advances against government and other trustee securities.
- (vi) Limits against government supply bills.
- (vii) Bill limits sanctioned under the rediscounting scheme of the IDBI and term loans sanctioned on a *pari passu* basis with the IDBI or the ARC, or under their refinancing schemes.

While these exemptions were afforded mainly on the basis of felt needs, the primary intention was to minimize the workload of the Section dealing

with CAS matters. An interim assessment of the scheme from November 1965 to January 1968, in fact, showed that of the 2,436 applications received from banks for authorization of credit limits sanctioned/enhanced by them and falling under the purview of the scheme, 2,353 were authorized and the remaining rejected/withdrawn by the banks concerned. The increase in the number of applications seems to have prompted Jha to comment, in the case of a rejected application referred to him according to the old practice: 'I feel that the practice of putting up all rejection cases to the Governor should be discontinued and the DG should pass final orders. However, when my successor joins, he may consult him on this matter again.'

As the turn of events would have it, the Deputy Governor became the next Governor. In May 1970, Jha's observations were submitted to him for his comments, to which he responded: 'I would not like the old practice of referring all rejection cases to the Governor to be revived. I would rather like the DG to consult the Governor, in particular in cases where he thinks such consultation to be advisable for any special reason.'

In August 1969, some more relaxations were allowed in the scheme according to which prior authorization from the Reserve Bank was not to be obtained by banks for sanction of the purchase/discount of inland documentary bills and limits against supply bills drawn on semi-government bodies. 1970 marked the end of the initial phase of the scheme and heralded the ushering in of a more organized and practical method of assessing the credit needs of large borrowers. In June that year, the Bank prescribed a set of proforma statements to be submitted while applying for prior authorization. The statements were designed to provide both to the lending bank and the Bank 'as complete and comprehensive a set of data as possible to permit a proper evaluation and financial appraisal of credit proposals'. They included particulars of the existing limits from the banking system, a statement of assessment of the working capital requirements and bank finance permissible, and a comparative statement of financial position (which included financial summary, analysis of balance sheet, income statement, balance sheet reconciliation, and analytical and comparative ratios). In the case of proposals for grant of term loans, banks were asked to submit additional information in the form of a cash flow statement and a statement showing the total cost of the project and sources of finance. It was also emphasized that banks should endeavour to obtain the data indicated in the proforma statements not only for furnishing the Reserve Bank with complete information with regard to proposals for limits relating to parties enjoying credit facilities from the banking system as a whole to the

tune of Rs 1 crore and above (which were covered by the scheme), but also for their own purposes in respect of appraisals for large individual credit proposals of, say, Rs 25 lakh and above. It was pointed out that although the discipline sought to be imposed might not be appreciated by the borrowers, and possibly even resented by them, it would be in the best interest of the banking system that steps were taken in this direction so that credit appraisal might be placed on a more organized footing. In cases where authorization was related to credit facilities to be granted by several banks on a participation basis, it was suggested that the banks concerned might designate one of the participating banks as a 'lead bank' for dealing with the Reserve Bank. The banks were, *inter alia*, cautioned that they should consider the collection of data in these statements not as an end in itself but as a tool for taking judicious decisions on proposals for credit facilities. The forms were thus not to be considered as substitutes for analysis and judgement based on the financial acumen and expertise acquired in the operational field. The data called for by the Reserve Bank for an 'account by account' scrutiny in the case of large borrowers did not fail to attract special media attention. *The Economic Times* dated 15 July 1970 reported: "The information sought is so comprehensive that one banker commented: "It would now be easier for a camel to pass through the eye of a needle than for a big borrower to hoodwink the authorities."

In an important case, the legal enforceability of the requirement of obtaining prior approval from the Reserve Bank was put to test. The First National City Bank had granted a medium-term advance to M/s Indian Express Newspapers (Bombay) Ltd without obtaining the necessary Bank approval under CAS. The question whether the RBI could direct the bank to recall such an advance was examined by the Legal Department in July 1970. After commenting on the scope of the relevant provisions under Sections 21, 35A and 36 of the Banking Regulation Act, 1949, the Legal Department finally concluded:

Failure, on the part of the lending bank, to take the approval does not detract from the validity of the contract (of lending and borrowing) between the bank and its customer. There is, therefore, no means of requiring the bank or the customer to treat the said contract as non-existing and calling on them to recall (or repay) the loan before it becomes due.

Reviews of the exemptions/relaxations granted under the scheme were undertaken as and when the circumstances warranted. While studying why there had been large rise in credit expansion to public sector enterprises by

the SBI, Hazari raised an important point in August 1970: 'The merits of these particular cases apart, I feel that government companies should also be brought within CAS for prior authorization.' As a result, the exemptions granted in May 1969 in respect of advances to state electricity boards and public sector enterprises, and those granted against guarantees of central and state governments came to be reviewed. A note dated 24 August 1970 said that the block requirements of projects which had been approved by the Planning Commission should primarily be met by the central/state governments out of their resources, and other suitable projects could, if the need arose, be financed by the IDBI and other term-lending institutions. Typically, the note said that there was no justifiable reason for commercial banks to lend to these projects. Alluding to external interference, it also noted that in respect of projects which did not have the Planning Commission's approval, the possibility of the concerned state governments pressuring the banks, particularly those with a pronounced regional presence, could not be ruled out. Hazari agreed and a draft circular was prepared. But when it was discussed with Jagannathan a different message came though and the matter was shelved for the time being. It took almost three years for it to be resurrected. It is worth noting in passing that the general election was held in March 1971 and assembly elections a year later.

But things could move in the other direction also. In May 1971, the purview of the scheme was extended to cover the segment of term-lending for the first time. The circular issued on 20 May 1971 advised banks that they should obtain the Reserve Bank's prior authorization under CAS for sanctioning, singly or jointly with other institutions, individual medium or long-term loans exceeding Rs 25 lakh, repayable over a period of more than three years, to any single party irrespective of the total credit limits available to it from the banking system as a whole.

The Indian Banks' Association, in a letter dated 7 July 1971, raised the issue of CAS approval for sanction of limits for acceptance on behalf of customers and sanction of limits for discount of bills that fulfilled the requirements under the Bills Rediscounting Scheme. Although the existing instructions and the clarifications were clear, it was decided to issue a formal circular on these issues clarifying that the limits for discounting accepted bills that were not accompanied by the documents of title to goods, as also the limits for negotiation of local usance bills accompanied by only invoices or challans, sanctioned to parties covered by CAS, required Reserve Bank's prior authorization. However, the limits for acceptance of such bills were kept out of the purview of the scheme, with the proviso that for the purpose of computing the total credit limits available to a party,

limits for acceptance facilities sanctioned to it should also be taken into account. This was followed by a series of exemptions from prior authorization afforded under the scheme and put into effect in September 1971, viz.:

- (i) Bills discounting limits in lieu of cash credit/overdrafts specifically authorized by RBI, not resulting in any increase in the overall limits.
- (ii) Reallocation of limits within the overall working capital limits provided it did not result in waiver of any specific condition stipulated by RBI. However, reallocation of limits from exempted category to non-exempted category continued to be subject to prior authorization, unless it was of a purely temporary nature.
- (iii) Occasional negotiation of bills, bank drafts or third party (outstation) cheques.

Three months later India was at war with Pakistan, and the Reserve Bank made certain special relaxations.

In the context of the war situation, it is necessary that the banks meet, on a priority basis, any increase in the financial requirements of industry to manufacture and supply goods for the defence effort as well as to augment production in general and ensure smooth distribution of goods particularly in the border areas.

Another circular issued on 11 December 1971 exempted 'defence packing-cum-supply' credit limits granted by banks, on merits, against confirmed defence orders or acceptance of tenders, from the purview of CAS prior authorization. Further, for the purpose of sustaining and increasing production in all spheres, banks were allowed at their own discretion and on merits to permit enhancement of credit limits in the case of CAS parties, up to a maximum of 15 per cent, without prior approval from the Reserve Bank. Subsequently, in January 1972, an office note was put up explaining that the Bank had been exempting certain credit facilities from CAS prior authorization mainly because these facilities were for unquestionably good purposes, or because the grant thereof would not result in additional accommodation, or because the proposals concerned had already been examined by IDBI/ARC, or to popularize the Bills Rediscounting Scheme, etc. The note further suggested certain additional exemptions which were approved by the Governor on 1 January 1972. A circular was issued on 7 January 1972 indicating that the following credit facilities were exempted from CAS:

- (i) sanction of credit limits up to Rs 10 lakh for periods not exceeding three months;

- (ii) where application for enhancement in limits in excess of Rs 10 lakh was pending with RBI, banks might release an interim limit up to Rs 10 lakh;
- (iii) purchase of third party (outstation) cheques/bank drafts;
- (iv) advances against the security of inland documentary bills (demand documentary bills or usance bills drawn on D/P basis) received for collection;
- (v) restoration to the original level of a limit authorized by RBI but reduced by the bank itself;
- (vi) credit limits sanctioned to a party in replacement of its limits with another bank as a result of which during the intervening period, i.e. till the accounts with the existing bank were adjusted, the total limits of the party aggregate/exceed Rs 1 crore;
- (vii) temporary excess drawings not exceeding 5 per cent or Rs 10 lakh, whichever is lower, over the sanctioned limit and advances against uncleared effects;
- (viii) credit facilities for purchase/discount of bills/third party (outstation) cheques/bank drafts on an 'ad hoc' basis.

Some of these exempted facilities were reviewed and enhanced subsequently in December 1972: viz., the sanction of temporary limits up to Rs 25 lakh for a period of three months; interim accommodation up to Rs 25 lakh (where application for enhancement is made to the Reserve Bank of India and is pending authorization for a higher limit); and temporary excess drawings over the sanctioned limit up to 10 per cent or Rs 25 lakh, whichever was lower.

DIVIDENDS AND FOREIGN COMPANIES

An interesting issue that came up was the distribution of dividends by the foreign companies. Many of them drew on their reserves for this. The matter was initially discussed under correspondence between the Exchange Control Department (ECD) of the Bank and the government, but then it was referred to DBOD in December 1971. The question of excessive dividends declared by certain foreign-controlled companies out of their reserves was taken up by the Finance Ministry, which suggested that so long as the foreign-controlled companies distributed reserves as dividends they should not be permitted to raise finance from banks or other financial institutions. The ECD examined the issue and concluded that no change should be made in the criterion for clearing applications from banks for sanctioning credit limits to these companies, viz. that the debt–equity ratio

should not exceed 2:1. The government apparently did not have an objection to these companies drawing upon their reserves for payment of dividends and advised that the ECD might continue to follow the procedure then in existence. However, it felt that at least the facility of having new borrowing limits sanctioned to such concerns, or an increase in their existing limits, should be denied until they had rebuilt the reserves that had been brought down for declaring heavy dividends. The government agreed to the ECD's suggestion that this could be done under the CAS.

DBOD, too, had its views on the matter. It wrote that if these companies desisted from declaring excessive dividends to be paid out of their reserves, their reliance on bank borrowings in India, as also the remittance of dividend amounts abroad, would, to that extent, be less. On the other hand, if they preferred to declare excessive dividends and draw upon their reserves, knowing fully well that their working capital requirements were also increasing, the government would be justified in concluding that their only intention was to take funds out of India. Also, these firms were perhaps emboldened to declare excessive dividends and take funds out of the country because of the easy availability of bank credit to them, mainly from foreign banks. The note, therefore, suggested that an effective check should be introduced to curb this tendency and that, as a matter of policy, the Reserve Bank should decide that where it was found that a foreign-controlled company seeking additional bank credit had declared unduly high dividends and had drawn upon reserves for the purpose, the additional bank credit sought should be denied to it till the reserves were rebuilt from its future earnings. This decision was later put into operation as part of the Credit Authorization Scheme.

BANKS AND SEBs

In mid-1972, there was a strong proposal to raise the cut-off point from Rs 1 crore to Rs 2.5 crore, on the argument that after the introduction in June 1970 of a comprehensive set of forms, the credit appraisal system in banks had been put on a strong and uniform footing. It was further pointed out that the economy had been developing well in many sectors. So the resources of banks were reasonably comfortable and the total bank credit was twice the size of that in 1965, when CAS was introduced. Out of the 1,000 and odd borrowers covered by the scheme at that time, those enjoying credit limits of up to Rs 2.5 crore were roughly about 500. The proposal was submitted to Jagannathan by Hazari and the former suggested that the cut-off point be fixed at Rs 2 crore instead of Rs 2.5 crore. He also

said that the government should be consulted in the matter. So, in May 1972, separate letters were sent to I.G. Patel, Secretary, Department of Economic Affairs, and V.M. Bhide, Additional Secretary, Department of Banking. DBOD had also prepared, in the meanwhile, a draft circular for issue to the scheduled banks. The proposal was shelved.

But it would not go away. The related circular dated 17 March 1973 stated:

In recent times, there has been a sizeable increase in the borrowings by various public sector and quasi-government undertakings. Advances to such units have hitherto been exempted from prior authorization of the bank under the Credit Authorization Scheme. All advances to public sector undertakings, including state electricity boards, as also advances against the guarantee of central or state governments will now come under the scheme. Prior authorization in respect of such advances will be needed for working capital loans totalling Rs 3 crore and above, and for term loans of Rs 1 crore and above.

How did this about-turn come about? In the end it was because of the excesses of the state electricity boards (SEBs). The Department of Banking studied the persistent demands of the SEBs for funds from nationalized banks and on 11 December 1972 its note to them on bank credit was forwarded to Hazari by V.M. Bhide, Additional Secretary, Department of Banking. The note dwelt at length on various aspects of the Plan outlays for operations of the SEBs, as also the avenues for bank finance to supplement these efforts, such as medium/long-term loans for financing specific programmes rather than as subscriptions to the open market debentures floated by the SEBs, bridge finance to meet advance payments, working capital requirements and finance for rural electrification programmes. As regards medium/long-term credit, the note made a simple but effective point: the circumstances under which and extend to which banks should extend credit for meeting a part of the outlay on power programmes were matters for the Planning Commission to decide in consultation with the Department of Banking. The note said that bank credit, excluding the proposed term-lending, ought to be brought under CAS.

These issues raised were examined by the Credit Planning Cell of the Bank and a copy of the note prepared by the cell was sent to Bhide by Hazari on 29 January 1973.

The point is not adequately appreciated that the country now faces a power famine of serious dimensions and that further

development hinges on the build-up of this vital infrastructure. This situation happens to coincide with one of adequate liquidity in the banking system. Even if this were not so, there would seem to be a case for involving banks to a greater extent in the financing of electricity projects. In the present circumstances, it would be little short of gross negligence to allow power schemes to languish for want of finance while banks are unable to find outlets for their resources. The alternative left for putting through the schemes would be through provision of governmental finance—which could mean, ultimately, recourse to the Reserve Bank. It would obviously make more economic sense to allow the turn-over of existing liquidity than permit further deficit financing.

As regards bringing the bank credit to state electricity boards under the purview of CAS, it was pointed out that

the distinction drawn in the note between term loans to State Electricity Boards (which would require clearance from the Banking Department and the Planning Commission) and working capital and bridging loans (which would require Reserve Bank clearance) is somewhat ambivalent. A good portion of the so-called working capital now being provided is in actuality utilized to meet medium and long-term requirements. If it be conceded that lending to State Electricity Boards is desirable in the present context, then what is necessary is an evaluation of each proposal taking into account not only the financial prospects but the overall portfolio of the lending bank and the position of the concerned Board and the power requirements of the state as well. This could be done in an integrated manner in the bank, not just under the Credit Authorization Scheme but from the angle of overall credit planning.

Bhide, Jagannathan and Hazari met in Bombay to discuss these issues. Later, the Finance Minister, the Finance Secretary and senior officers of the Department of Banking were also consulted. Eventually, the Finance Ministry suggested a specific course of action, which was conveyed to the Governor by Bhide in a letter dated 1 March 1973.

- (i) Bank finance for implementation of power programmes should take the form of increased subscription to open market loans floated by the boards and not be direct loans to individual boards in financing

specific projects; banks may, however, extend credit directly for rural electrification programmes related to energizing tube wells or pump sets.

- (ii) Banks could extend short-term accommodation to meet working capital requirements, bridging requirements and ways and means requirements.
- (iii) The credit requirements of electricity boards, as well as of other public sector undertakings should be brought within the purview of the Credit Authorization Scheme.

The next credit policy announcement, in March 1973, therefore included the stipulation that CAS was applicable to advances to all public sector undertakings including SEBs, with cut-off points as indicated above. The attempts by some states to take recourse to these borrowings in an effort to circumvent the restraint placed by the Planning Commission on their access to market funds for budgetary and other requirements were under scrutiny. An article titled 'States' bid to by-pass RBI curb', which appeared in the *Economic Times* dated 28 August 1973, provided some valuable insights.

At least three of the 20 State Governments which completed their market borrowing programme for 1973–74 today, with substantial support from the scheduled commercial banks, are pressing the banks for term loans.... Maharashtra, Rajasthan and Uttar Pradesh are among the states which want bank funds for financing electricity generation and rural electrification programmes.... Willingness to lend notwithstanding, banks have qualms about assisting states on two general counts. First, the issue raised by certain bankers is whether the states are not seeking an alternative to ways and means borrowings from the Reserve Bank, the lid on which was tightened in early 1972–73. Second, these bankers wonder if the states are not seeking to tap voluntary public savings in excess of what the Planning Commission visualized.... What banks are worried about is the propensity of the states to ask for funds so much so that one state interpreted the Reserve Bank's permission to banks to extend 'bridging finance' as finance for construction of bridges.... As in the case of bridging finance where the states appear to be asking for credit in excess of the resources raised or to be raised by them through bond issues, in the case of rural electrification programmes involving energization of pump sets

etc. there are doubts if demand for agricultural power was being induced in excess of available and likely power supply.

The Reserve Bank's circular dated 27 March 1973 on some related subjects clarified that finance for implementation of 'power programmes' would cover all types of capital investment by SEBs, and that bank finance for these programmes should take the form mainly of increased subscription to open market loans or special debentures floated by them. The Bank also stressed the need for a proper scrutiny while extending credit for rural electrification programmes relating to energization of tubewells or pump sets. It cautioned that the proportion of expenditure on other items, such as street lighting, etc., should be kept to the minimum. As regards short-term accommodation to SEBs for meeting their working capital, bridging, and ways and means requirements, emphasis was laid on the need to extend such finance only for short periods not exceeding one year, and that too on a clear indication of the amount as well as the source of funds from which the bridging finance was to be cleared.

Perhaps as a part of its efforts to quell the criticism regarding the states' tendency to overestimate their requirements, the Bank followed this up with another circular on 24 September. It advised banks that they should, before submitting proposals for credit authorization for extending term credit for rural electrification programmes relating to energization of tube wells, pump sets, etc., satisfy themselves that the proposed programmes were technically feasible, economically viable and financially sound by getting the relative project reports vetted by the bank's own technical cell or the Rural Electrification Corporation or the Agricultural Finance Corporation.

There were some funny moments as well. It turned out that some state governments had interpreted the Bank's permission to extend 'bridge finance' as finance for construction of bridges. This came up when the Uttar Pradesh State Bridge Corporation, through Bank of India and Punjab National Bank, sought sanction for term loans of Rs 40 lakh and Rs 22.09 lakh respectively, for construction of bridges over Kali Nadi in Farukkabad and over Banaily in Bijnore district. The Bank had taken the view that bridge construction, being an infrastructure activity, should be financed by the state government through budgetary allocations and that bank credit for this purpose, if at all given, could only be marginal, say, not exceeding 25 to 30 per cent of the cost of the project. Accordingly, in 1976, approvals were afforded for term loans of Rs 12 lakh and Rs 6.60 lakh to Bank of India and Punjab National Bank, respectively. Subsequent demands from the Corporation were dealt with similarly.

In another singularly unique proposal in 1973, the Reserve Bank considered an application by Punjab National Bank for sanction of a bill discounting limit of Rs 5 crore to Haryana Roadways. The case was disposed of with Hazari commenting, 'We may inform PNB that we are not in favour of financing state governments. If the Roadways were a corporate enterprise, we would have considered the proposition on merits.' He also sought the opinion of the Executive Director, K.S. Krishnaswamy, on the subject, who replied that

lending to departmental concerns, even though in the form of discounting usance promissory notes, contravenes the objective of ensuring that 'trading' activities of government are separated from 'general administrative budgets'. In other words, this will constitute technically, a loan to Government and hence does not come within the purview of the CAS.

In December the Bank set up a Study Group on Extension of Credit Limits on Consortium/Participation Basis, under the chairmanship of G. Lakshminarayanan, chairman and managing director of Indian Bank, to make recommendations for sharing of advances to units in public and private sectors, participation amongst banks for revival of sick units, and better cooperation amongst banks in respect of multiple banking. The recommendations of the Group were accepted by the Bank and communicated to all scheduled commercial banks on 8 August 1974. They were:

- (i) Large credit limits by a bank to any single borrower in the private or public sector (including electricity boards) in excess of 1.5 per cent of its deposits should normally be extended on participation basis. This norm was in the nature of a guideline, to be operated flexibly.
- (ii) In cases where the working capital requirements of a borrower were financed by a number of banks without a consortium arrangement, a proper procedure for coordination amongst the financing banks should be evolved on the following lines:
 - (a) periodical exchange of essential information between the financing banks;
 - (b) review of borrower's performance through periodical inter-institutional meetings; and
 - (c) joint review of credit requirements of the borrower when the limits become due for renewal, etc.

In 1974, was a significant change made in the applicability of the scheme, relating to export packing credit and post-shipment credit, which were in the exempted category. From July 1974, while post-shipment credit con-

tinued to be exempted from CAS, export packing credit, including advances made against duty drawbacks, cash assistance, etc., were brought within the purview of the scheme. However, packing credit limit of up to Rs 5 lakh to a single bank borrower was exempted from prior authorization.

By 1975 the scheme had been in operation for a decade. A great deal had changed in the meanwhile. The economy had become more diversified. The financial sector had grown but banking was now practically a government monopoly. The banking system was asked to adopt a new approach as a credit agency, based on economic development potential rather than on security alone, to assist the weaker sectors of society and to lend to the public sector. Significant sectors of the economy, which were once outside the scope of bank lending, were brought within its ambit. However, the bulk of the credit was still availed of by the organized industry, though in terms of proportion to the total, its share had drifted downward. A world-wide flare-up of oil prices and stagnation in Indian industrial and agricultural production fuelled an unprecedented rise in prices; this, in turn, led to a rise in the demand for credit, part of which could be 'speculative' in nature. In late 1973, when the demand for credit rose steeply at a time when production was not keeping pace with the former, the Reserve Bank imposed certain credit restraints on the banking system. Later, in 1974, when inflation touched the unprecedented level of 31 per cent, a package of measures was introduced aimed at bridling the runaway inflation.

Clearly, the time had come to stop tinkering with the CAS and undertake thorough reform. It had become necessary to correlate the demand for bank credit of borrowers to their business/production plans, as also their own resources including long-term funds at their disposal. This implied the need for a shift from a 'security-based' to production-related ('need-based', as it was referred to) approach to lending.

A year earlier, the RBI had set up the Study Group to Frame Guidelines for Follow-up of Bank Credit (popularly known as the Tandon Committee). In 1975 the Group submitted its recommendations, and the Bank accepted them. With this the scheme entered its third and perhaps the most important phase.

The terms of reference of the Study Group were:

- (i) To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end-use of funds and keeping a watch on the safety of the advances, and to suggest the type of operational data and other information that may be obtained by banks periodically from such borrowers and by the Reserve Bank of India from the lending banks;

- (ii) To make recommendations for obtaining periodical forecasts from borrowers of (a) business/production plans, and (b) credit needs;
- (iii) To make suggestions for prescribing inventory norms for different industries both in the private and public sectors and indicate the broad criteria for deviating from these norms;
- (iv) To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings;
- (v) To make recommendations regarding the sources for financing minimum working capital requirements;
- (vi) To make recommendations as to whether the existing pattern of financing working capital requirements by the cash credit/overdraft system, etc., requires to be modified, and if so, to suggest suitable modifications; and
- (vii) To make recommendations on any other related matter as the Group may consider germane to the subject of enquiry or any allied matter which may be specifically referred to it by the Reserve Bank of India.

The Group met for the first time on 6 August 1974. Hazari initiated the deliberations. He said that various omnibus issues relating to credit had been referred to the Group because it had become necessary to take an integrated view of all these problems. But there was to be a departure from the supervision and follow-up of bank credit. The Study Group then formed three sub-groups.

INVENTORY NORMS

The Bank asked the Group to submit an interim report on inventory norms for the 1974–75 ‘busy season’. This was done in October and immediately accepted by the Bank. It communicated the decision to banks on 8 November for implementation but warned that the norms were ‘tentative’ and in the ‘nature of an experiment’. Banks were advised to apply the inventory norms to both existing and new borrowers. While certain punitive measures, such as charging higher rates of interest, were suggested for non-compliance with the prescribed norms, the banks were also cautioned to exercise ‘due flexibility and understanding of the circumstances’ that might warrant deviation from the norms for temporary periods. The RBI asked the banks submit a report to it with industry-wise comments in regard to their experiences in applying the norms and with suggestions for improvement.

A second interim report was submitted by the Group in December, as it felt that an experimental set of statements for obtaining information from

the customers of banks should be prepared and launched at a seminar. On 13 January senior credit executives of thirty-four banks with deposits of Rs 50 crore and above met at the Bankers' Training College in Bombay. Each participating bank was asked to introduce the forms devised by the Group in the case of a minimum of five to ten customers, on an experimental basis.

A suggestion was made at the seminar to constitute a Committee of Direction in the Reserve Bank, as also in those banks that participated in the seminar. The Committee was set up in the RBI in April. Its main function was to consider the problems that might arise in the implementation of the recommendations of the Study Group. Only a few banks were represented but it was clarified that other banks would be invited by turn to attend the meetings. At a follow-up seminar on 22 April, Hazari said that the new information system was intended to assist in improving the quality of supervision and to ascertain whether the borrower was responsive to the required discipline. Banks complained that the response from borrowers was slow and that they had not understood the need for the new system. They asked for the forms to be simplified and obtained at half-yearly intervals. The borrowers complained that the information sought was confidential and would affect the value of their shares in the market. Nevertheless, everyone accepted the need for a uniform approach in adopting the new system. After discussions, the participating banks were furnished with a simplified version of the statements under the new information system.

As regards the norms of inventory and receivables suggested in the first interim report, the bankers had the following things to say:

- (i) The exemptions from the norms should be clearly understood and identified to leave no room for borrowers to circumvent the spirit behind the norms.
- (ii) The bunching of imported and domestic raw materials caused difficulties in implementing the norms.
- (iii) Classification of items like stock-in-process and finished goods varied even among units in the same industry.
- (iv) The norms could be more liberal for new units.

These and similar observations made by the banks, based on the trial run of the information system and inventory norms, helped the Group in crystallizing its views and drafting its final report. It submitted the final report in August 1975. Its main focus was on working out uniform inventory norms and facilitating better bank supervision. The suggested inventory norms were to be applied to all industrial borrowers, including small-scale industries with aggregate limits from the banking system in excess of

Rs 10 lakh, and later extended to smaller borrowers progressively. All borrowers were to be brought under this discipline. However, in cases where inventory levels in excess of the norms prescribed were continued without justification, banks might, while not attempting to abruptly stop operations in such accounts, after a reasonable period of, say two months, consider whether they should charge a higher rate of interest on the portion of the borrowings considered as excessive.

The Group had worked out three alternatives for determining the maximum permissible level of bank finance on the premise that borrowers should be expected to hold only a reasonable level of current assets in relation to their production requirements. The total current assets would be carried partly by a certain level of credit for purchases and other current liabilities. The funds required to carry the remaining current assets represented the working capital gap and this gap, the Group contended, should be bridged only partly by short-term bank advances. The balance would be required to be provided by the borrower out of owned funds and long-term borrowings including those from banks. The three alternative methods worked out by the Group for this purpose were intended to progressively increase the involvement of long-term funds comprising the borrower's owned funds and term borrowings to support current assets. The first method arrived at the maximum permissible bank finance (MPBF) by deducting the amount of current liabilities (other than bank borrowings) from the total current assets to arrive at the working capital gap, and then allocating 25 per cent of this to be met out of long-term resources. In the second method, the total amount of current liabilities (other than bank borrowings) was deducted from 75 per cent of the current assets for arriving at the MPBF. The third method introduced the concept of 'core' current assets, which was excluded from the total amount of current assets to arrive at the 'real' current assets; thereafter, the MPBF was worked out as in the case of the second method. The Group had arrived at the current ratio of 1.17:1, 1.33:1 and 1.79:1 for the first, second and third methods of lending, respectively.

Banks were asked to initiate immediate action to place all borrowers with limits in excess of Rs 10 lakh on the first method of lending. Beginning with the weaker borrowers, the process was expected to be completed by the end of September 1976. In the case of borrowers who were already in a position to maintain the second method of lending, it was cautioned that they should not be allowed to slip back into the first method. As regards the third method of lending, the Bank did not take any decision at that time. As recommended by the Group, instead of making available the entire credit limit by way of cash credit, banks were advised to split the

accommodation into two parts: a loan comprising the minimum level of borrowing that the borrower expected to use throughout the year, and a demand cash credit to take care of fluctuating requirements. Both would be reviewed annually. Within the overall eligibility, bill limits could also be allowed. Implementation of the various recommendations of the Group was to begin with bigger borrowers with limits aggregating Rs 1 crore and above, but eventually would cover all borrowers with limits of Rs 10 lakh and above from the banking system.

A QUESTION OF DISCRETION

While these far-reaching refinements were being introduced into general credit regulation, the Reserve Bank suddenly raised the cut-off point for prior credit authorization for working capital limits from Rs 1 to Rs 2 crore for borrowers in the private sector. The credit policy announcement on 1 November 1975 asked banks to ensure that this relaxation did not result in any dilution of the standards of credit discipline, both for appraisal and for supervision. But there is no official record of why this decision was taken. One of the Deputy Governors has said that it was entirely Governor Puri's decision, essentially to help Maruti. He says he told the Governor that the existing CAS limit of Rs 1 crore could not be raised without making a general policy review. Puri did just that.

Maruti had made an application for grant of credit facilities of about Rs 25 lakh in addition to the Rs 95 lakh it already had. The lead bank, Central Bank of India, had approached the RBI for approval of this arrangement under the Credit Authorization Scheme, which laid down that all credit facilities beyond Rs 1 crore needed the approval of the Bank. The Credit Planning Cell was of the view that the proposal should be rejected. The Deputy Governor concurred. The papers were then put up to Governor Puri—who simply raised the prevailing limit to Rs 2 crore.

The DBOD was upset but, under the prevailing circumstances, could do nothing about it. On 5 November 1975, the DBOD recorded a note making the following main points:

The banking system is on the threshold of a big change in the manner of lending etc. arising from the implementation of the recommendations of the Study Group (Tandon Committee); the facility for overseeing the switchover to the new system which was available to us through the media of CAS would not cover a number of parties enjoying facilities up to Rs 2 crore.

The raising of the limit would not also enable us to tender

advice and guidance to banks in regard to improving their appraisal system and enforcing financial discipline in the above cases.

Even from the statistical angle the absence of data in respect of units whose limits are now exempt from authorization might affect our 'study of trends' in different industries.

Above all, the smaller/medium banks are likely to be practically out of authorization scheme.

It was also estimated that 848 borrowers would escape the CAS net on account of this quantum jump in the cut-off limit. In November 1975, banks were advised that interim/bridge finance exceeding Rs 25 lakh for private sector borrowers, and Rs 100 lakh and over for public sector borrowers for capital expenditure, would be subject to prior authorization, unless such finance was against the bank's share of term loan sanctioned on a *pari passu* basis with all-India term-lending institutions or against the latter's committed financial assistance.

The CAS database was revised in December 1975 in light of the discussion that took place in the meetings of the Committee of Direction set up to implement the recommendations of the Tandon Study Group recommendations. The impact of the new credit discipline was, however, debated within the banking system as well as in the press. The ramifications of the various recommendations were covered by the *Financial Express* of 4 and 5 May 1976 as follows:

It is argued that the situation in which the Group was conceived has completely altered and its recommendations are no longer valid in the present economic situation. But this is not correct. The main thrust of the report is growth with discipline in the availment and use of scarce funds.... The timely action by banks could lighten the draft on the scarce national funds and lessen the burden on Government which could direct its attention to other areas of importance and urgency.... The type of attempt made by the Group is unique in the sense that no such attempt to traverse such a wide ground in the area of bank lending has been made in the past as has been done by this Group. There will be a fairly common approach towards the lending system by different banks once the new system gets going, and this will also facilitate orderly growth of bank credit. It needs to be appreciated that what the Group has attempted to do is to marry credit

flows with genuine production needs and avoid wasteful use of the scarce working capital funds

In 1976, comprehensive guidelines were issued to banks for scrutiny of annual/quarterly information/data received from borrowers. Further, in respect of borrowers having aggregate credit limits of Rs 1 crore and above, separate data on a monthly as well as quarterly basis was called for.

Following a decision taken by Puri and the chief executives of major commercial banks on 12 March 1976, the RBI constituted a Committee on transfer of borrowal accounts under the chairmanship of R.K. Talwar, chairman of SBI. A streamlined procedure for transfer of borrowal accounts with credit limits of Rs 25 lakh and above was communicated to all scheduled commercial banks in June 1977. From now on each bank would have to constitute a high-powered internal committee to give a hearing to the grievances of customers intending to transfer accounts to another bank, and while the internal committee was not to stand in the way of the customer selecting the bank of his choice, it would examine whether the customer was transferring the account to avoid financial discipline. Further, the two banks involved were asked consult each other and if a difference of opinion remained unresolved for a month, either bank was encouraged to approach the Reserve Bank.

The change in government in March 1977 did not lead to a change in the overall CAS limit. The only issue of note that took place before I.G. Patel took over as Governor of RBI was bringing advances against fixed deposits under the purview of prior authorization. Governor Patel invited comments on CAS with a view to streamlining the scheme, delegating more authority to the banks themselves and facilitating quick decisions. In an attempt to revitalize CAS and redefine its objectives, the Bank, in May 1978, issued detailed instructions to scheduled commercial banks, setting out broad objectives as under:

- (a) to ensure that additional bank credit was in conformity with the approved purposes and priorities and that the bigger borrowers did not pre-empt scarce resources;
- (b) to enforce financial discipline on the larger borrowers, where necessary, on uniform principles;
- (c) where a borrower was financed by more than one bank, to ensure that the customer's proposal was assessed in the light of the information available with all the banks; and
- (d) to bring about improvement in the techniques of credit appraisal by banks and their system of follow-up.

In August 1978, certain categories of non-fund-based facilities were brought under the purview of CAS. The cut-off point for working capital limits (Rs 2 crore for private sector borrowers and Rs 3 crore for public sector borrowers) was allowed to be computed without taking into account term loan outstandings.

In the meantime, a new issue had come to the fore, namely, the overlap between commercial banks and term-lending in institutions. An inter-institutional group was set up on coordination of the lending operations of term-lending institutions and commercial banks. On 28 March 1978, a decision to this effect had been taken at the Governor's meeting with representatives of term-lending institutions and commercial banks. A.K. Bhuchar, who was then chief officer in the DBOD, was named as head of the group. The over-riding consideration was that as the term-lending institutions geared themselves for meeting the increased long-term lending requirements, commercial banks should avoid undue involvement in term lending and conserve their resources for meeting the demand for short-term credit. The Reserve Bank later constituted a Standing Coordination Committee for considering policy issues pertaining to the coordination between banks and term-lending institutions.

Its recommendations, with certain modifications/clarifications, were communicated to banks in November 1978. These laid down that the term loan requirements of small and medium industries with a project cost not exceeding Rs 1.50 crore could be financed by banks, preferably in participation with state-level institutions such as state financial corporations (SFCs) and state industrial development corporations (SIDCs) irrespective of the size of the paid-up capital and reserves of the borrowing company. As regards other projects, where the total project cost exceeded Rs 1.5 crore but did not exceed Rs 5 crore, banks were told that they need not ordinarily participate in the extension of term credit. In the case of larger projects, where the project cost exceeded Rs 5 crore, banks might participate to the extent of 25 to 30 per cent of the total term loan (including deferred payment guarantees) requirements of the project. The recommendations also dealt with various aspects of coordination among the participating agencies in the spheres of appraisal, conduct/operation of accounts, joint inspections, etc.

By 1980, it became clear that the Credit Authorization Scheme was in need of some more modification. The banks were facing a major problem in implementing the credit regulatory measures. There was extensive use of the cash credit system. While reviewing the monetary and credit trends in March 1979, the Governor stressed the need for exercising continued

restraint on further expansion of credit. He also indicated the need for considering certain long-term issues relating to banking operations. Many changes had been suggested but nothing had been done. Reform was needed and it was in this context that Patel wrote to banks on 16 March 1979:

I would like to initiate action on certain structural matters which need further examination. It is necessary to take a fresh look at another major problem faced by banks in implementing the credit regulatory measures, viz., the extensive use of the cash credit system. Its drawbacks have been pointed out by various Committees in the past including the Tandon Committee, which suggested the bifurcation of credit limits into a demand loan and a fluctuating cash credit component. Although the banks were advised to implement this recommendation, I am afraid, the progress achieved has been very slow. Clearly this problem needs to be looked into further and for this purpose I propose to set up immediately a small Working Group, to report to me ... on the reforms to be introduced.

With this, CAS entered its fourth phase. The terms of reference of the Working Group to Review the System of Cash Credit, known as the Chore Committee, after K.B. Chore, additional chief officer (later chief officer) of DBOD, were as follows:

- (i) To review the operation of the cash credit system in recent years, particularly with reference to the gap between sanctioned credit limits and the extent of their utilization;
- (ii) In the light of the review, to suggest:
 - (a) modifications in the system with a view to making the system more amenable to rational management of funds by commercial banks; and/or
 - (b) alternative types of credit facilities, which would ensure greater credit discipline and also enable banks to relate credit limits to increase in output or other productive activities; and
 - (c) to make recommendations on any other related matter as the Group may consider germane to the subject.

The Group's suggestions were discussed and eventually the Bank accepted the recommendations, subject to certain modifications. The salient features of the main recommendations and the decisions taken by the Reserve Bank were advised in the circular dated 8 December 1980.

- (i) It was not feasible to replace the cash credit system totally by another system. The banks should strictly ensure that review of all the

borrowal accounts enjoying working capital credit limits of Rs 10 lakh and over from the banking system was made at least once in a year. The information system was also to be strictly enforced in respect of all borrowers having working capital limits of Rs 50 lakh and over from the banking system. It was also decided that the quarterly statements that were so far required to be submitted by borrowers enjoying credit limits of Rs 1 crore and over, should henceforth be obtained from all borrowers having working capital credit limits of Rs 50 lakh and over from the banking system. Non-compliance, if any, with the above requirements was to be reported to the Reserve Bank, specifying the reasons therefor, on a half-yearly basis.

- (ii) As regards bifurcation of cash credit into demand loan for core portion and fluctuating cash credit component, as advised by the Tandon Committee, it was decided to withdraw the instructions issued earlier. In cases where the cash credit accounts had already been bifurcated, steps were to be taken to abolish the differential in interest rates with immediate effect.
- (iii) While assessing the credit requirements of borrowers, the banks should fix separate limits, wherever feasible, for the normal non-peak-level as also for the peak-level credit requirements. One of the important criteria for deciding the normal non-peak-level and peak-level requirements should be the borrower's utilization of credit limits during such periods in the past. In the case of CAS accounts, the relevant forms had necessary provision for assessment of the peak-level requirements separately.
- (iv) Within the limits sanctioned for peak-level/non-peak-level periods, the borrower should indicate, before the commencement of each quarter, the requirements of funds during the quarter (i.e. the operative limits). (While this part of the Group's recommendation had been accepted, the further suggestion that drawings less than or in excess of the operative limit so fixed—with a tolerance of 10 per cent each way—but not exceeding sanctioned limit, should be charged additional interest of 2 per cent per annum over the normal rate, however, was not accepted by the Reserve Bank, in view of the practical difficulties involved.) If the borrower did not submit the returns within the prescribed time limit, banks might charge penal interest of 1 per cent per annum on the total outstandings for the period of default in submission. In the case of persistent defaults in submission of returns the operations in the account of such borrowers might be frozen

after giving sufficient notice, if, in the opinion of the banks, such deterrent action was warranted.

- (v) While borrowers should be discouraged from approaching banks frequently for ad hoc or temporary limits to meet unforeseen contingencies, such limits if sanctioned should be allowed only for pre-determined short durations and should be charged additional interest of 1 per cent, except in special cases.
- (vi) In order to avoid over-dependence on bank credit by medium/large borrowers as well as to enhance borrowers' contribution, it was decided that banks should adopt the second method of lending recommended by the Tandon Committee, according to which the borrower's contribution from owned funds and term finance, to meet the working capital requirements, should be equal to at least 25 per cent of the total current assets; giving a current ratio of 1.33:1. In cases where the borrower was not in a position to comply with this requirement, the excess borrowing was to be segregated and treated as a working capital term loan (WCTL), which could be made repayable in half-yearly instalments within a definite period which should not exceed five years in any case. The WCTL was to carry an interest rate not less than the rate stipulated for the relative cash credit limit and banks were given the discretion to charge higher rates of interest within the ceiling prescribed. While the measures enunciated were made compulsory in the case of all borrowers, without exception, having working capital limits of Rs 50 lakh and over from the banking system, they were to be enforced in stages on borrowers who were enjoying credit limits less than Rs 50 lakh. As far as sick units under nursing programmes were concerned, the banks were to prescribe separate packages of measures for their rehabilitation.
- (vii) Banks should take steps to discontinue the system of allowing cash credit limits against book debts and change over to financing through bill limits. The Group also suggested that, to start with, the banks should, in the case of borrowers having credit limits of Rs 50 lakh and over, extend at least 50 per cent of the cash credit limit against raw materials to manufacturing units by way of drawee bills only.

The Reserve Bank followed up the implementation by conducting seminars, providing further clarifications and incorporating certain refinements. The period essentially witnessed a reiteration of the unimplemented recommendations of the Tandon Committee regarding control over unduly heavy dependence on banks for working capital requirements.

On the organizational front, the RBI had advised all banks to set up 'cells' in their central offices to keep a continuous watch on the operations in large accounts and on key branches that accounted for the bulk of their advances. This suggestion was again emphasized in December 1980. The various functions that could be assigned to the special 'cell' to enhance the quality of credit regulation, while facilitating the work in the credit authorization section, were also spelt out. In mid-1981, the work relating to the Credit Authorization Scheme was taken over by the Industrial Credit Department (ICD) from DBOD. In an internal note prepared by ICD that year, certain critical issues involved in the operation of the scheme were discussed:

It has been suggested that the Reserve Bank has been merely ratifying the decisions of the Boards of banks in respect of credit proposals received under CAS. While this may be true of a large portion of the proposals authorized by us, there is a sizeable number in which the proposals had been either turned down or modified by us after a detailed study; this will be borne out by the data on proposals received since 1979 onwards as given in the table below. What is more important, however, is the qualitative aspect of the relevant proposals. As a result of our scrutiny and our attempts to analyse objectively the need-based requirements of borrowers within the framework of the norms and other parameters laid down by the Tandon Study Group, limits approved by the banks are often trimmed down or they are allowed subject to certain conditions. At times, mainly because of certain objectionable aspects observed in the proposals, the validity of our authorization is restricted to limited periods considered adequate for the facilities in question, and within which borrowers are expected to take corrective steps. Instances are not wanting wherein the proposals have been rejected altogether. This happens when, even after obtaining clarifications from banks (including cross-the-table discussions with bankers who at times are accompanied by the concerned borrowers), it is found that the proposals have been recommended by the banks ostensibly for attracting or retaining larger business, disregardful of certain undesirable tendencies like dilution in current ratio following diversion of short-term funds for acquisition of fixed assets, imbalance in capital structure, unrealistic projections in regard to production and sales, main-

tenance/projection of inventory/receivables levels considerably higher than the norms suggested by the Tandon Study Group or those prevailing in other similar industries, etc.... Due care is taken to ensure that the relaxations asked for are given in deserving cases and the concerned borrowers are advised to take steps to satisfy the requirements of norms etc. over a stipulated period.... The scrutiny of credit proposals under CAS is to be looked at basically not from the angle of avoiding credit risks but as a measure to restrain banks from deploying larger than necessary credit in the case of bigger borrowers. As such, it has become essentially a credit control measure at the micro level in the context of inflationary trends in the economy and pressing demand on bank credit from various other sectors, particularly the food and priority sectors.

Applications Treated under CAS

	1979	1980	1981 (up to March)
(i) No. of applications received	1497	1558	472
(ii) No. of applications authorized in full	903	1441	338
(iii) No. of applications authorized for reduced amounts	86	71	36
(iv) No. of applications rejected	55	46	24

A review of the Credit Authorization Scheme undertaken around the end of the reference period of this volume indicated that the scheme covered 877 borrowers and the total limits sanctioned to them amounted to Rs 11,395 crore. The public sector borrowers were 185, i.e. 21 per cent of the total number of CAS borrowers, but they accounted for as much as 44.6 per cent of the amount of total limits sanctioned.

PARTICIPATION CERTIFICATES

One of the biggest problems that banks had traditionally faced was paucity of resources. They simply did not have enough deposits to lend. The Credit Authorization Scheme described above was a negative way of dealing with the problem, namely, by credit rationing. The other way was positive: one of the financial instruments that flourished during the 1970s was the participation certificate (PC). These certificates became an important means

of raising resources for banks during the entire decade of the 1970s. The Reserve Bank's approach in the initial years after the introduction of the instrument was one of ambivalence. It was only when it realized that its operations impinged on the effectiveness of monetary policy that it took action in line with the prevailing policy of credit control. The process of reaching this realization was accompanied by a minor spat with the Finance Ministry.

The PC was an instrument representing a part or all of an advance made by a bank to a borrower and sold by it to a third party, the transferee. As such, it was a deed of transfer. By implication, the bank would have transferred to the holder of a PC a part of the advance it made to the borrower against hypothecation of goods or against book debts. The PC holder was thus a participant along with the bank—a joint participant so to say—in lending to the customer of the bank. The security transferred was invariably the hypothecation right of the transferor bank over the borrower's movable assets. PCs were of two kinds—one 'with recourse' and the other 'without recourse'. But in India only certificates of the former kind existed, that is the ones without risk for the purchaser.

The initiative to introduce the PC in India was taken by the First National City Bank, Bombay. It approached the Reserve Bank in March 1969 for securing 'no objection' to its entering into participation arrangements with other banks, and permission was granted. Not being able to introduce PCs immediately, it requested the RBI again, in March 1970, for reconfirmation to launch the scheme. This was accorded on a pilot project basis in April 1970. Subsequently, National & Grindlays Bank Ltd., United Commercial Bank, Bank of Baroda and Bank of India were allowed to operate the scheme on an 'experimental' basis, followed by other banks.

As part of the scheme, PCs could be issued to another bank or to other financial institutions specifically approved by the Reserve Bank. The major financial institutions which were allowed to participate in the PC scheme were Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), and Industrial Credit and Investment Corporation of India (ICICI). Some private insurance companies and other financial companies were specifically approved for the purpose.

To the extent that the funds accepted by banks on account of selling PCs were excluded from the requirement of maintenance of cash reserves in terms of Section 42 (1) of the Reserve Bank of India Act and liquid assets in terms of Section 24 of the Banking Regulation Act, the liquidity of such banks was augmented and their profitability improved. This was because, if a bank was a purchaser of a PC and the funds provided by it were not

reckoned as 'dues from other banks' but were included in bank credit, double counting could result. If, on the other hand, PCs were purchased by other financial institutions, they became the 'liabilities' of the banks even though banks' liquidity was augmented in the process.

In the initial years, the amount of PCs issued and outstanding under the scheme remained at a very modest level—the amount outstanding at the end of December 1974 was only Rs 59 crore. As PCs became popular with banks, the amount outstanding showed a steady rise, which became more pronounced from 1977.

The table on the next page gives data for PCs issued and outstanding during the years 1971–82.

PCs outstanding nearly doubled, from Rs 59 crore at the end of 1974 to Rs 114 crore by the end of the next year. Thereafter there was a steep growth and over the two-year period from 1977 to 1979, the increase in PCs was nearly two-fold, on a heightened base. Throughout the period, PCs to financial institutions (other than banks) constituted the bulk of the PCs issued and outstanding; the proportion of such PCs to the total varied between 68 per cent in December 1976 and 94 per cent in June 1979. Both banks and financial institutions found the scheme to very useful. Banks were able to expeditiously meet urgent unforeseen demands for funds from their clients; moreover, the cost of raising funds through PCs worked out cheaper than raising funds from the call money market as PCs were not subject to statutory liquidity ratios (SLR) and cash reserve ratios (CRR) till 1979. For financial institutions—LIC, GIC and UTI—PCs were convenient for immediate day-to-day deployment of funds realized from sales of life insurance/general policies/units, pending their eventual investment in long-term assets. Non-availability of an adequate number of viable investment proposals fetching an attractive return was a contributory factor for the preference shown by financial institutions for PCs.

When PCs were launched in 1970, the Reserve Bank did not place any restriction on the maximum or minimum period for which they could be issued. Nor did it restrict the amount up to which resources could be mobilized through issue of PCs. In the initial months, the maturity periods of PC issues ranged between thirty days and 365 days. But in February 1971, the period of maturity was stipulated to be not less than 80 days and not more than 180 days. Subsequently, the RBI restored the minimum maturity period to thirty days. In March–June 1972, the Bank advised the participating banks that the maximum interest payable on PCs should be 8 per cent per annum. But the ceiling rate was periodically raised. The ceiling rate, however, was not applicable to PCs issued to other commercial banks.

TABLE 1 PCs Issued and Outstanding

(Rs crore)

Last Friday (1)	PCs outstanding (2)	Last Friday (1)	PCs outstanding (2)
1971 (December)	16	1980 (January)	472 (471)
1972 (December)	14	1980 (March)	485 (468)
1973 (December)	45	1980 (June)	312 (311)
1974 (December)	59	1980 (September)	265 (265)
1975 (December)	114 (101)	1980 (December)	256 (256)
1976 (December)	156 (107)	1981 (July)	188 (188)
1977 (December)	294 (257)	1981 (September)	190 (190)
1978 (June)	416 (372)	1981 (December)	99 (99)
1978 (December)	455 (419)	1982 (July)	59 (59)
1979 (January)	511 (456)	1982 (September)	49 (49)
1979 (April)	626 (575)	1982 (December)	23 (23)
1979 (June)	606 (572)		
1979 (July)	541 (486)		
1979 (September)	516 (505)		
1979 (December)	447 (454)		

Note: Figures in brackets relate to amount of outstanding PCs issued to financial institutions other than banks.

Source: Data for the years 1971–74 are taken from office files; for the years 1975–79 from the article in the *RBI Bulletin*, November 1979; and for the remaining years from Table 3 in *RBI Bulletin*, various issues.

This exemption led to situations where the rates of interest shot up, at times to 17–20 per cent, thereby placing pressure on the call market. The Bank overcame the problem by imposing a uniform rate of interest of 12 per cent but this was done much later, in 1977; this, again, was raised periodically.

The episode also raised questions about the definition of an eligible financial institution. The Finance Ministry enquired through a letter dated 8 May 1973 whether:

- (i) the term ‘financial institution’ was defined,
- (ii) PCs issued to banks should figure as ‘liabilities’ or ‘contingent liabilities’ in banks’ balance sheets; and
- (iii) the possibility of circumventing the Bank’s directive regarding interest rates on deposits through the medium of the issue of PCs existed.

The Reserve Bank, for some reason, chose not to reply for some time. But it could not be silent for long, since pressures began to build on it to respond. It finally chose to inform the Ministry on 7 February 1974 that it had allowed ‘some of the banks’ to participate in the PC Scheme on an ‘experimental’ basis up to the end of June 1974 and that it would make a detailed review of the scheme soon, after which the specific points raised by the government would be clarified.

A few days later, at the annual general meeting of shareholders on 29 March 1974 at Madras, R.K. Talwar, Chairman of SBI raised the issue of the propriety of banks issuing PCs. He argued that the funds acquired by a bank from financial institutions through the issue of PCs ‘steer clear of the discipline imposed on regular bank deposits’. He elaborated that while a bank might not lend more than 60 out of every 100 rupees of its deposits, it remained unhampered in lending the entire amount of Rs 100 derived through the issue of PCs. Talwar also raised two related points pertaining to the practice of approved financial institutions rediscounting bills when they were not eligible for refinance by the Reserve Bank, and the adverse impact on the banking system on account of the participation of LIC and UTI in the call money market. D.N. Ghosh, Joint Secretary, Department of Banking, in a letter of 6 April 1974, brought Talwar’s speech and viewpoints to the notice of R.K. Hazari and requested a brief from the Bank on the matter. It was apparent that the government was not satisfied with the Bank’s earlier reply.

The Reserve Bank sent a reply to Ghosh’s letter by telex on 30 April 1974. It said that the funds raised by issue of PCs were equivalent to deposits; the PC Scheme envisaged loan participation and, as such, the funds derived through PC issue were in the nature of refinance obtained by the

issuing bank. The net result was that the Bank was spared of such re-finance. The Bank also noted that the cumbersome legal formalities associated with the issue of PCs showed that the transactions were in the nature of loan participation and not another mode of acceptance of deposits.

The first exhaustive review of the working of the PC Scheme during 1973–74 by the DBOD was, in a sense, a trendsetter. In its note dated 29 May 1974, DBOD observed that thirty-two commercial banks were authorized to issue PCs. The amount of PCs issued and outstanding increased over time—from Rs 25 crore at end-September 1973 to Rs 45 crore at end-December 1973 and further to Rs 61 crore at end-January 1974. Most PCs were obtained by private general insurance companies. LIC did not participate because it was not satisfied with the maximum rate of interest of 10 per cent allowed under the scheme. With the exception of a couple of certificates for Rs 75 lakh issued by Mercantile Bank to British Bank of the Middle East, there was no participation arrangement among the banks *inter se*. Of the total amount of Rs 45 crore outstanding at end-December 1973, five banks—Bank of India, Bank of Baroda, Central Bank of India, Indian Bank and First National City Bank—accounted for Rs 40 crore. The largest amount of PCs was issued by Bank of India.

The review also suggested that while banks accepted deposits at any time of the year, they issued PCs only to the extent necessary when they were faced with a resource constraint. It also stated that ‘a distinction has to be made between the funds made available by financial institutions and others’. Financial institutions like LIC, UTI, general insurance corporations/companies, were not ordinary depositors. They were institutions that mobilized funds with their own effort and at their own cost. Therefore, there would be justification in giving them a special facility as envisaged under the PC Scheme. The review went on to say that it would not be correct to assume that all their surplus funds would necessarily be kept with banks in the form of deposits. These institutions would, to the extent possible, try to secure maximum returns on such funds. The scheme, therefore, offered an incentive to them to invest their funds in the banking system at a reasonable rate of interest and even to bring more funds to the banking system. Besides, to the extent that banks were able to attract funds by the issue of PCs, their recourse to the Reserve Bank would be less.

The DBOD suggested that, in view of ‘the scale of operations under the scheme and the advantages that accrue to banks’, the PC Scheme should be extended on ‘an experimental basis’ for a period of one year, up to the end of June 1975. In making this recommendation, DBOD also took into

account the fact that abrupt discontinuation of the scheme would force banks to repay an outstanding balance of over Rs 60 crore as of 1 July 1974, a sum that they might find difficult to arrange for.

The scheme was renewed on certain conditions that consisted mainly of defining who was eligible to participate and who was not. It was restricted to a few financial institutions—LIC, UTI, general insurance companies/corporations and ICICI. The Industrial Finance Corporation of India (IFCI), the state finance corporations (SFCs) and state industrial corporations, as well as two private investment companies (*viz.*, Industrial Investment Trust Ltd and Pilani Investment Corporation Ltd), were excluded. The inclusion of ICICI in the scheme was conditional on ‘further examination’. It had been included because ICICI was approved by the RBI for acceptance of bills of exchange and for rediscounting them with the Bank. The decision to exclude so many institutions and financial entities was based on the advice of the Bank’s Legal Department, which took the view that the statutes of the SFCs and IFCI did not permit them to subscribe to PCs. Besides, the bulk of the resources of SFCs was raised through issue of bonds in favour of commercial banks. It was, therefore, not appropriate for banks to get back the same funds at higher rates of interest. The arguments against the inclusion of state-level industrial development corporations were that they solely depended on the state governments for their financial needs and, as their financing activities were normally confined to units promoted by state governments, they should not be encouraged to divert their funds to channels that promised higher yields.

As for the two private investment companies, the issue was different. From the information available, it was not clear whether they were investment companies/trusts. Their investments in PCs ranged from Rs 1 crore to Rs 2 crore and aggregated Rs 2 crore at the end of January 1974. The legal adviser’s view was that if they were trusts, they could not hold PCs as the loans normally granted by them were required to be covered by the first mortgage of assets, which was not available under the existing scheme. Further, there was no good reason to extend the PC Scheme to such companies once the state-level industrial development corporations in the public sector had been excluded. The Reserve Bank also feared that it would become difficult if requests were received for granting approval from other similarly placed investment companies.

The scheme did not allow cooperative banks to participate either, because they were exempted from the RBI’s directive on deposit rates. Hazari recorded on the DBOD office note that he had discussed with the

Governor the proposals outlined in the note, and instructed that while the Bank might tentatively allow the position in the case of ICICI to continue, it should examine the issue further.

It is worth noting here that SBI had been operating, since 1971, a 'scheme' akin to the PC Scheme, for banks within its own group. The purpose was to even out temporary liquidity problems and to minimize borrowing from the RBI. The certificates were issued 'on demand' and carried interest rates at the same level as those charged on loans transferred but subject to a service charge of one half of 1 per cent payable to the bank issuing the certificates. The Bank had allowed this arrangement to operate outside the PC Scheme. This meant that SBI and its subsidiaries could individually participate in the Bank's PC Scheme vis-à-vis other banks or approved financial institutions.

In retrospect, it is not clear why the Reserve Bank allowed the PC Scheme on an 'experimental' basis for only one year, even after acknowledging the benefits of the scheme. One possible reason could be that it found the scheme to be of help in containing its accommodation of commercial banks. It is worth recalling that 1973–74 was a very difficult year for the Bank in that the net RBI credit to the government and to the commercial sector rose by Rs 963 crore and Rs 294 crore, respectively. The RBI's balance sheet for 1974 showed an increase in loans and advances to scheduled commercial banks of 271 crore, from Rs 138 crore in 1973 to Rs 409 crore in 1974. Had there been no PC Scheme, the Bank's accommodation of banks' needs could have been still higher, given the sharp credit crunch that had been experienced following the announcement of the monetary and credit policy measures in 1973 on account of the first oil crisis and the flare-up in the general price level.

The DBOD review for 1974–75, on 5 May 1975, recommended extension of the scheme for one more year. It also took the view that as ICICI was an important all-India term-lending institution, next only to IDBI, it could, on certain occasions, have substantial surplus funds to spare. It therefore proposed that ICICI be treated on par with LIC and UTI. It also said that, apart from the popularity of the scheme, the Study Group on extension of credit limits on consortium/participation basis had suggested that the growth of PCs between institutions approved by the Reserve Bank should not be discouraged. But it was only with the review for 1975, on 10 May 1976, that the Bank finally decided not to treat the scheme as 'experimental', subject to annual reviews. At the end of December 1975, the volume of PCs stood at Rs 114 crore as against Rs 59 crore a year earlier.

The review for 1976–77, on 14 May 1977, went further. It recommended

that the scheme be made permanent and to do away with annual reviews. It, however, suggested retention of monthly reports from banks. The note also referred to the Bank giving permission to banks in February 1977 to issue PCs to Industrial Reconstruction Corporation of India Ltd and rejecting the requests of state-level institutions—Industrial Promotion and Investment Corporation of Orissa Ltd and Tamil Nadu Industrial Investment Corporation Ltd—to participate in the scheme. The ceiling rate of 12 per cent was prescribed uniformly without any exception. It was also noted that the requests of small banks to participate in the scheme, which were hitherto not acceded to, could be approved, since these banks too face liquidity problems just as large-sized banks do. Deputy Governor K.S. Krishnaswamy thought the DBOD proposals were ‘reasonable’ and regarded the scheme as useful for meeting liquidity mismatches and limiting the draft on the Bank. The review was approved by Governor Narasimham on 20 June 1977.

PCs were found to be most attractive for banks especially from 1973, when the liquidity crunch loomed large for the first time, and partly because PCs were not subjected to strict monetary and credit discipline till the end of the 1970s. The PC Scheme was an example of the Reserve Bank attempting to keep to itself the maximum degree of discretion in determining the number and the institutional size-class of the participants, the maturity period of the certificates, and the maximum interest rate that could be charged, and to limit the size of refinance/accommodation. The case by case approach was especially used in respect of institutions that sought approval of the Bank for participating in the PC scheme. Some such instances are given below.

INDUSTRIAL RECONSTRUCTION CORPORATION OF INDIA

While considering the application of the Industrial Reconstruction Corporation of India (IRCI) to participate in the scheme in January 1974, even though the Department was satisfied that it could be termed as a financial institution, Hazari turned down the proposal on the ground that it received interest-free funds from government, which it was supposed to keep in government securities till required for disbursement. After discussion with the Governor, he instructed that, for the present, IRCI should be kept out of the PC Scheme.

In March 1976, IRCI came up with a different request, which ultimately resulted in it being allowed to keep its funds in PCs. Unlike other financial institutions and organizations, IRCI dealt only with closed or sick industries, many of which were not in a position to pay interest as per the

payments schedule, leave alone timely repayment of the principal. Its disbursements were erratic as it depended on the requirements of industrial units, which were more intent on improving operations than working to a long-term plan. Sometimes, it was compelled to prematurely encash its deposits with banks as the needs of units had to be met suddenly. In the process, there was considerable loss of interest income. So IRCI requested the Reserve Bank to exempt it from the directive prescribing a ceiling on interest rates on deposits or, alternatively, to allow it to operate in the call money market like LIC and UTI until it got a higher rate on the funds raised through issue of bonds. The Credit Planning Cell of RBI examined the representation and said no.

Banks have not been happy about the operations of the LIC and the UTI as perpetual lenders in the market since it meant that a part of the funds, which would have come back to the banking system as deposits, is made available to the banks at a higher cost in the call market. And there is a material difference between the funds which the LIC or the UTI place in the call market and the funds which the IRCI put in the call market. While the funds of the LIC and the UTI are obtained from outside the banking system, the funds which the IRCI proposes to invest are from the ten-year bonds subscribed entirely by banks and these bonds carry a coupon rate of only 6 per cent. Thus what the IRCI wants to do is to lend to the banks at a higher rate, the funds obtained from them at a low rate. This would be unfair to the banks and may even affect their willingness to subscribe to future bond issues of IRCI. While the concern of IRCI regarding the idle funds is conceded, allowing it to place the funds in the call market does not appear to be the solution to the problem.

The IRCI was not to be put off. It wrote to the Reserve Bank again on 7 December 1976 with the plea that unless it was allowed to keep funds with banks at negotiated rates or operate in the call market, it would be difficult to manage its interest commitments except out of fresh borrowings. This time the Credit Planning Cell reviewed the request from a different angle. A proposal from the IDBI for placing funds in the call market outside the purview of the directive on deposit rate had been turned down once, as its resources were generated mainly from Government of India or bank funds. But a similar request from the Tamil Nadu Industrial Investment Corporation had been approved on the reasoning that a part of its resources was

raised from the public by way of deposits. The Bank thought it preferable to allow IRCI to participate in the PC Scheme, enabling it to realize its surplus funds at any point of time since the surplus funds could be invested for fairly short maturities. Krishnaswamy approved of the proposal on 27 January 1977 and IRCI was suitably advised on 2 February 1977.

In another decision taken in March 1974, the Reserve Bank did not allow the Agricultural Finance Corporation Ltd to participate in the scheme because its memorandum and articles of association revealed that its main objects were to finance agriculture and allied activities, and it was therefore not competent to finance large industrial/trading units as envisaged under the scheme. Similarly, the proposal from SBI to issue PCs to the Uttar Pradesh Small Industries Corporation Ltd in January 1974 was rejected because it had been established primarily to assist small-scale industries and not for granting assistance to larger units, which the scheme indirectly sought to promote.

Indian Overseas Bank Ltd, whose licence to carry on banking business was cancelled after its nationalization, made an application to the Reserve Bank in February 1974 for functioning as a financial institution and to invest its surplus funds in discounting of trade bills or in participation certificates with banks. The Bank did not find any merit in the application as the company could hardly be deemed to be a financial institution within the meaning of Section 45I of the RBI Act, and was therefore not eligible to be treated as an approved financial institution for PCs or bill discounting.

The Unit Trust of India (UTI) proposed certain major amendments to the Unit Trust of India Act, 1963, as it was facing difficulties in investing its surplus funds. The statutory provisions of UTI restricted it from investing its monies except in shares, securities or keeping them in deposits with scheduled banks or with other approved institutions. Securities of first-class companies were then not available in sufficient quantities and, pending investment of the funds on a long-term basis, UTI had recourse to government securities and call and short notice deposits with banks. These generally did not yield sufficiently good rates of return and hence were not considered suitable for investment in the context of UTI's obligation to pay reasonable dividends to unit holders. Moreover, unlike the other term lending institutions, it was precluded from giving direct loans; consequently, UTI had to take recourse to the tortuous procedure of subscribing to privately placed debentures, which was time-consuming as well as expensive. James Raj, UTI chairman, in a letter on 23 January 1974 to Governor Jagannathan, stated that the Trust proposed to invest in participation certificates or rediscount bills and thus earn better yield on its funds in terms

of the powers already available under the existing statute.

DBOD, in its office note of 28 February 1974, while examining certain other proposals of UTI, noted that the latter was already one of the institutions approved for entering into participation arrangement with banks, and that the suggestion of UTI was in order. But the chief officer, M.L. Gogtay was doubtful. He wondered if the provisions in the UTI Act were adequate to empower the institution to invest in PCs. The matter was referred to the Legal Adviser, R.M. Halasyam, who wrote that it would be advisable to incorporate a specific provision in the Act for the purpose, as investment in PCs could neither be construed as 'making of loans and advances' nor could the certificates be treated as 'mercantile instruments' eligible for purchase even after the relevant clause in the Act was amended. Thus the Reserve Bank felt that it would be advantageous to anticipate any contingency and incorporate a suitable provision at the stage when the Act was being amended. The Bank advised UTI accordingly in March 1974.

The Export Credit and Guarantee Corporation Ltd. (ECGC), on 1 February 1975, requested the RBI to approve its name for being eligible to accept participation certificates. A central government undertaking, it had been established for financing exports, and its objects clause permitted it to draw, make, accept, discount, execute and negotiate bills of exchange, and also to invest funds not immediately required in such a manner as determined by it (from time to time); it was thus generally authorized to invest in participation certificates issued by banks. ECGC, according to its memorandum of association, could extend financial assistance to exporters by way of loans against pledge of goods, title to property, give facilities for financing exports, provide financial assistance for purchase of Indian goods on extended payment terms, provide guarantees in respect of advances given by banks and other financial institutions in connection with export of goods, and give guarantees to exporters with a view to assisting them in conducting market surveys, etc. But in the early 1970s, it had restricted its business to insurance of export risks and promotion of foreign trade.

The purpose of ECGC's request was to secure higher returns on its investments because participation certificates with maturity of 30–180 days would fetch a return of up to 12 per cent, whereas term deposits with banks of similar maturity gave a rate of interest only of 3–6 per cent. The Reserve Bank considered it to be primarily an insurance organization but with a difference. ECGC was a government undertaking meant for promotion of exports and any augmentation in its income was welcome inasmuch as the additional resources would go to assist development of exports, which was of great importance to the country. The Bank realized that if it approved

ECGC's request there could be some diversion of its funds away from term deposits with scheduled banks, government securities and units. Nevertheless, its core function was to cover the risk of loss involved in exports made from the country, and this was akin to the function of a general insurance company which also covered varied risks within the country, and which had already been approved under the scheme.

On these considerations, the Bank decided to approve ECGC's request on the usual terms and conditions. However, as instructed by Governor Jagannathan, the Corporation was advised that this facility was extended only for enabling it to temporarily utilize its surplus funds profitably and that it should not be used as an avenue for long-term investment of funds, which would disturb its normal pattern of investments including those in government securities.

Lakshmi Vilas Bank Ltd, Karur (Tamil Nadu), a licensed scheduled bank, was not on the list of approved banks for the issue of PCs. Nevertheless, it issued PCs to United India Fire and General Insurance Company Ltd in April/May 1976, to the tune of Rs 20 lakh. This unauthorized act became known during the inspection of the bank and the RBI sought an explanation. The bank clarified that due to its tight resources position, it resorted to issuing PCs against working capital advances made to industrial concerns and, at the same time, offered an application for inclusion in the scheme. Even though DBOD was inclined to accede to the request, Executive Director J.C. Luther instructed that while the breach of the regulation could be condoned, the bank was not to be given the permission to participate in the scheme. This was approved by Krishnaswamy. The bank made a representation against the decision and received favourable responses from DBOD and the Credit Planning Cell as another small scheduled bank in Karur, namely, Karur Vysya Bank Ltd, had been approved for issue of PCs, thereby placing Lakshmi Vilas Bank at a comparative disadvantage. But the Deputy Governor once again turned down the application with the observation that 'the Participation Certificate Scheme has not always been used with sufficient care by the small banks, with the result that they are apt to get into resource jam. On balance, we may say no to Lakshmi Vilas Bank and also review if the Karur Vysya Bank should remain in the list.'

FOREIGN BANKS

In the early years of the Participation Certificate Scheme, only four foreign banks had been permitted to issue PCs, namely, First National City Bank, National and Grindlays Bank, Mercantile Bank and Banque Nationale de

Paris. The Reserve Bank had declined to approve applications from other foreign banks, the only exception being Algemene Bank Nederland N.V., which was allowed mainly on the ground that the bulk of its advances helped exports.

In 1974, requests from the American Express International Banking Corporation, Bank of America, Mitsui Bank and the Chartered Bank were turned down owing to instructions from Governor Jagannathan. American Express had earlier issued PCs without the RBI's prior approval. When this was pointed out to the bank, it had regretted the lapse. The Bank did not take any penal action and accepted the explanation. In the review of the working of the scheme conducted in May 1974, no specific decision was taken in so far as foreign banks were concerned. The Bank, after examining individual cases afresh, rejected their proposals citing the stance of a tight credit policy. On DBOD's office note of 5 December 1974, in which the joint chief officer, K.B. Chore, had proposed rejection of the request, Executive Director Krishnaswamy had commented:

On the basis of Governor's decision for the last busy season, we may so 'no' to American Express Banking Corporation. However, I think Governor's general position regarding not giving this discretionary facility to foreign banks could perhaps be reconsidered. I am not sure it would be right to deny them this facility for the reason that they are 'foreign'. We might, in fact, say no to most of them for other reasons—such as, slender deposit base, limited clientele, etc.

This was forwarded to the Deputy Governor, Hazari, who was in agreement with the above views; he, therefore, requested Governor Jagannathan to consider the general point made by Krishnaswamy. Governor Puri recorded that (1) we may say 'no' to American Express; (2) on the general issue it would be alright to take a decision on bank-to-bank basis rather than on the ground of banks being foreign; (3) we would be justified in denying the facility to American Express.

Towards the end of 1975, the issue came up for re-examination by DBOD. Joint chief officer Chore, following the instructions of the Governor, proposed that the cases of foreign banks could be reconsidered if they applied afresh, on merits, i.e. on the basis of their export performance, deposit mobilization, etc. He also expressed the view that since they got refinance facilities from the Reserve Bank and could also rediscount bills with other banks, denying them the PC facility might not be 'reasonable'. Hazari, to whom the case was marked, agreed but instructed the banks to be advised

informally—particularly American Express, which had raised this issue in the credit budget discussion. He also indicated that Mitsui Bank's performance so far was in overall terms rather poor and hence its proposal would have to be examined separately. During the course of the next one year or so, four foreign banks, viz., American Express, Bank of America, Chartered Bank and Mitsui Bank, got approvals.

Till the end of 1976, the Reserve Bank had not prescribed any uniform accounting procedure that banks had to follow for PCs. This was perhaps because the scheme had initially been evolved by the banks themselves and had been operated on an experimental basis subject to annual reviews. As and when the banks sought any clarification regarding reporting of PC transactions, the RBI had advised them to devise their own accounting procedure in consultation with their auditors. In early May 1973, the government had wanted to know from the Bank the manner in which such transactions should be reflected in the balance sheets of banks. The Bank had preferred not to clarify at that time. In the case of a reference made by SBI in January 1976, DBOD, in its reply in March 1976, had indicated that it was not appropriate to lay down any specific accounting procedure to be adopted by banks except for outlining certain essential terms and conditions governing the scheme.

But SBI was not satisfied and persisted with its query. It contended that the instructions sought earlier had been for classification of the amounts of PCs in the weekly returns submitted to the Reserve Bank under Section 42(2) of the RBI Act as well as in the balance sheet, and not exactly for the accounting procedure to be followed by the bank internally. DBOD, after examining the issue, 'suggested' in a letter of 4 June that the PCs issued by SBI might be treated as 'contingent liabilities' on the liabilities side of statutory and other returns, and the amount deducted from the figures of total advances. The amount of PCs purchased by it was to be included in the returns in the total advances on the assets side. As contingent liabilities were not reported in some of the returns, for statistical purposes, the quantum of PCs issued/purchased was to be explained in the footnotes to the returns. Soon thereafter, the Bank was compelled to abandon this approach. The Credit Planning Cell, on its own, instructed the banks, in September 1976, to adjust PCs in calculating gross bank credit for credit budget formulation and, at the same time, suggested to DBOD to lay down a uniform accounting practice in view of the varying practices followed by different banks. Consequent upon the scheme being placed on a permanent basis from June 1977, DBOD worked out the reporting details—which were the same as those advised to the State Bank of India—and formalized them in

a circular dated 21 June 1977, which, *inter alia*, announced the continuation of the scheme beyond June 1977. Thus, the total advances figure of all banks taken together was inclusive of PCs issued by banks to other banks but exclusive of PCs issued by them to other financial institutions.

Around the middle of 1978, the Reserve Bank became concerned about the dominance of insurance companies. They accounted for nearly 80 per cent of outstandings and their proclivity to park their surplus almost on a continuing basis in PCs was aided by banks, who willingly renewed PCs on the due dates. Transactions in PCs were outside the scope of reserve requirements of banks and this became important in the context of the increase in SLR by 1 per cent, to 34 per cent—from 1 December 1978. In a note prepared by DBOD, the propriety of financial institutions' dependence on PCs was called into question:

The disposable funds of the financial institutions are meant for investment in long-term projects and by investing in PCs the idea of employing their funds in long-term projects gets defeated. In fact, the funds are utilized for working capital finance. The surplus funds available with them should normally represent the liquid resources meant for day-to-day operations of the financial institutions. These resources should not be kept with banks on an on-going basis in the form of PCs, thus becoming a source of revenue for them. What started as an outlet for temporary investment of surplus funds has now become a source of almost continuous income at a high rate of interest (10 per cent) for the financial institutions.

The RBI was worried that commercial banks might get around the higher SLR requirement and restrict their non-food credit to 40 per cent of incremental deposits by selling PCs and obtaining finance from long-term financial institutions. It wondered if the credit window available to commercial banks through the PC Scheme needed to be closed, at least temporarily, so that the above objective could be achieved. This would have meant restricting PCs to commercial banks only.

It should be noted that while, in June 1977, the Reserve Bank prescribed broad guidelines for reporting the sale and purchase of PCs by banks, the credit extended by them through the issue of PCs did not get fully reflected in the advances figures, thus presenting an opportunity for them to circumvent the Bank's instructions issued in November 1978 that the incremental non-food gross credit–deposit ratio from 1 December 1978 should not exceed 40 per cent. In such a situation, the Governor pointed out on 15

March 1979, while marginal recourse to the PC facility was understandable, and might even be essential, any large use of such non-banking sector's resources was clearly inconsistent with credit planning or credit control. Simultaneously, the Governor announced the decision of the Bank to set up a Working Group to examine the entire question of PCs because the manner in which the scheme had evolved in practice had brought about several distortions in the banking system.

Accordingly, in early April 1979, the Bank set up a Working Group under the chairmanship of W.S. Tambe, Executive Director. The Group was asked to review banks' recourse to PCs and borrowings in the call money market. Its main terms of reference were to examine:

- (1) the size and pattern of operation in the call money market in respect of PCs and clarify their implications for monetary and credit policies;
- (2) the basis on which the broad magnitude of resources available to banks from sources other than commercial banks and refinancing agencies (such as IDBI and ARDC) might be assessed; and
- (3) the implications of any limitations on supplies of such funds from the non-banking institutions participating in the all money markets and participation certificate arrangements, and suggest alternative avenues for productive use of such funds.

The Group submitted its report in May. It was decided, to begin with, to initiate measures to discourage banks from excessive recourse to PCs. So the RBI began to operate a tight monetary policy which blocked any source of funds of the banking system that was not amenable to its control. Gradually, PCs became an unattractive form of investment and this effectively ended their growth.

In view of the sizeable expansion in money supply in two successive years (1976–77 and 1977–78) and the prospects of only a moderate growth of national income in 1978–79, the Reserve Bank adopted a slew of restrictive measures to restrain credit expansion and relate it to increases in output, economic activity and employment creation. Governor Patel, in a circular letter dated March 16, commented that banks had not increased their investment in government securities as advised by the Reserve Bank but continued to expand credit by increased recourse to the call money market and sale of PCs to other financial institutions. Therefore, besides raising the SLR, stipulating an incremental non-food gross credit–deposit ratio, and imposing a penalty for default in maintaining SLR and CRR at the prescribed levels, banks were exhorted in mid-March 1979 to keep to a minimum their reliance on external resources, such as borrowings from RBI, the call money market and recourse to PCs.

A meeting with the chief executives of major scheduled commercial banks was held on 25 May 1979. Governor Patel outlined the credit policy measures proposed to be adopted that year and expressed concern at the trend of banks resorting to funds raised through the issue of PCs. The trend had become particularly noticeable from the previous November, when the Reserve Bank had sought to further tighten credit expansion. Since the arrangements were not considered satisfactory, the Bank decided to tell the banks about the decision taken on the interim recommendations of the Working Group that had been headed by Tambe—these included bringing under the purview of SLR and CRR, the funds raised through PCs after they were approved by the Governor. For the present, the banks were asked to keep their involvement in PCs to the minimum.

The RBI decided, in June, to bring the funds raised through PCs within the purview of SLR and CRR and to discourage banks from having excessive recourse to PCs. At the same time, it wanted to ensure that this did not result in large-scale dislocation in the operations of banks and financial institutions. The latter would have to shift to other monetary instruments for short-term investment. It decided that:

- (i) Outstanding PCs should be treated as deposits.
- (ii) The amount of PCs issued by banks should be included in the figure of total advances (replacing the earlier instruction of deducting the amount of PCs issued from total advances).
- (iii) The funds raised through PCs should be subjected to control under SLR and CRR, with the process to be implemented in a phased manner.

Accordingly, the banks were told on 21 June that from the last Friday of July 1979, they should cease to classify outstanding PCs as contingent liabilities and instead treat them as deposits, and that such outstanding PCs would attract 34 per cent SLR and 6 per cent CRR in stages—50 per cent of the outstanding PCs from the last Friday of July, 75 per cent of the outstanding PCs from the last Friday of August and 100 per cent of the outstanding PCs from the last Friday of September. They were also asked to maintain with the RBI an additional average daily balance, equivalent to not less than 10 per cent of the increase in PCs over the outstanding level as on the last Friday of July 1979. Now that the RBI adjudged PCs as akin to deposits and hence not to be deducted from the banks' advances, the banks were asked to report the funds flowing from issue of PCs in weekly returns under Section 42(2) of the RBI Act—under 'Demand and Time Deposits from Banks' and under 'Other Demand and Time Liabilities', depending on whether the instruments were issued to banks or other financial institutions.

Further, banks which purchased PCs were instructed not to include the amount of such certificates in total advances (as they had been required to do earlier in accordance with the terms of the Reserve Bank's letter issued in June 1979) but to show it under 'Advances to Banks', i.e. due from banks. The letter to banks dated 21 June 1979, under the signature of Krishnaswamy, also forwarded the relevant directive and notifications, and reiterated the RBI's earlier advice to reduce their reliance on PCs and keep their involvement in PCs to the minimum.

Despite the Reserve Bank bringing PCs under the SLR/CRR regime, banks continued their recourse to this type of borrowing on a sizeable scale. The Governor, therefore, in a letter dated 24 August, urged them to limit their issue of PCs to the level on 27 July. Where the level of outstanding PCs was above the corresponding level on that date, banks were required to bring it down to the July 1979 level by the last Friday of September, and where the level was already below the July level, they were not to be raised.

On 24 November, the Governor once again advised banks to reduce their reliance on PCs during the 1979–80 busy season, and to avoid accepting special deposits at preferential rates from financial institutions and others, as these amounted to circumvention of the directive to reduce their reliance on PCs. But this had no effect. Between end-November 1979 and end-March 1980, some banks increased their dependence on PCs, while most others brought about only a small reduction. The Reserve Bank, therefore, once again directed banks, in March 1980, to bring about a significant and lasting reduction in their recourse to PCs within the next few months. The Governor, in a letter dated 28 March 1980, came down heavily on the banks.

It is unfortunate that some banks have increased their dependence on Participation Certificates while most other banks have only brought about a small reduction. It is, therefore, necessary that banks should bring about a significant and lasting reduction in their recourse to Participation Certificates in the next few months.

At the time of their introduction, PCs had been envisaged mainly as a means of evening out liquidity imbalances within the financial system. The Reserve Bank felt that in the limited sense of providing a temporary avenue of investment for 'floating funds'—funds awaiting eventual investment—the PCs Scheme was justified.¹ But, subsequently, the financial institutions

¹ See article in *RBI Bulletin*, November 1979, titled 'Data Relating to Bank Credit Inclusive/Exclusive of Participation Certificates—An Explanatory Note'.

found PCs convenient for parking sizeable amounts on a continuing basis through renewal of maturing PCs. At the same time, since the cost of raising funds through PCs was relatively low, banks also resorted to PCs on a sizeable basis. 'It is this sizeable recourse by banks to PCs on a continuing basis which posed serious problems for credit planning and control' (ibid.).

The Bank perceived the modifications in the scheme as forming part of the kit of credit control instruments used to effectively decelerate credit expansion in 1979–80. The modifications introduced in July 1979 in respect of banks' recourse to PCs, among other steps, impacted on the resources position of commercial banks. The RBI tried to impress on the banks that while marginal recourse to the facility of PCs was understandable, any large-scale resort to such non-banking sector resources on a continuing basis was clearly inconsistent with credit planning and control. The other instruments deployed to keep liquidity under check in the banking system included quantitative ceilings, restriction on utilization of limits sanctioned under the cash credit system, application of SLR and CRR to resources raised through PCs, an upward adjustment in interest rates, reduction in the total assistance from the Reserve Bank as well as raising the cost of such assistance, and, finally, moral persuasion.

The regime of strict credit discipline was continued in the 1979–80 busy season as the normal seasonal fall in commodity prices did not manifest itself, and industrial and agricultural output recorded a slowdown. While reinforcing the already existing credit control measures, the Reserve Bank advised banks to limit credit expansion within their own resources, and to resort to refinance facilities at the Reserve Bank in only very special cases of need. As a corollary, banks were urged to refrain from giving guarantees for private placement of deposits with companies by financial institutions and other non-banking entities and to reduce their reliance on PCs; to avoid accepting special deposits at preferential rates from financial institutions as this would be tantamount to circumvention of the policy of reduced reliance on PCs. The RBI reiterated the continued need for banks to reduce their reliance on PCs on 27 June 1980, as the persistent pressure on prices and the incipient difficult balance of payments situation left no alternative but to continue a cautious monetary and credit policy.

In a letter of 1 July, the RBI Governor gave a clear indication to banks that the supply of PCs would get reduced as a result of the exhortation by the Bank in March 1980 to bring about a significant and lasting reduction in their recourse to PCs, and also as a consequence of certain measures introduced in the central budget. The interim budget for the year 1980–81, presented by Finance Minister R. Venkataraman, envisaged that a part of

the investible resources of LIC, GIC and UTI should be lodged with the government in special deposit accounts to augment the resources for financing the plan budget for 1980–81; it took credit worth Rs 100 crore on account of these deposits. Therefore, banks were advised to plan their lending, taking into account the reduced availability from this source.

The cumulative impact of these credit control measures was that the level of outstanding PCs was brought down from Rs 606 crore in June 1979 to Rs 313 crore by June 1980, and the expansion in total credit during 1979–80 was significantly lower both in absolute and in percentage terms than during the previous year—Rs 2,366 crore or 12 per cent in 1979–80, as against Rs 3,621 crore or 22.5 per cent in 1978–79.

THE PRIORITY SECTOR

If credit could be rationed via the Credit Authorization Scheme, it could also be directed to flow into areas where it would not ordinarily flow. By the end of the 1960s, it had become very clear that state intervention was needed to push credit into such areas. The debate on social control had generated interest in ‘social banking’, the nucleus of which was the concept of ‘priority sector’ lending. Bank nationalization in 1969 gave the government just the tool it needed to direct credit into this sector.

The concept and rationale of priority sector lending was formalized by an economist of impeccable credentials, D.R. Gadgil. As Deputy Chairman of the Planning Commission, he circulated a note to members of the National Credit Council (NCC) at its inaugural meeting on 16 March 1968, which pointed out the shortcomings of the credit structure and the need to effect a structural reorganization of the banking system.

It is the hall-mark of an unequal society that not only is the ownership of the resources of production not broadly distributed within it but also that operational and other facilities are equally mal-distributed. In case of the banking and credit system as it operated twenty years ago, this inequality was glaringly evident. Those commanding the largest resources not only could get their credit requirements satisfied in the fullest measure but also obtained credit at specially favourable rates. At the other extreme, large masses of small business and households had no access to any institutional credit facilities. Developments during the past twenty years have in part changed the picture. The successful carrying out by the State Bank of India of its programme of branch expansion, the bringing together of

the State Bank and older Indian State Banks into one structure covering the whole country, and a number of experiments undertaken by the State Bank of India in financing small industry and cooperative organizations have contributed to this. Developments in the cooperative credit structure have made fuller and more widespread institutional credit available to much greater numbers than before and special schemes in finance of small industry have slightly improved the position of categories of artisans and small industrialists. Even so, the basic inequality is still large and the main objective of social control of banking and credit would appear to be that of more evenly spreading available credit over different areas and categories and relatively lowering the cost of credit to small operators.

Gadgil followed this up with a letter dated 1/2 July to L.K. Jha, in which he elaborated on the need to meet the credit needs of small borrowers. The problem, he wrote, was very difficult in the urban areas inasmuch as salary-earner societies, wherever they existed, looked after the consumption needs of their members but their operation was confined to those in regular salaried employment, and the consumption needs of the bulk of the urban population and of most small artisans and businessmen were not looked after by any appropriate institution. In exceptional cases, there were primary cooperative banks or industrial cooperative finance societies or small commercial local banks, which partially performed the latter function. But, for most of the country, no such institution existed. Gadgil wanted the National Credit Council (NCC) to give serious thought to this problem of 'appropriate institutional development' and to initiate action in this regard. His note was circulated among members of the NCC.

Jha responded on 18 July. He said he was doing 'a certain amount of loud thinking' with a view to enable Gadgil to deal with this question comprehensively when it came before the NCC. He admitted: 'I confess that I myself see no satisfactory answer even though I fully understand the problem you have posed.' He, however, identified certain major constraints. First, while it was true that the small borrower was not easily able to borrow from a big bank, when it came to depositing his money he preferred a big bank to a small one. Second, without adequate deposit resources, small banks might be willing but unable to help small borrowers. Third, all too often managements of small banks were susceptible to local influences and pressures, so that, in course of time, they ceased to be sound and viable.

Finally, small banks suffered from all the weaknesses of cooperative banks in certain states.

Jha went on to suggest that one solution was to get the large banks involved in financing small business but this was beset with obvious difficulties. He wondered if greater decentralization of authority and delegation of powers from the central offices of banks to field officers could make things easier. Alternatively, large all-India banks should have small subsidiaries that would be largely localized and oriented towards meeting the needs of smaller borrowers. Such bodies would not have to observe the same standards regarding wages and employment as all-India banks, because they would be separate and distinctly small entities. This idea, novel as it was then, was developed more fully by the Banking Commission and subsequently, in 1975, when regional rural banks (RRBs) became a reality. His main thrust was clear, even though it was not a widely accepted view: greater emphasis should be laid on the adequacy of credit availability than on cheapening its cost.

Gadgil proceeded to develop the issues on the lines suggested by him through the Study Group on the Organizational Framework for the Implementation of Social Objectives set up by the National Credit Council, of which he was the chairman. In its report, in October 1969, the Group drew pointed attention—perhaps for the first time—to the prevalence of credit gaps in key sectors of the economy, such as agriculture. It highlighted the skewed nature of distribution of bank finance and traced the causes for this, namely:

Modern banking owed its origin to the development of trade and commerce to organized industry. The doyens of commerce and industry were, until recently, in substantial control of the management and policies of banks and hence commercial banks had a pronounced urban orientation in their development and did not encompass the rural areas to any significant extent. Against this background banks evolved procedures and practices primarily suited to cater to the industrial and commercial clientele on conventional basis. Banking norms established under such procedures and practices were not suited to meeting the needs of the rural sector and other non-conventional borrowers. Nor did they feel any urge to modify these procedures because there was no motivation on their part to spread to the rural areas and undertake non-conventional business.

The report pointed out that, in addition to uneven distribution of credit as between states, there was uneven distribution of credit among different economic sectors, and credit was virtually not available to certain types of borrowers, particularly small borrowers and weaker sections of the community. The Group estimated that in 1967–68, about 39 per cent of the total credit requirements of agriculture was met by institutional credit agencies, and the gap between the credit needs of small-scale units and the credit made available to this sector by institutional agencies was at least 35 per cent. It also found that the sectoral distribution of credit by commercial banks was skewed in favour of large-scale industries, wholesale trade and commerce, rather than agriculture, small-scale industry, retail trade and small borrowers. Agriculture, excluding plantations, accounted for less than 1 per cent of total bank credit, and advances to retail trade for less than 2 per cent. The data compiled and case studies undertaken for the Group revealed that credit extended by commercial banks was not widely dispersed and there were credit gaps particularly in the case of small borrowers, and confirmed that there was a potential demand for credit from small borrowers but the lack of institutional facilities resulted in their approaching moneylenders, who charged exorbitant rates of interest.

It was not that the big banks were oblivious to the needs of social banking. But whatever little assistance they provided to the agricultural sector was by way of credit for marketing of agricultural products or indirectly for distribution of fertilizers and other inputs, and to state electricity boards for pump-set connections. The banks also provided finance to plantations, such as tea, coffee and rubber, but these were in the organized sector. All these limited avenues of lending to agriculture by banks did not add up to more than 2 per cent of the total credit. The major banks had taken the initiative of setting up the Agricultural Finance Corporation (AFC) to identify agricultural projects and offer guidance for extending financial assistance. But such initiatives hardly touched the fringe of marginal borrowers.

NEW DEMANDS

The RBI, on its part, tried to induce banks to channel more credit to sectors starved of credit. Jha, at a meeting of the representatives of major banks held in October 1968, stressed this aspect. His letter to the bankers proposed that they allocate 15 per cent of the banks' deposits to agriculture and 31 per cent to small-scale industry, after providing for statutory liquidity requirements. The Reserve Bank asked commercial banks to enhance the flow of credit to the priority sectors of agriculture and small-

scale industry, so as to achieve the quantum indicated by the National Credit Council.

After the March 1969 meeting of the NCC, the Reserve Bank also asked the banks to provide credit to specific sectors, namely, retail trade in rural areas, hire-purchase of trucks, taxis and scooters and the self-employed. At the same time, banks were cautioned against lending for speculative activity and to restrict credit to sectors that exhibited an unhealthy rising trend in prices. It announced the continuation, after 30 June, of refinance facilities available under the Bill Market Scheme in respect of food procurement, agriculture and small-scale industries. Refinance for exports and in respect of packing credit was also extended beyond June 1969.

At its second meeting, on 24 July 1968, the National Credit Council considered the need for increasing the participation of commercial banks in financing agriculture and small-scale industries as being urgent. It therefore recommended that credit to agriculture should increase to Rs 300–400 crore by the end of 1968–69, including finance for plantations and the marketing of produce other than foodgrains. It also suggested that for credit to the small-scale industrial sector, commercial banks should allocate an additional amount of Rs 60–70 crore in 1968–69, as against the estimated expansion of Rs 30–35 crore in 1967–68.

The NCC propounded an important guideline: that banks, while providing finance for the priority sector, must consider the viability of the schemes, which meant that the banks would have to satisfy themselves that the projects and programmes being financed by them were viable. But this did not mean that undue emphasis was to be placed on margins and guarantees.

The Ad-hoc Committee of Bankers, at its meeting on 16 August, considered these proposals and came out in favour of individual meetings between the Reserve Bank and each of the major commercial banks. Accordingly, allocations were made to individual banks for credit that was to be extended to the two priority sectors. D.N. Ghosh had called for information in order to reply to a parliamentary question, and Narasimham conveyed the above decisions of the NCC. He assured the government that the Reserve Bank would follow these recommendations in formulating its own credit policies, and take appropriate steps to ensure that credit extended by the banking system was in conformity with these guidelines.

The RBI lost no time in tuning its credit policy to the new demands. It had decided in November 1967 to liberalize its refinancing scheme. It made available at the Bank rate (irrespective of the net liquidity ratios of the

respective banks), refinance against advances covering sale and distribution of chemical fertilizers and pesticides. In February 1968, it announced that the total increase in bank advances to the three priority sectors—agriculture (defined as sale and distribution of chemical fertilizers and pesticides), small-scale industry covered by the Credit Guarantee Organization (CGO) and exports—over the average of such advances during the base period (i.e. July–October 1966 for the slack season and November–April 1966–67 for the busy season) was eligible for refinance at a concessional rate of 4.5 per cent, irrespective of the net liquidity position of the respective banks.

The Reserve Bank also granted relief in the computation of net liquidity ratios by banks (which governed the rate of interest on their borrowings from it) by treating the increases in lending to the above sectors as part of their liquid assets. Unsecured advances to finance sales on hire purchase or on deferred payment terms of machinery and equipment for agriculture, dairy farming and fishing were exempted from the norm stipulated for banks' unsecured advances and guarantees in terms of the RBI's letter of 3 May 1967. Advances to small-scale industries covered by the CGO and performance guarantees executed on behalf of small-scale industries were also exempt from the above norm. Further, term loans granted for agricultural development, whether refinanced by the Agricultural Refinance Corporation or not, and to small-scale industries covered by the CGO were excluded from the total term loans that were generally not to exceed the prescribed norm of 5 per cent of total deposits. In October 1968, the RBI extended refinance facilities under its Bill Market Scheme to banks' advances to cooperative banks, to enable the latter to make advances to small-scale industries.

The Industrial Development Bank of India, which was a subsidiary of the Reserve Bank, provided refinance to banks in respect of medium-term loans to small-scale industries covered under the Credit Guarantee Scheme at a concessional rate of 4.5 per cent (as against the normal lending rate of 6 per cent), provided the effective interest rate of the lending institution was not more than 8 per cent. The minimum amount of loan refinanced and the extent of refinance were also liberalized in April 1968. Another affiliate of the Bank, namely, the Agricultural Refinance Corporation, relaxed the conditions governing refinance to banks, to enable them to extend credit to farmers, especially in areas where the cultivators came under the area of operation of a sugar factory and that factory was prepared to assist the bank in supervision, technical guidance, recovery of loans, etc. The Corporation also decided to entertain proposals from banks for finan-

cing the purchase of power tillers, tractors, pump sets, etc., and to provide refinance for the same, provided the schemes were drawn up keeping in view the aspect of 'area development'.

In a detailed memorandum to the Central Board of the Reserve Bank, dated 21 October 1968, Deputy Governor Adarkar narrated that twenty major banks had agreed to increase their lending to agriculture in 1968–69 by Rs 44 crore and to small-scale industries by Rs 93 crore. On this basis, the overall credit to these two sectors amounted to Rs 51 crore and Rs 108 crore, respectively. But, as some of the major banks were known to deploy on their own a larger share of credit to these sectors, it was expected that total lending by the banking system to the two priority sectors as a whole would be larger than the amounts specified above. This analysis implied that banks would deploy about 47 per cent of their available incremental deposits (after providing for statutory liquidity ratio) for financing agriculture and small-scale industries, as against the National Credit Council's norm of 33–38 per cent. The memorandum examined whether the above allocations would starve other sectors of bank finance. The Bank concluded that although the banks would aim at higher targets, it was somewhat doubtful whether the actual utilization of credit would turn out to be as high as anticipated. Success in this matter depended on the progress they made with organizational and other arrangements. 'The higher target aimed at banks should, therefore, be regarded as what the banks are aiming at to ensure that at least the targets set up by the Council will be fulfilled.' Further, with the improved prospects for deposit mobilization, availability of resources to meet the requirements of other areas was not expected to pose a serious problem. In any event, refinance facilities available from the RBI—both for general purposes and for special purposes such as food procurement, exports, etc.—could ease seasonal pressures on individual banks.

Jha wrote to Narasimham on 17 March 1969, asking about the yardstick to be adopted for fixation of targets for agriculture and small-scale industries. He wanted to know whether this would be in absolute amounts or in terms of percentage of increase in deposits. He said that his understanding from the NCC discussions was that there was no attempt to relate the targets to any estimate of increase in bank deposits. The anxiety was to ensure that the targets were not placed too high because banks take time to build up the momentum of lending in new areas. He added that a high target was set for small-scale industry not because its needs were greater than those of agriculture, but because banks were more familiar with this type of lending and would have fewer organizational problems. Moreover, to avoid rigidity, a 'range' rather than a precise figure was indicated. Jha was constrained

to remark that in many of the comments offered by the Reserve Bank, attention was getting focused 'on percentages of deposit increase', which was never intended by the NCC.

Narasimham marked the Governor's query to Director A. Raman, who clarified on 26 March that in the press note issued by the Reserve Bank after the meeting of the NCC on 24 July the previous year, the targets of lending to agriculture and small industries were indicated in 'absolute sums' and did not refer to any estimate of deposit mobilization. However, during the discussions at the NCC meeting, C.H. Bhabha of Central Bank of India had felt that, instead of indicating specific figures in absolute terms, it would be more appropriate for the NCC to consider percentage-wise allocations between the various sectors of the additional deposit resources accruing to banks. When the Bank held discussions with individual banks to draw up guidelines and targets, attention was focused on 'percentages of deposit increase' so as to arrive at the minimum target for an individual bank. The targets in relation to deposit increase for all the major banks as a whole with whom the Bank held discussions were mentioned in the paper subsequently circulated to NCC members. Adarkar remarked on the note that for apportioning credit targets among banks, deposit accretion was found to be a convenient basis and yet absolute figures were being used. The Governor saw the paper on 28 March 1969, but did not offer his views. It was against this background that, on 29 April, Jha highlighted the different considerations that had to be given due importance in framing the overall credit policy for the slack season of 1969, and urged both the Deputy Governors J.J. Anjaria and B.N. Adarkar, as well as Narasimham, to do 'some active thinking' and then take a final view.

Anjaria had been worrying about the general price trend and suggested that a measure of restraint be shown regarding expansion of bank credit. He sought parameters for the determination of priority sectors and targets for the period July 1969 to June 1970. Jha responded that merely to set up targets for agriculture and small-scale industries would not serve the purpose because the Reserve Bank had to evaluate whether, even after a sizeable increase in bank credit to small-scale industries, large-scale additional needs for working capital would still be left out. Agriculture was in a different position because it was much larger. The Bank had already brought in a variety of relaxations—some of them extremely easy, such as lending to government or government-sponsored bodies against stocks of food and fertilizers—as eligible to be included in priority sector lending. As such, he said that unless some kind of sub-quotas were introduced, the really diffi-

cult areas of lending may remain neglected. He also raised a rather moot point: whether these two areas really exhausted all the possibilities. In this connection, he cited the case of the export sector for which there was no target. 'Can anything else be done to ensure that banks are on the look-out for export business rather than merely deal with such requests as come to them? As the return to banks is not high when they finance exports the danger of their not being over-active is there.'

Jha also wanted the RBI to pay attention to regional imbalances. Not only were there many states that were underbanked, but there was also evidence that the banking system sometimes transferred resources from poorer areas to richer areas. He wanted something done about this. 'Can we have any objective non-political criterion on the strength of which we can ask banks to increase their lending in particular states and possibly set targets for it?' In attaining such targets, due credit would have to be given to the contribution of banks to state loans, etc. He wanted to weave into the scheme as 'area approach'. For example, he thought it might be better for particular banks to undertake to increase the supply of banking services in underbanked states. He concluded with instructions that in formulating the Reserve Bank's ideas on all these subjects, Anjaria's point about the need for monetary restraint should be borne in mind. The slack season policy of 1969, therefore, reflected the concerns expressed by the Governor. But the more important and pressing issues highlighted by Jha, namely, regional disparities in banking operations, more equitable distribution of credit through an area approach, etc., had to wait for bank nationalization.

In the course of discussions with individual banks, the Reserve Bank brought to their notice the areas where action could be taken by them with advantage. It advised them to set up a sub-committee of their board of directors consisting, among others, of the directors representing the interests of agriculture and small-scale industries, in order to adopt a focused approach to the problems involved in financing the priority sectors and to infuse a sense of urgency to such lending. Banks were also asked to devote special attention to expeditious processing of applications received from small-scale industries and to set up special cells or departments to deal exclusively with such applications. Qualified personnel were to be recruited to speed up completion of technical formalities involved in the processing of applications. To impart the desired orientation to their lending policies, banks agreed to bring all their new advances under the scope of the Credit Guarantee Scheme. This was expected to result in banks taking a larger interest in financing small-scale industries. The Reserve Bank, on its part,

reduced the fee for guarantee cover under the scheme. Some of the procedures relating to obtaining guarantee cover, particularly relating to filling up forms, were considerably simplified.

This persuasion, however, had little effect on the banks and there was no perceptible increase in lending to agriculture. Then came nationalization and priority sector lending became a major policy objective of the government. The Statement of Objects and Reasons to the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969, observed that the banking system had to be inspired by a larger social purpose and greater attention should be paid to sectors neglected till then.

The banking system touches the lives of millions and has to be inspired by a larger social purpose and has to subserve national priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising employment levels, encouragement of new entrepreneurs and the development of backward areas. For this purpose, it is necessary for Government to take direct responsibility for the extension and diversification of banking services and for the working of a substantial part of the banking system.

For the government to assume complete control and effective supervision over the functioning of the bulk of the banking system, extension of banking facilities to unbanked areas, larger mobilization of deposits (especially from rural areas) and distribution of credit in an equitable manner in tune with the priorities of socio-economic development became necessary. In this milieu, credit flow to the priority sectors was given top priority. That the banking policies were fashioned to serve as a powerful instrument of economic empowerment of the large mass of people was evident from the address of Prime Minister Indira Gandhi to the newly appointed custodians of nationalized banks in September 1969. She declared:

Banks, being closely linked with the development of the economy, cannot remain entirely uninfluenced by the needs of the political situation. The political situation in our country demands that banking facilities should be extended in an increasing measure to backward areas, to agriculture, to small-scale industry and so on, and banking operations should be informed by a larger social purpose.

One of the immediate policy decisions taken as a follow-up to national-

ization was a scheme of guarantees for lending by banks to channel more funds to the priority sectors and other sectors that had remained neglected. This resulted in the setting up of the Credit Guarantee Corporation of India under the aegis of the Reserve Bank. Chapter 6 narrates the developments in this regard.

The Reserve Bank had conceptualized the strategy of priority sector lending in association with the NCC, by integrating it with credit policy in a manner that commercial banks found easy to implement. The government, seeing in it a powerful opportunity, decided to prescribe targets for lending. The Bank had not, in the initial years, prescribed any specific targets to be achieved. Whatever quantum of lending it suggested was more in the nature of an indication, and that too at the instance of the NCC. After nationalization, too, the Bank sought to promote the same indicative approach. But the political and social demands were such that apportionment of credit to the priority sectors became unavoidable. This was reflected in recommendation no. 13 (paragraph 2.31) of the 62nd Report of the Estimates Committee. In 1974, the government accepted a target of 33.3 per cent for lending to priority sectors in a planned manner, such that the overall target could be achieved by public sector banks by the end of the Fifth Plan period, i.e. by the end of March 1979.

Further, as assured to the Committee, the plans for lending to the priority sector were made an integral part of the performance budget prepared by public sector banks every year. These decisions were conveyed directly to the chiefs of public sector banks on 11 November. Consequently, the priority sector advances of banks doubled from 15 per cent of total advances in 1969 to 33.3 per cent in 1979. The sectoral distribution of advances under the priority sectors at end-June 1979 stood as follows:

Sector	Amount (Rs crore)	Percentage to total of priority sector advances
Agriculture	2221	42.6
Small-scale industry	2061	39.6
Others	927	17.8
	5209	100

Soon after Indira Gandhi was voted back to power in January 1980, on 6 March, the Finance Minister and the CEOs of public sector banks met to discuss enhancement of the target for priority sector lending. It was decided at the meeting that public sector banks would aim at raising the

proportion of their advances to priority sectors to 40 per cent by 1985, and that within the overall target, a significant proportion would be allocated to the beneficiaries of the Twenty-point Programme.

This target was endorsed by the Krishnaswamy Working Group, which noted that the ratio of agricultural lending to total advances was going up every year by 1 per cent and expected the same trend to continue on the assumption that banks would be actively participating in the Integrated Rural Development Programme (IRDP) introduced in 1976–77. It envisaged that banks should be able to step up their credit to agriculture to 16 per cent by March 1983 and exceed this ratio after March 1985. Moreover, in view of the dominant position occupied by agriculture in the national economy, the Working Group recommended that at least 40 per cent of priority sector credit should be extended to the agricultural sector (which roughly worked out to 16 per cent of the total credit), and that this limit was to be only a minimum; it did not place 'an embargo' on a bank to step up the limit if its operational strategies and the potential of the area of its activities warranted such an increase. For ensuring fair allocation of credit among the weaker sections within the priority sector, the Working Group recommended that advances to small/marginal farmers and agricultural labourers—collectively termed as weaker sections—should have a share of 50 per cent in indirect agricultural credit.

IMPORTANT FINDINGS

The Credit Planning Cell of the Reserve Bank carried out a study of commercial banks' advances to the priority sector during the years 1972, 1973 and 1974. A. Raman prepared a note on the basis of this study, which revealed that the share of priority sector advances in the total bank credit of public sector banks was 24.7 per cent in March 1974 as compared to 23.7 per cent in March 1973, and concluded, on that basis, that the share of the priority sector had not suffered as a result of the policy of credit restraint. Figures of advances to agriculture (direct and indirect) in respect of SBI and the fourteen nationalized banks indicated that, between March 1973 and March 1974, the share of advances to agriculture in total bank credit showed only a fractional decline, from 8.3 to 8.2 per cent.

The figures in respect of all scheduled commercial banks' advances to agriculture (direct finance) showed that the share of increase of such advances to increase in the total bank credit was 6.5 per cent between March 1972 and March 1973, and 9.1 per cent between September 1972 and September 1973. Of the direct finance given, term loans accounted for about 58

per cent. The Reserve Bank had provided refinance at the Bank rate between February 1970 and July 1973 (irrespective of net liquidity ratio but impairing net liquidity ratio for other borrowings), for incremental short-term direct finance to agriculture. Notwithstanding this statistical exercise, the real picture was much grimmer, according to the government.

In a d.o. letter dated 16 May 1974 to Governor Jagannathan, N.C. Sen Gupta, Secretary, Department of Banking, commented that even though the Reserve Bank had impressed upon banks the need to maintain the tempo in priority sector lending during the busy season of 1973–74, over the last busy season the incremental ratio in respect of priority sector lending was lower than the average at the commencement of the season (Document 4. D31). Alarming, quite a few banks were reported to have completely stopped further lending to priority sectors. ‘This has laid them open to justifiable criticism that banks are using their branches in rural and semi-urban areas as mere deposit-collection points and the deposits were siphoned off to urban areas and organized centres’, Sen Gupta averred. The letter also informed that the Finance Minister (Y.B. Chavan) had observed that small borrowers and priority schemes (like the Differential Interest Rate Scheme) were being denied bank credit, while the requirements of the organized sector were being met adequately. In view of this position and as the policy of credit restraint would have to be pursued through the slack season as well, the government considered it necessary to urgently formulate some scheme of assistance to encourage banks to maintain the tempo of flow of funds to the priority sector. Sen Gupta proposed the introduction of a scheme of refinance with two possible alternatives, namely, a differential rate of refinance covering priority sector advances over the specified base level, or cent per cent refinance in respect of the increase in advances over the base date in respect of all priority sector advances covered by the Credit Guarantee Scheme/Credit Guarantee Organization. Advances to small-scale industrial units drawing more than Rs 2 lakh from a bank were to be excluded from the proposed refinance facility. He clarified that ‘priority sector’ in this context was not to include ‘exports’, for which refinance facility was already available on a discretionary basis. Sen Gupta wanted this matter to be urgently examined and to be apprised of the policy measures the Reserve Bank proposed to initiate, to meet the situation. Jagannathan seems to have spoken on the matter with the Finance Minister during the course of a meeting held in June at Lucknow, but it was not pursued. Jagannathan, however, expected the matter to crop up again.

Finance Minister Y.B. Chavan, at an informal meeting convened by him

on 5 June 1974 at Lucknow, discussed with bankers the setback to growth in priority sector advances after the imposition of credit controls in the busy season credit policy towards the end of November 1973 (Document 4.17). He pointed out that, for the banking system as a whole, priority sector advances had increased by Rs 58 crore over the three-month period from January to March 1974, as against a rise of Rs 58 crore during the month of October 1973 and the average of Rs 47.5 crore per month during the two subsequent months. Moreover, out of the figure of Rs 58 crore, Rs 57 crore was accounted for by small-scale industries. Thus, other areas of the priority sector had stagnated. A large number of representations had been received by the Department of Banking (Ministry of Finance), that new proposals from applicants in the priority sector were not being entertained by the public sector banks. While the Reserve Bank was examining the introduction of some sort of refinance facility to maintain the tempo of priority sector lending, the government was of the view that the 'need for the banks to ensure that restraint on credit did not mean a neglect of the priority sector lending'. The Finance Minister was also not happy that the performance in lending to agriculture was even poorer than that for the priority sector as a whole.

In defence of the Reserve Bank, Jagannathan pointed out that in order to comply with the credit restraints, certain banks had withdrawn all sanctioning powers from their field staff in the beginning but this anomaly was later removed. Jagannathan, however, felt that priority sector lending would not suffer much on account of this action. He was not in favour of instituting some sort of refinance facility for the priority sector as it was a 'complicated issue'. Banks had already been obtaining accommodation from the Reserve Bank in magnitudes that had been causing anxiety to all concerned. While he was against extending the refinance facility indiscriminately, he was prepared to further examine helping sectors like agriculture and small-scale industries selectively.

Prime Minister Indira Gandhi, at a meeting held on 16 September 1974 in her room in New Delhi (at which Governor Jagannathan was present), raised the issue whether within the sectors that received preferential credit there should be a redefinition of priority, particularly to prevent undue appropriation of the available credit by big farmers or big borrowers in the small industries sector. Finance Minister Chavan observed that in achieving this objective, there should be no downgrading of the preferential treatment accorded to deserving categories of the priority sector. Jagannathan was judicious enough not to join issue. That his judgment was correct was confirmed by the discussions, where there was a general recognition that

the question of according relative preference within the priority sector (within small industry, for example) was a complex and difficult one. A mere redefinition on the basis of size-wise classification of advances might not be adequate unless it was related to the purpose of the loan, which again was subject to serious operational limitations. Therefore, it was not considered desirable to set up an elaborate system of centralized control for allocation of credit to individual borrowers. But in reality, credit authorization existed.

At a meeting of the Finance Minister with the chief executive officers of public sector banks held on 6 March 1980, it was agreed that the banks should aim at raising the proportion of their advances to the priority sector to 40 per cent by 1985, and that, within the overall target, a significant proportion would be allocated to the beneficiaries of the Twenty-Point Programme, which came into being in July 1975 in the initial stage of the 'Emergency'. It was also decided that the Reserve Bank should constitute a Working Group to consider the modalities of the above programme. Accordingly, the Bank set up a Working Group on 13 March 1980, under the chairmanship of K.S. Krishnaswamy, Deputy Governor, which included representatives of the government, public sector banks, the Reserve Bank, and the Agricultural Refinance and Development Corporation. The Group submitted its report on 22 April 1980, and its recommendations pertaining to the priority sector were as below.

Of the seven terms of reference of the Group, two related directly to the priority sector, namely: (i) the fixing of sub-targets (within the enhanced overall target of 40 per cent for assistance to the priority sector) for the beneficiaries identified under the Twenty-Point Programme; (ii) the modalities of evaluation of the performance in lending to the priority sector, particularly under the Twenty-Point Programme. On the first item, dealt with in Chapter IV of the report, the Group highlighted certain anomalies that had crept into priority sector lending, the need for uniformity in definitions, carving out a share for the weaker sections in the priority sector and the need for special concessions for the weaker sections. Firstly, there was found to be a lack of uniformity in the classification of priority sector advances by banks, which vitiated comparison of the data furnished by different banks for compliance with the prescribed targets. Secondly, as the guidelines issued by the Reserve Bank did not specify any ceiling on limits, the finance extended by banks to the more affluent sections within the priority sector came to be included under this category. The Group felt that the time had come when 'a new direction is to be given to banks' advances to these sectors'. To ensure that banks granted advances

increasingly to the comparatively weak and underprivileged sections, the Group recommended certain modifications to the existing definition of priority sector advances. Further, the Group suggested introduction of the concept of a sub-sector within the two main priority sectors (i.e. agriculture and small-scale industries), to focus the attention of banks on the need to give more finance to relatively underprivileged sections. It advocated that the use of the term 'priority sector' should be restricted to the aggregate priority sector, and sub-sectors comprising the more underprivileged within this main group would be known as the 'weaker sections'. The weakness alluded to here might be due to either economic or social causes. The weaker sections were identified as small and marginal farmers, landless labourers, and borrowers from allied activities with credit limits up to Rs 10,000. Similarly, in the small-scale industry sector, units/borrowers with credit limits up to Rs 25,000 were to be treated as weaker sections. Thirdly, the socially weaker sections of the society (also known as underprivileged) were, as a class, financially weak, and suffered from a lack of bargaining power and articulation in getting their grievances redressed. The beneficiaries under the Twenty-point Programme who had been identified by the Group belonged primarily, such weaker sections. By introducing a separate sub-sector for three weaker sections within the priority sector, the Group felt that the objectives of the Twenty-point Programme would be met effectively. Fourthly, according to the Group, if the concept of 'weaker sections' in the priority sector was accepted, the concessions being presently offered to the priority sector as a class could be oriented to meet the needs of the weaker sections. While the banks should continue to give preferential treatment to the other groups in the priority sector, compared to the advances to the traditional sectors, the maximum benefit of all types of concessions should be invariably available to the weaker sections.

The government and the Reserve Bank generally accepted the recommendations. The need for a schematic and integrated approach for assisting the beneficiaries, in consultation with the state development agencies, was emphasized. At the district level, district credit plans (DCPs) prepared by banks were to explicitly provide for allocation of credit to the beneficiaries under the Twenty-point Programme. On its part, the Reserve Bank issued detailed guidelines to all the commercial banks for their implementation, in October 1980. They focused on overall assistance to the priority sector to constitute 40 per cent of total advances by March 1985; at least 40 per cent of the advances to the priority sector to be extended to agriculture and allied activities; direct advances to 'weaker sections' in agriculture and allied activities to constitute at least 50 per cent of the total

direct lending to agriculture (including allied activities) by March 1983; 'weaker sections' in this sector to comprise small and marginal farmers and landless labourers; persons engaged in allied activities whose borrowing limits did not exceed Rs 10,000 also to be included in the 'weaker sections', and advances to the 'weaker sections' in small-scale industries, i.e. those with credit limits up to and inclusive of Rs 25,000, to constitute 12.5 per cent of the total advances to small-scale industries by 1985.

POLICY ON REFINANCE TO BANKS AGAINST PRIORITY SECTOR ADVANCES

The incentive to extend priority sector loans was provided by the Reserve Bank through the mechanism of refinancing. As stated earlier, till July 1973, advances by commercial banks to the priority sector were eligible for refinance from the Bank at the Bank rate, irrespective of the individual bank's liquidity ratio. Short-term direct lending to agriculture, to small-scale industries and to primary cooperative credit societies, besides exports, were all treated as eligible for refinancing. The lending banks could recoup their lendable resources because of the refinancing facility. However, while exhorting the banks to increase their advances to agriculture and small-scale industry, the Reserve Bank invariably impressed on them to ensure that there was an adequate turnround of the funds lent to these sectors (see circular DBOD. Sch.1696/C.96-70 dated 10 November 1970, reproduced here as Document 4. D32). The refinance entitlement for the priority sector, however, underwent modifications (in terms of quantum of availability and interest rates) from time to time, depending on the macro-economic indications that influenced the formulation of monetary policy. For instance, the preferential treatment of priority sector lending came to an end in July 1973 as the serious price situation and the rigours of credit restraint warranted curtailment of overall borrowing from the Reserve Bank except in exceptional circumstances and for short periods. Governor Jagannathan, vide his letter dated 12 July 1973, withdrew, among others, the then existing concessionary refinance entitlements at the Bank rate or below, with the only exception of a limited amount of refinancing of export credit and refinancing of amounts lent by commercial banks to primary credit societies and farmers' service societies. At the same time, banks were advised:

The withdrawal of some of the concessionary facilities in the reference system does not in any way alter the stress of policy to assist the priority sectors, namely, agriculture, small industry,

other small borrowers and exports. Banks should continue to increase their involvement in financing these sectors.

In the subsequent credit policy pronouncements, exhortations not to neglect the export sector in particular and the priority sector in general, continued. This perhaps had to do with the growing perception of the government that preoccupation with credit restraint could lead to neglect of priority sector lending, a point made by N.C. Sen Gupta in his letter of 16 May 1974 to Governor Jagannathan, referred to earlier. In a letter dated 11 January 1974, banks were reminded that they should give primary consideration to the priority sector, including exports, and to meeting the essential needs of production and seasonal movement of commodities. The RBI always kept in view the special requirements of exports and the policy of refinancing a portion of export credit at the Bank rate was maintained. Again, in a letter dated 18 April 1974, the Bank expressed the view:

It is likely that during the slack season there will be some additional demand for credit for financing food procurement, exports, priority sectors, and other essential production. Banks would be striving for better deposit accretions and return flow of funds than has been evident in the recent past. With the realization of these expectations, banks should by and large be able to meet these increases in credit requirements.

In its circular dated 22 July 1974 (paragraph 6), the RBI informed banks that in respect of direct short-term finance to agriculture, incremental performance over a determined base period would be one of the important factors that would be taken into account for providing discretionary re-finance. The concern of the Bank for the growth of these sectors was again restated in its circular dated 29 October 1974 as follows:

- (i) Agricultural credit requirements, including those for distribution of agricultural inputs, should continue to be given the maximum possible attention. In recent years, besides agriculture, certain designated priority sectors, such as, small-scale industry and other small borrowers, have received an increased share of bank credit. It is necessary to introduce in these sectors a greater degree of selectivity in the deployment of further credit. The benefit of access to the scarce resource of bank funds should be extended in accordance with the needs of the borrowing unit, determined not only by its size but also by the type of production in which it is engaged. Small-scale industrial units producing inputs for core sector and wage goods indus-

tries should be preferred to the small-sized units in less essential lines. The policy of giving priority to small industry as such may be refined in its application so as to accord such treatment more particularly to units having credit limits of Rs 10 lakh and below.

- (ii) There should be no slackening of our export efforts. The special requirements of export credit should, therefore, continue to be accorded high priority. The policy will continue of applying the concessionary rate of interest on export credit to periods not exceeding 90 days, except in regard to post-shipment credit arising out of exports to the Western Hemisphere. The intention of policy is that credit may be made available even beyond this period of 90 days or 120 days, as the case may be, to meet all legitimate needs of exports, in particular difficult situations such as unavoidable delays in obtaining essential inputs and shipping bottlenecks.
- (iii) In such exceptional cases, banks are required to charge their normal lending rates for the extended period.

Borrowers falling under the category of the priority sector were eligible to a number of benefits. First, they got preference over others in the allocation of bank credit. Second, banks normally allowed certain relaxations in the terms and conditions governing the loan, including the rate of interest and percentage of margin to be maintained. For some priority sector advances, the maximum lending rates were below the normal lending rates on traditional advances.

THE BANK AND THE EMERGENCY

Unlike its close involvement in the policy on priority sector lending, the Reserve Bank's involvement with the Twenty-point Programme was rather peripheral, mainly because not all the items specified in the programme needed help from the banking system. Also, agencies other than banks were also involved in implementation of the programme.

The banking system could play its part in the implementation of the following ten of twenty points, directly and indirectly. These were:

- (i) procurement and distribution of essential commodities;
- (ii) assistance to landless labourers;
- (iii) assistance to released bonded labourers;
- (iv) bridging the credit gap following a moratorium on rural indebtedness and its progressive liquidation;
- (v) implementation of minor irrigation programmes and better utilization of underground water resources;

- (vi) assistance to the handloom sector;
- (vii) assistance to holders of national permits for road transport;
- (viii) schemes for supply of essential commodities and books and stationery to students at controlled prices;
- (ix) workers' participation in industry; and
- (x) apprenticeship scheme for enlarging the employment opportunities particularly of the weaker sections of the people.

From the very beginning, the Finance Ministry liaised directly with the commercial banks in the implementation of the programme. Very rarely did it recognize the need to send signals through the Reserve Bank. The banks were

expected to play an important role, among other things, in bridging the gap created in the rural credit structure following imposition of moratorium on debt recovery, in assisting the farmers who have been newly allotted lands for cultivation, in providing assistance to those released from bonded labour for taking subsidiary activities allied to agriculture, in financing minor irrigation programmes, in promoting development of handloom sector and in enlarging employment opportunities, especially for the weaker sections.

In April 1976, the government instructed banks to involve themselves more actively. K.P.A. Menon, Joint Secretary, Department of Revenue and Banking (Banking), in a letter dated 15/19 April 1976 to R.K. Talwar, chairman, SBI, specifically asked SBI to assist in the rehabilitation of freed bonded labour and distribution of surplus land among them. While the state governments were to take the initiative to facilitate the beneficiaries taking up productive activities, banks had a role to play wherever land had been distributed by the state governments. They were to make arrangements for extending production loans to the allottees, besides identifying the possibilities of rehabilitation and lending financial support to schemes prepared for emancipated bonded labour. Commercial banks, in districts where they carried the lead responsibility, were asked to shoulder the primary task of preparing a complete programme of financing new allottees of surplus lands and freed bonded labour either through their own branches or through the branches of other banks operating in that area.

SBI was also asked to ensure that the necessary credit was made available to implement the schemes prepared by the departments of the state governments. To monitor the progress made by public sector banks in this sphere, they were asked to submit periodical reports from the quarter ended

31 March 1976, *directly* to the Department of Revenue and Banking. The disquieting feature for the RBI was that, as the central banking authority, it was not kept in the picture at all.

In May, the government enquired of the public sector banks whether, in pursuance of the programme, they had evolved schemes for assisting landless labourers to undertake activities allied to agriculture and for assisting allottees of surplus lands by providing short-term and long-term credit. The banks were told that mere formulation of schemes was meaningless unless the benefits reached the weaker sections of the society. They were also instructed to advise their branches to keep in constant touch with the local administrative authorities so that allottees of house-sites and freed bonded labour were identified and assisted. They were advised to set up special implementation cells within the planning and development divisions of their head offices. Lead banks could play a useful role in promoting better liaison with the district authorities and in ensuring expeditious, collective action. District Consultative Committees were to be utilized for formulating schemes and for promoting the participation of all banks in the programme. As Members of Parliament had evinced a keen interest in the schemes, banks were asked to give greater attention to the publicity aspect. Among other things, each bank was advised to bring out every quarter brochures highlighting the various schemes under which the beneficiaries of the programme were assisted by them, the number of persons assisted and the quantum of assistance given in different states. A proforma was also prescribed by the government for providing quantitative quarterly information on the subject.

The Reserve Bank was not pleased at this turn of events. It was being continuously sidelined in the administration of the programme. It eventually decided to protest. Deputy Governor Krishnaswamy wrote to N.C. Sen Gupta, who was the Banking Secretary, on 13 July, that the RBI was not even informed of the government having issued instructions to public sector banks in five specific instances during the first half of 1976, and stressed the need for involving the Bank at least in an indirect manner.

We feel that normally, instructions to banks should issue from the Reserve Bank. This will not only avoid confusion at the banks, but would also lead to better coordination. In case of any urgency, while Government may write to banks direct, copies of these letters should invariably be endorsed to us. In case Government asks the banks to submit any information/statements to them directly, the banks should also be advised to

forward copies of such statements etc. to us to avoid our writing to them again on the same subject. It is also necessary that copies of all important communications addressed by Government to any bank are endorsed to Reserve Bank.

Krishnaswamy requested that suitable instructions be issued to all concerned.

In October, things came to a head. It was from a report in *The Economic Times* on 29 October that the Reserve Bank came to know that the Department of Revenue and Banking had allocated the task of coordinating the efforts for implementation of the schemes prepared under the Twenty-point Economic Programme in the various states, to nine public sector banks. The designated banks were to form a Bankers' Committee for each state, to consider problems requiring inter-bank coordination, for allocation of schemes to be implemented at the district level, and for bringing uniformity in the terms and conditions of credit under specific schemes. The members of the committee included the banks, chairmen of RRBs, government agencies, and representatives of state cooperative banks and lead development banks. The Reserve Bank was not included. The DBOD recorded in an office note of 4 November that the Bank had been consulted neither nor had a copy of the government's instructions been sent to it. Krishnaswamy asked the chief officer to write to the ministry asking for definite information as to what instructions had actually been sent to the banks. Later, he decided to write the letter himself. On 17 November, he conveyed the disappointment of the RBI at being completely sidelined in the matter. He drew his attention to his letter of 13 July and pointed out that 'the basis on which the allotments of states have been made to banks is also not known to us'. He reiterated the Reserve Bank's request that the government issue instructions to public sector banks only through the Bank and not directly. The only result was that the government, *post facto*, endorsed to the Bank a copy of the circular instruction sent earlier to the SBI and other nationalized banks; it did not care to assure the Bank of the better treatment in future.

In despair, Krishnaswamy asked the DBOD to prepare a note chronicling the events. The note was sent to Governor Puri on 25 November, with the remark: 'This is yet another instance of bypassing of the RBI by the Department.' But, again, nothing happened. The Governor merely initialled the note on 9 December without any comments, despite Krishnaswamy's prompting.

Meanwhile, another issue was coming to boil: the treatment of senior

Bank functionaries by the government. Puri was not inclined to join issue with the Ministry and preferred to softpedal the issue. But in November Krishnaswamy again submitted a draft letter for Puri's approval. The letter was addressed to K.P.A. Menon and drew attention to two specific instances of instructions issued to banks on important matters that had implications for credit planning, without the knowledge of the RBI. One of them was the government's letter of 4 September issued to the chairmen of SBI and other nationalized banks enhancing the banks' lending target to the priority sector to 33.3 per cent of their total advances by the end of the Fifth Five Year Plan. Krishnaswamy pleaded: 'We would once again request Government to ensure that there is no communication gap between the Reserve Bank and the Department of Revenue and Banking on such vital matters of policy and also in other matters and to instruct all the officials concerned suitably in the matter.' This attempt, too, was stillborn. The draft letter was returned to the DBOD in May 1977, with the remark: 'returned by Shri Raman, Adviser, with whom it was left by Governor Puri'. It was clear that the Governor was not willing to confront the government.

With the lifting of the Emergency in January 1977 and after the general election of March, a new government took office. With that the Reserve Bank's relations with the government returned to normalcy.

DIFFERENTIAL RATE OF INTEREST SCHEME

The Differential Rate of Interest (DRI) Scheme was based on the budget speech for 1970-71. Prime Minister Indira Gandhi had kept the Finance portfolio with herself after the split in the Congress party in July the previous year. She had emphasized in the speech:

The weaker sections of the society are the greatest source of the potential strength and with our limited resources, a balance has to be struck between outlays which may be immediately productive and those which are essential to create and sustain a social and political framework which is conducive to growth in the long run.

The DRI scheme was probably the brainchild of Ashok Mitra, Chief Economic Adviser in the Finance Ministry. In 1977, he became the finance minister of West Bengal in the first communist government of the state.

By May 1970, Mrs Gandhi had handed over the Finance portfolio to Y.B. Chavan. He urged the chief executives of public sector banks and

senior officials of the Reserve Bank, on 22 July, to charge lower interest rates on loans given to ‘carefully selected low income groups, who deserve financial assistance for productive endeavours’ but could not easily negotiate with banks. Affluent borrowers could be charged higher rates, he said. The Bank appointed a Committee in September to examine the question. It was headed by Hazari and had six other members; Ashok Mitra was also a member. The Committee’s terms of reference were to:

- (i) Review the scope and extent to which differential interest rates were already being charged by banks to borrowers in each sector;
- (ii) Determine the criteria for identifying borrowers who could be granted the benefit of a lower interest rate within each sector;
- (iii) Indicate the range of the differential that could be allowed in each sector; and
- (iv) Examine if any other concessions could be granted either in lieu of or in addition to lower interest rates.

The Committee submitted its report in May. It was not unanimous, as Ashok Mitra recorded a minute of dissent (see below). The report said that the interest rate mechanism by itself provided rather limited scope for adopting redistributive policies, and that any wide-ranging selective subsidization for the DRI Scheme could have far-reaching implications for bank earnings and financial policies and practices in general. In the majority view, an element of differential had already been built into the interest rate structure, applicable to certain priority sectors such as exports and the financing of primary cooperative societies by commercial banks in selected areas. In certain cases, banks had been obtaining refinance from the Reserve Bank, IDBI and the government. The Committee observed that since the cost of servicing or administering loans to small borrowers was more than that of loans to large industry and trade, the effective additional cost to banks on account of lending to priority sectors was higher than the interest rates charged for borrowers in these sectors.

The Committee also pointed out that there was no attempt to assist weaker borrowers within any sector through reduced interest charges. In working out a scheme of intra-sectoral differential rates, it implicitly assumed that a reduction in interest rate to some borrowers should not adversely affect the earnings of banks, and, for this purpose, the cost of credit extended to other borrowers should be enhanced suitably to cover both the fall in income caused by disbursal of selective cheaper credit and the rise in costs following from the administration of a number of small loan accounts.

As regards the criteria for identifying borrowers who could be granted the benefit of lower interest rates within each sector, the Committee

favoured confining the scope of preferential interest rates to those sectors in which the economically handicapped were preponderant, i.e. borrowers from agriculture, small-scale industry, small business, transport operators and professionals.

For identifying eligible borrowers in agriculture, the size of the loan was considered 'clear, objective and administratively practicable'. As a measure of automaticity for the selection of small borrowers, the majority of the Committee suggested that the DRI Scheme should be linked with the new Credit Guarantee Scheme for covering small loans to borrowers in the priority and neglected sectors.

The report contended that in order to be beneficial, acceptable and practicable, too wide a range of differential would be inadvisable. It was feared that very low interest rates on loans to some borrowers would lead to a sharp increase in the demand for bank funds, generate pressures that the banks might not be able to withstand, and involve charging an unusually high rate at least from some sections of borrowers. Besides, banks were not in a position to charge interest at rates that were 2–3 percentage points higher than the current maximum lending rates of 12 per cent per annum due to the provisions in the prevailing legislation aimed at regulation of moneylending. The report reasoned that even if there was a possibility of charging higher interest rates from the bigger borrowers, the higher costs could get transmitted through marking up of prices.

In view of these considerations, the majority report suggested that the lowest interest rate to be charged to any borrower (exclusive of any direct subsidies) should be approximately equal to the ratio of the cost of raising and using funds (i.e. deposits, borrowings and owned funds). With the current structure of interest rates, this rate was estimated at about 8.5 per cent on an average. The Committee favoured the system of a single cut-off point, setting apart preferred borrowers from the others, rather than credit slabs for different interest rates. Accordingly, it suggested charging rates varying between 8.5 and 10 per cent to preferred borrowers. To all other borrowers, banks were allowed to charge higher rates as they considered appropriate and permissible by law and/or as indicated by the Reserve Bank. It was also recommended that the guarantee fees in the case of all borrowers who were granted preferential interest rates should be borne by the lending bank.

On the last of the terms of reference, a relaxation in favour of weaker borrowers, of the standards adopted by banks in regard to margins and securities, was considered essential. Concessions in the form of lower margins were envisaged for such borrowers as farmers, small retail traders, small

business concerns, transport operators, doctors setting up practice and small-scale industrial concerns. Experimenting with unsecured loans was also advocated. Going a step further, it was suggested that margin requirements could be dispensed with in deserving cases and loans sanctioned to the extent of the full value of the security offered. This could be of special assistance during the gestation period of projects started by small entrepreneurs. Concessions by way of relaxation in security and repayment holidays were also viewed as options. In the case of self-employed persons, particularly, softer terms could prove even more meaningful than cheaper credit. Finally, the majority report acknowledged that while its suggestions had immediate relevance to commercial banks, the possibility of extending similar concessions to weaker borrowers from cooperative banks should be examined.

In his dissenting note, Ashok Mitra did not concur with many of the recommendations of the majority of the members. He did not agree that the size of the loan should be the principal determinant of eligibility for the benefit of an interest differential. He argued:

If the smallness of the size of the loan asked for would automatically qualify the applicant for being offered a favoured rate of interest, the genuinely needy parties would often be crowded out by those who have the organization, acumen and ingenuity to set themselves up as small farmers, or small traders. It should be possible to evolve more objective criteria for judging the economic condition of the parties seeking loans.

He also thought that the proposed linking of the selection of small borrowers with the new Credit Guarantee Scheme was neither justifiable nor necessary. Differential lending rates, including, in some instances, loans at even zero interest rate, were an established feature of international lending and it should be possible for banks to charge varying rates of interest to different income groups, beginning with a very low nominal rate of interest for the most needy and going up to 20 per cent for prosperous traders. He then argued that the current practice of offering loans at preferred rates for exports or to cooperative societies or to small industries, borrowers who scarcely belonged to the category of the underprivileged, had perpetuated and had even aggravated inequalities in the distribution of incomes and assets. The majority report's recommendation for keeping the rates of interest within the range of 8.5 to 10 per cent for weaker borrowers when the overwhelming proportion of advances already attracted interest rates

in the range of 8 to 12 per cent amounted to maintenance of the existing structure of lending rates with minor modifications.

Mitra was of the view that, along with the commercial banks, the cooperative sector should be brought under the proposed scheme, as roughly two-thirds of the total institutional loans flowing to agriculture still emanated from the cooperative sector. He wrote:

To leave out this sector from the purview of the differential rates structure would, therefore, mean the exclusion of institutional financing of the bulk of the most important economic activity in the country. It would also lead to the absurdity of two parallel rate structures obtaining in agriculture, with attendant practical difficulties. There is hardly any economic justification for according a kid-glove treatment to the cooperative sector.

On the feasible structure of interest rates, Mitra agreed that a reduction in the interest charged to some borrowers would not adversely affect the overall earnings of banks (i.e. the average return from total advances should yield at least 10 per cent), but he was against equating the lowest rate of lending to the ratio that the cost of raising and using funds bore to total banking resources, as suggested by the majority report. He contested the logic that the incidence of higher interest would be shifted to the consumers as, in most cases, manufacturers, traders and speculators were generally aware of the limit as to what the traffic could bear at any given moment.

He favoured cross-subsidization, i.e. raising the lending rate to 20 per cent for the bigger borrowers in selected sectors, making it possible to reduce substantially the rate for the less affluent groups without affecting the overall return from lending operations. More importantly, he wanted one-fifth of the total credit to be earmarked for the economically deserving groups, who could be asked to pay only a commitment charge of, say, 1 per cent. According to his scheme, a return of 10 per cent on total advances could be arranged thus:

Advances	Rate of interest
1 st quintile	20 per cent
2 nd quintile	14 per cent
3 rd quintile	10 per cent
4 th quintile	5 per cent
5 th quintile	1 per cent

Y.B. Chavan, while admitting in a policy statement made in the Parliament on 25 March 1972, that it was difficult to reconcile the two points of view, expressed no doubts about the basic soundness of the idea that led to the formation of the Committee. The government then formulated guidelines for identifying persons eligible to get loans at concessional rates and other rules of operation, and advised the public sector banks directly in the matter. The records do not show whether the Reserve Bank was consulted in framing the guidelines. As regards cooperative banks, since their ability to recoup consequential losses by charging higher interest rates from larger farmers was in doubt, the government decided to consider in detail, in consultation with the Bank, the extent of differential rates and the manner in which cooperative banks should be compensated for the loss incurred.

Things went on in this mode for a few years. Then, on 24 September 1975, N.C. Sen Gupta wrote to Hazari advising that the government proposed to make certain changes in the scheme so as to extend its geographical coverage and to provide for special treatment to government-sponsored corporations concerned with the welfare and development of scheduled castes and scheduled tribes.

The major issues identified for reconsideration were as under:

1. Extension of the geographical coverage of the DRI Scheme to all the districts in the country, except the metropolitan areas.
2. Restricting the scope of the scheme to lending to scheduled castes (SCs) and scheduled tribes (STs) only. This would mean that persons belonging to the 'rest of the community' would cease to be eligible and the scheme would operate virtually for the benefit of SCs/STs.
3. Government-sponsored corporations concerned with the welfare of SCs/STs (besides the institutions then eligible to borrow under the scheme) should also be declared eligible to borrow, provided they satisfied certain criteria, such as: services exclusively for the welfare of SCs/STs, formulation of specific schemes to be operated on commercial basis and bank lending to be utilized only for these operations and not for meeting normal administrative and other costs, and the borrowing institution undertaking repayment of the bank loan and interest thereon.

As an alternative, it was suggested that no change was required to be made in the 275 districts where the scheme was in operation but in the remaining 108 districts (where the scheme was not in operation), only members of SCs/STs were to be declared eligible. The rationale for this suggestion was that the districts in the latter category were neither backward nor SFDA/MFAL districts and, thus, somewhat better-off; as such,

there was some justification for confining the scheme to SCs/STs.

Sen Gupta finally requested the Reserve Bank to keep in mind the fact that regional rural banks were being set up to serve the rural population and that this opened another avenue for making finance available. He suggested convening a meeting of commercial banks to expedite decision on the above issues, to which he offered to send a representative from his Department.

Raman, who was then Director of the Credit Planning Cell of RBI, discussed the matter with the Finance Ministry and suggested that the scheme had to be extremely selective in application, that its scope be confined to lending only to scheduled castes and tribes, and that the income criterion be retained to ensure that even among these categories the really poor got the benefit. At the same time, Raman recognized that some special institutions, such as those for physically handicapped persons, orphanages and women's homes, were already within the purview of the scheme. After further discussions, on 2 December, between Raman, Hazari and K.S. Krishnaswamy, the Reserve Bank finalized its views. Hazari wrote to Sen Gupta on 3 December 1975 suggesting some modifications.

1. The scheme should be made applicable in respect of persons belonging to SCs/STs throughout the country, irrespective of the size of their landholdings (as hitherto). The ceiling on annual income (i.e. Rs 3,000 in urban/semi-urban areas and Rs 2,000 in rural areas) and other conditions, such as ceiling of Rs 1,500 for working capital loans and Rs 5,000 for term loans, could continue unchanged.
2. Government-sponsored corporations should be set up exclusively for the promotion of welfare of SCs/STs to be made eligible to borrow under the scheme, subject to their satisfying the prescribed criteria. However, the limits up to which advances might be granted to such corporations was to be specified and authority conferred on the lending banks to inspect the accounts of the corporations covered under the scheme.
3. In respect of persons other than those belonging to SCs/STs who had already availed of loans in the districts to which the scheme extended, the amounts were to be recovered as and when they fell due for repayment but the facilities would not be renewed.

In 1977, the guidelines of the scheme were revised. The more important changes were:

1. The scheme was extended to the whole country. (As it stood, since August 1976, the scheme had been extended to all SFDA districts/ areas declared by the central government, including those set up in

the Fifth Five Year Plan period, and was operated in the districts declared as industrially backward by the Planning Commission and notified as such by the Reserve Bank.)

2. With a view to ensuring the flow of adequate benefits of the scheme to rural areas and to persons belonging to scheduled castes/tribes, banks should ensure that at least two-thirds of their total advances under the scheme are made through their rural/semi-urban branches.
3. At least one-third of the total DRI advances should be given to members of scheduled castes/tribes. It was expected that any regional imbalances in the existing pattern of disbursal of a bank's lending under the scheme would be corrected by individual banks in accordance with these norms at the latest by March 1979, and that the flow of credit would be biased in favour of underdeveloped states.

In October 1978, after the Prime Minister met the chief executives of public sector banks, a Working Group was set up to further revise the DIR Scheme. The Group suggested the following changes, which were accepted. Its emphasis was on the need to gear up the administrative machinery in banks to improve recoveries and ensure the rapid recycling of the limited funds available under DRI. At the same time:

- (i) The prescribed limit of DRI advances was raised from 0.5 per cent to 1 per cent of the aggregate advances of the bank as at the end of the previous year.
- (ii) A minimum of 33.33 per cent of loans under the scheme was to be given to eligible borrowers from among the scheduled castes and scheduled tribes, which was enhanced to 40 per cent to ensure that persons belonging to these categories got their due share of benefits under the scheme.
- (iii) Banks were permitted to route their advances through the medium of cooperative societies/large multipurpose societies (LAMPS) organized specifically for the benefit of the tribal population in areas identified by the government; this was in addition to banks routing their DRI loans through state-level corporations for scheduled castes and scheduled tribes.

At a meeting convened by the Governor on 28 November, the major private banks agreed in principle to lend 1 per of their aggregate outstanding advances under the scheme. But they also suggested that, to begin with, this proportion could be 0.5 per cent in the case of smaller banks, say, those with deposits of less than Rs 25 crore. The government agreed. The Reserve Bank then asked all private sector Indian commercial banks (excluding three banks that had lead status and which were already implementing the

scheme) to initiate immediate action to implement the scheme. To correct the regional imbalances in flow of credit under the DRI Scheme, the banks were asked to step up their lending under the scheme in backward areas.

Several knotty issues came up during the implementation of the scheme. First, there was the question of the levy of a penal rate of interest in case of default. One of the public sector banks had enquired of the Reserve Bank in May 1973, whether it could levy a penal rate of interest on default in respect of overdue loans granted under the scheme. The Bank sought instructions from the Finance Ministry. Its own view was that although the persons eligible for assistance under the scheme belonged to the poorer sections of the society, enforcement of a certain amount of discipline was necessary. So charging a penal rate of interest of 2 per cent in case of default should not be considered unreasonable. It took the Department of Banking ten months to reply. Eventually it said no, because this could kill the momentum that was in evidence, and because there had been criticism both in the Parliament and outside it that the performance was still not up to expectations. Moreover, the government felt that levying such a penal rate at that stage could be misconstrued as withdrawal of the concessional interest rates that formed an essential element of the scheme. But the Ministry offered to review its position later if defaults under the scheme turned out to be substantial.

In 1980, this issue came up once again. During the course of the debate over the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1980, the Minister took up with the Reserve Bank the question of not charging a penal rate of interest on defaults against DRI loans. On a reference received from the government, the Bank replied, on 26 September, that, based on the recommendations of the Committee on Penal Rates and Service Charges, it had advised scheduled commercial banks on 26 June 1976 that all small loans up to a credit limit Rs 5,000 and all advances made by public sector banks under the DRI Scheme to selected low income groups should be exempt from the levy of a penal rate of interest. Similar instructions were given to private sector banks in October 1980.

THE QUESTION OF RATES

Then there was the interest rate question: should it be continued at 4 per cent? In 1972, when the scheme was introduced, it was thought proper to charge 2 per cent below the then prevailing RBI rate of 6 per cent. Although the Bank rate was raised subsequently to 7 per cent in May 1973, 9 per cent in July 1974 and 10 per cent in August 1981, the rate of 4 per cent stipu-

lated initially was allowed to remain unchanged. As a result, the differential widened from 2 per cent to 6 per cent. Banks wanted to know why the DRI rate could not vary with the general level of interest rates. The Working Group appointed in 1980 to examine the role of banks in implementation of the new Twenty-point Programme had given the verdict on the matter. It pointed out that a substantial portion of the priority sector advances of banks carried a lower rate of interest. Further, export credit and food credit carried lower rates. Considering the effect of this on the profitability of the banks, it was not considered possible for the banking system to lend at a low rate of 4 per cent to any significant extent. Taking these aspects into account, the Group was of the view that there was no scope for raising the target. Within the target, however, there was need to ensure that the benefits of DRI lending went to the weakest among the eligible borrowers. But nothing happened and the rate was left as it was, at 4 per cent.

There was also the question of how much the scheme was costing the banks. A Working Group set up by the government in October 1978 conducted a review of the scheme. It estimated the cost of its administration by the banking system to be 13 per cent and, as a result, banks suffered a loss in terms of 900 basis points. Subsequently, from 2 March 1981, the interest rate on deposits was raised. The Group also recommended that, considering the risk involved in lending under the DRI Scheme, the guarantee cover of 75 per cent then available under the Small Loans Guarantee Scheme, 1971, for such advances should be increased to 90 per cent in order to induce banks to step up their advances to weaker sections of the community. Accordingly, in January 1979, the guarantee cover in respect of such loans and advances was increased to 90 per cent.

The recoveries of DRI advances also became an issue, as they were far from satisfactory. So the Reserve Bank asked the DICGC to review the extent of the guarantee cover and to take steps to increase the lending bank's share in such lending. The government referred this issue to the National Institute of Bank Management (NIBM), which was then doing a study of the DRI Scheme. But nothing concrete emerged from this referral.

EXTENSION OF THE SCHEME TO PRIVATE SECTOR BANKS

In early 1978, Governor of RBI wanted to know the manner in which the Differential Rate of Interest Scheme was working, particularly after May 1977 when it was extended all over the country, and how the parties were selected. The DBOD explained the operational details to him and highlighted two crucial features. One was the problem faced by banks in iden-

tifying borrowers even though, by and large, they were guided by the list of borrowers previously identified by SFDA, MFAL or state government agencies. The other was the slowdown in the flow of information on the bank-wise position of outstanding advances, due to the introduction of a comprehensive format by the government in 1977.

The DBOD highlighted the comparative performance of banks in complying with the target of one half of 1 per cent of the total loans and advances under the DRI Scheme. The overall achievement of SBI and its subsidiaries, bar two, and the fourteen nationalized banks was considered satisfactory, as they had already crossed the target. The advances, in end-September 1977, stood at 0.54 per cent of the aggregate advances, compared to the goal of 0.50 per cent. Patel enquired whether the Reserve Bank could issue some sort of 'exhortation' to Indian private banks as well, and whether foreign banks could be involved in the DRI Scheme. He met bankers on 28 March where a view was expressed that Indian private sector banks should be called upon to fall in line with the public sector banks in the implementation of the scheme. The RBI then issued a circular to thirty-six private sector Indian banks, on 6 July 1977, inviting them to voluntarily adopt the scheme. Five said yes, one said no and the rest did not reply.

The banks that did not respond had a network of 4,259 branches, of which 2,775 were located at rural/semi-urban centres, at small places which allowed little scope for other banks to open offices there for a long time to come. The disinclination of these banks meant that several eligible persons would not be able to borrow under the scheme. The Reserve Bank took the view that since the aggregate amount to be advanced under the scheme would not be very high, the profitability of the banks would not be materially affected. It also believed that the private banks should discharge certain social obligations. Accordingly, in April, the RBI issued a circular which said that it was only fair that they participate in the DRI Schemes, to benefit the poorest among the poor. It pointed out that the modest target set for individual banks was unlikely to affect their profitability. Basically, it said, 'fall in line' by sending a quarterly report.

Foreign banks, as before, were excluded.

The private sector banks responded slowly. On 27 October, the Finance Ministry asked the Reserve Bank to urge them to improve their lending under the DRI Scheme and also to expedite submission of the outstanding quarterly reports. The Bank replied that while it had already issued instructions to private sector banks to fall in line with the public sector banks, the position about submission of quarterly reports continued to be unsatisfactory despite reminders. The Ministry then wrote directly to the private banks.

A copy of the letter was marked to Krishnaswamy, who was peeved enough to ask if it was the normal practice of the Banking Division to instruct private sector banks. He spoke to M.R. Shroff, who was then an Additional Secretary in the Finance Ministry, who promised to 'look into this'. There the matter was allowed rest.

There were several allegations of misuse as well. On 20 November 1981, *The Indian Express* reported that Rs 2 crore were being distributed by a nationalized bank in Kanpur under the DRI Scheme, and that application forms had been sold at Rs 10 each. The Finance Ministry requested the Reserve Bank to get the full details. A question was also raised on this issue in the Lok Sabha. The Kanpur and New Delhi offices of the Bank made detailed enquiries and it transpired that Punjab and Sind Bank had organized, on 21 November 1981, a mass loaning programme under the DRI Scheme and the Twenty-point Economic Programme at their Transport Nagar branch, Kanpur. Rajiv Gandhi was supposed to attend the function but did not. Loans aggregating Rs 18,300 were disbursed by Chief Minister V.P. Singh to ten borrowers. The branch manager of the bank denied the alleged sale of application forms or their distribution through any agency.

The Business Standard, in its edition of 25 November 1981, carried a more tendentious report on the same event. It alleged that certain Congress(I) leaders of the city had spearheaded this scheme to help the needy with bank loans ranging from Rs 500 to Rs 5,000 at differential rates of interest through the medium of Punjab and Sind Bank, which agreed to disburse Rs 2 crore. The newspaper also said that as criticism mounted, the bank slowly backed out and decided that only persons who filed applications in the prescribed form would be eligible for the loan.

The officer of the Reserve Bank deputed to inspect the branches of Punjab and Sind Bank reported that the quality of the appraisal left scope for improvement inasmuch as the income of the borrowers was not assessed properly, and the information supplied by the borrowers was taken for granted without verifying from independent sources, especially where the income related to the whole family and not to the individual. However, no relaxation of normal terms and conditions was made and the branches had paid the amounts directly to the suppliers, and obtained invoices/cash memos that were retained for record.

In another case, the Finance Ministry wrote to the Reserve Bank that South Indian Bank Ltd had rejected the loan application of one N.M. Sriramulu, a cobbler, on the basis that his yearly income was Rs 4,200, i.e. higher than the eligibility limit. This was contested by no less a personage than the Deputy Speaker of the Lok Sabha, who annexed a certificate

according to which the income of the cobbler worked out to only Rs 2,880. The government wanted to know the circumstances under which the application was turned down. After repeated reminders, the head office of the South Indian Bank Ltd at Trichur clarified, in January 1982, that the party himself had stated in his application that his annual family income was Rs 4,800 and that his family consumption need was only Rs 4,200. (According to the eligibility criteria under the DRI Scheme, the total income of the applicant family from all sources was not to exceed Rs 2,000 in rural areas and Rs 3,000 in urban areas.) The Reserve Bank added that the party had neither submitted an income certificate along with the original application nor made any fresh application. Since the Madras branch of South Indian Bank Ltd had forwarded all the files to its head office at Trichur, the Trivandrum office of the DBOD was asked to depute an officer to the bank to verify the papers. The inspecting officer of the RBI confirmed that the applicant did not satisfy the eligibility requirements.

Cooperatives were not allowed to operate under the scheme because they largely depended on the Reserve Bank for their resources, with re-financing provided at 2 to 3 per cent below the Bank rate of 9 per cent. They could not lend directly under the scheme at 4 per cent unless their overdue position improved and the loss was made good by a subsidy from the state or central government. The issue was raised when Pratibha Patil, the minister for prohibition, rehabilitation and cultural affairs in the Maharashtra government, wrote to Puri in July 1976, that cooperative banks run by women should be allowed to give finance at differential rates of interest to needy women and women's organizations. The Agricultural Credit Department (ACD), to whom the case was referred, said that cooperative banks could not afford to lend at differential rates, notwithstanding the availability of refinance facilities from the Reserve Bank at concessional rates of interest. The question was also discussed at the seventh meeting of the Agricultural Credit Board, where the consensus was that the feasibility of introducing a differential interest rate depended on the number of farmers to be covered under the scheme. If the size of holdings of the beneficiaries was kept sufficiently low, it would not be difficult to implement the scheme by slightly increasing the rate of interest on loans to other farmers. But in states where the majority of farmers had small-sized holdings, it would be difficult to implement the scheme without external aid. So the Board left it to the discretion and judgment of the banks.

As regards cottage and small-scale industries, the ACD felt that they should be treated separately as business enterprises. While sanctioning limits to cooperative banks, the Reserve Bank made a stipulation that the rate of

interest to be charged from industrial units should not be unreasonably high. It was noted that the bulk of the resources of urban cooperative banks was raised by way of deposits. Their borrowings from higher financing agencies being very small, urban banks offered higher rates of interest on deposits than other banks and hence the cost of funds to them for lending was higher. The Bank, therefore, had not prescribed any minimum rate at which they should lend to any class of borrowers; it was left to the discretion of the banks. The ACD had no objection to banks implementing the scheme in respect of any particular type of advances or advances to any class of borrowers.

Krishnaswamy eventually replied to Pratibha Patil that the RBI had no objection to urban cooperative banks, on their own, extending the benefits of the DRI Scheme to any type of loans and advances made to any class of borrowers, including women. However, advances made by these banks in respect of commodities covered under the selective credit control measures should carry a minimum rate of 15 per cent per annum.

The issue of extending the DRI Scheme to cooperative banks was raised by the Home Ministry also. The Finance Ministry referred it to the Reserve Bank in January 1981. The Banking Division expressed the view that no useful purpose would be served if the meagre funds allocated for the scheme were spread thinly to cover all lending institutions, including cooperative banks, and that any meaningful extension of the scheme would call for allocation of more funds under the scheme. A suggestion was made that either the state governments could provide interest subsidies to cooperative institutions or, alternatively, the Agricultural Refinance and Development Corporation (ARDC) could provide funds at a lower interest rate for advances under the scheme, the cost of subsidy being shared by the ARDC and state governments on a matching basis. The RBI agreed.

Regional rural banks were required to make available credit to borrowers at the same rate as cooperatives and were thus precluded from granting loans at concessional rates of interest. In order that customers served by RRBs were not deprived of the benefits of the scheme, the sponsoring banks were permitted to lend under the DRI Scheme through RRBs on an agency basis; consequently, the eligible borrowers were able to obtain loans at the concessional rate of 4 per cent in areas served by RRBs. On receipt of a query from certain banks, the Reserve Bank clarified that they may lend directly to beneficiaries under the scheme so long as they were within reasonable distance from the branches of RRBs. Also, the banks were allowed to lend through the agency of RRBs to beneficiaries in remote areas not easily accessible through their own branch network. While RRBs might

serve as a conduit for disbursement of credit to the ultimate beneficiary and for recovery of dues, the overall responsibility for proper appraisal, disbursement, supervision, follow-up and recovery of the dues would continue to rest with the sponsor banks.

In March 1978, the board of directors of Syndicate Bank took a policy decision not to implement the DRI Scheme through RRBs. This was because their bank had already achieved the target and had a good network of branches in the districts where the RRBs sponsored by them were operating. The decision was conveyed to the Finance Ministry by the Reserve Bank. The government did not take kindly to this decision and wrote to the chairman of Syndicate Bank that it was not correct to totally exclude RRBs from lending under the DRI Scheme since there was no limit for maximum lending, and since RRBs were meant for offering cheaper credit to the weaker sections and most of their clientele would otherwise be ineligible to get loans under the scheme. The government 'requested' Syndicate Bank to continue to implement the DRI Scheme through RRBs on an agency basis.

In January 1981, the government allowed sponsor banks to lend through RRBs on a refinance basis as well. Eligible borrowers under the DRI Scheme were granted advances by RRBs at 4 per cent, preference being given to small borrowers. The RRBs would make advances on their own account and the sponsoring bank provided refinance to RRB on the basis of outstanding amounts at 2 per cent rate of interest. The sponsor banks were entitled to take into account, for the purpose of the target of 1 per cent of the total lending under the scheme, the amount of refinance made to RRBs.

The Department of Revenue and Banking (Banking Wing) advised (by a letter dated 22 July 1976) that the benefits of the DRI Scheme had been made available to all SFDA districts/areas and industrially backward districts declared by the Planning Commission, and requested the Reserve Bank to issue suitable instructions immediately to the public sector banks to extend this benefit to these categories. The Reserve Bank issued a circular on 18 August 1976 to public sector banks extending the scheme to all SFDA districts/areas covered by the central government—but not to SFAL and other similar agencies created by state governments—and in the districts declared as industrially backward.

SOCIAL SERVICE AGENCIES

Governor M. Narasimham, acting on the suggestion made to him by the Finance Minister, instructed the DBOD in May 1977 to examine whether banks might be asked to lower the rate of interest charged on advances to

purely social service institutions like tribal welfare associations.

The Department studied the activities of these voluntary agencies and found that, in a majority of the cases, administrative grants released by the government were utilized for organizational purposes, for maintenance of the office or for providing training facilities. Apart from purely social service activities involving administrative expenditure, such as those on training, research, provision of scholarships and child development programmes, the Department of Social Welfare had started socio-economic programmes aimed at providing opportunities for work and earning wages to needy women, such as widows, destitutes and physically handicapped persons. The Social Welfare Boards provided financial assistance for setting up small production units in sectors like small-scale industry, ancillary units, handicrafts training-cum-production units and dairy schemes. The Department took the view, on 29 June 1977, that it would not be appropriate to provide bank funds to finance purely administrative activity or any other activity that did not generate income for repayment of the loan. In other words, only the production and sale activities of the units should be provided bank credit facilities at low rates of interest. Since the total credit disbursed under the scheme amounted to Rs 17 crore at the end of September 1976—far short of the target of 0.5 per cent of aggregate advances—the Department suggested widening of the list of eligible categories under the DRI Scheme to all social service institutions under the Department of Social Welfare which were engaged in economic activities (besides orphanages and women's homes, institutions for the physically handicapped, and state corporations for scheduled castes and tribes). Where the credit requirements exceeded the ceilings, interest should be charged on the entire advance at 5 per cent per annum. Governor Narasimham, while appreciating the suggestion, cautioned that there would be no dearth of special cases in our economy.

However, he used the logic of the DBOD note in his correspondence with the government on the issue. In a letter to Manmohan Singh, Secretary, Department of Economic Affairs, dated 21 July 1977, Narasimham argued that with the scheme already covering a few institutions—namely, orphanages and women's homes, institutions for the physically handicapped and state corporations for scheduled castes and scheduled tribes—there was no reason why social service agencies should be excluded from its purview, provided other terms and conditions stipulated in the scheme were satisfied. The government preferred not to make any change in the scheme (vide telex dated 16 August 1977).

STATE-SPONSORED CORPORATIONS

One of the recommendations of the K.S. Krishnaswamy Working Group on Priority Sector Lending and the Twenty-point Economic Programme was that banks, while continuing to provide direct assistance, might also route credit to individual beneficiaries through state-sponsored corporations/agencies, besides functional cooperatives. Till then, DRI advances were routed only through state corporations set up for the welfare of SCs/STs and cooperatives/LAMPs in identified tribal areas. RRBs were permitted to utilize the scheme either as an agency or on refinance basis. Some state governments and state-sponsored corporations made requests to the Finance Ministry to be recognized as approved intermediaries for channelling credit under the DRI Scheme, to scheduled castes, scheduled tribes and other weak sections of the society. The government's Banking Division was not inclined to agree to such requests but wanted the RBI to consider the issue *de novo* in light of the recommendation of the Working Group.

The Bank explained, in its reply dated 9 May 1981, that one of the main reasons that prompted the Working Group to suggest routing assistance through intermediaries was because it might not be possible for commercial banks to directly cater to the credit requirements of a large number of beneficiaries in the future. Moreover, banks were under compulsion to ensure that the proportion of advances to the priority sector went up to 40 per cent by 1985, as against 30 per cent of total advances at the end of December 1979, and it was expected that by 1985, the volume of priority sector advances would be more than double the present level while the number of beneficiaries would be about three times the present number. In contrast, under the DRI Scheme, banks had to lend a minimum of 1 per cent of their aggregate advances; at the end of March 1980, advances under the scheme amounted to Rs 150 crore, constituting 0.9 per cent of total bank advances. Banks had almost reached the target and the additional funds that would be available for lending under the scheme were limited. Besides, the RRBs that operated mainly in rural areas had also been recently permitted to lend under the scheme on refinance basis. In the circumstances, the Reserve Bank felt that no useful purpose would be served by allowing state-sponsored corporations as intermediaries to lend directly with their own resources under the scheme. Further, it feared that permission to lend under the DRI Scheme through them might also bring about an anomaly in the interest rates charged to the borrowers, as these corporations were expected to finance other schemes at normal rates of interest.

SCHEDULED CASTES/SCHEDULED TRIBES

The Ministry of Finance forwarded to the Reserve Bank in August 1973, a letter from the Commissioner for Scheduled Castes and Scheduled Tribes, New Delhi, asking that instructions might be issued to nationalized banks to provide for gathering information about SC/ST borrowers. The Department of Banking Operations and Development, in its reply to the Ministry of Finance (Department of Banking), expressed the view that getting such statistical data through earmarking of a column in loan applications would be neither practicable nor desirable. Besides, there was no system in the banks for earmarking of funds or fixing targets for lending to any sector or class of borrower. The Delhi Scheduled Castes Welfare Association, as well as a member of the Minorities Commission, Government of India (Ven. Kushok G. Bakula), took up the matter raised by the Commissioner for Scheduled Castes and Scheduled Tribes, New Delhi. The Reserve Bank, however, did not change its views. It was only when the government accepted the recommendation of the Working Group set up in 1978 to review the DRI Scheme, to ensure that banks routed credit under the scheme through large-sized multiple purpose societies (LAMPS) in the cooperative sector (organized specifically for the benefit of the tribal population in areas identified by the government on the same terms and conditions applicable to state-owned corporations for the welfare of scheduled castes/scheduled tribes), that the DBOD issued necessary instructions to commercial banks on 22 December 1978. However, as the progress in the implementation of the DRI Scheme in tribal areas was found to be slow, the Bank suggested in January 1980 that the credit guarantee cover of the DICGC might be extended to LAMPS by the state government providing the guarantee. Also, the Bank asked banks to grant such advances and suggested that this approach could be adopted in the case of LAMPS as well. As regards the flow of information from banks relating to direct and indirect finance, the Bank suggested that it could be given in their quarterly returns prescribed by the government.

IRREGULARITIES IN IMPLEMENTATION

In the course of a scrutiny conducted by the New Delhi regional office of DBOD, of Bank of India, Chandni Chowk branch of Delhi, it was found that the branch was sanctioning advances under the DRI Scheme to various parties in a highly irregular manner, viz.:

1. More than 80 per cent of the accounts under the scheme were introduced by staff members, with the whereabouts of some of the bor-

rowers not known to the branch. In most of the cases, the borrowers were close relatives or friends of the concerned staff members.

2. Application forms were, in most cases, filled by staff members; these were found to be incomplete/incorrect as to the occupation of the borrower and his income, purpose of the advance, etc. As the borrowers were otherwise gainfully employed or belonged to affluent families, they were not eligible for any advance under the DRI Scheme.
3. The branch had not ascertained the end-use of the funds in all the accounts, as the pre-sanction and post-disbursement inspections were waived altogether.
4. The photographs affixed on the application forms were not those of the borrowers but of their relatives, and the signatures on the account opening forms and security documents were found to be fictitious/forged.

The DBOD did not rule out the possibility of negligence/malafides on the part of staff members in introducing DRI advances and misutilization of the proceeds although the advances were sanctioned in different names. K.R. Subrahmanyam, additional chief officer, DBOD, brought this to the notice of N. Vaghul, chairman and managing director of Bank of India, and advised him to take corrective action.

THE BANK AND A STATE GOVERNMENT

At meeting of the District Consultative Committee for Mandya held on 2 July 1976, S.M. Krishna, Minister for Industries, Karnataka state (also in charge of implementation of the Twenty-point Economic Programme), was reported to have made certain unflattering comments about the branch managers of banks, to have threatened to withdraw government deposits from banks that failed to toe the line of the state government, and also instructed the deputy commissioner of the district to 'create problems' for banks. The Reserve Bank—perturbed by the news about the state government officials' attempts to exert pressure on bank officers to lend liberally under the DRI Scheme without observing the prescribed norms—considered it appropriate to take up the issue with the state government and also to bring it to the notice of the Department of Banking. The decision was taken at a high management level, having been approved by the Executive Director, J.C. Luther, and Deputy Governor, K.S. Krishnaswamy.

Accordingly, P.N. Khanna, chief officer of DBOD, in a letter to G.V.K. Rao, Chief Secretary to the government of Karnataka, reported that the assistant commissioner of Puttur, at a meeting of banks convened on 29 May

1976 had told bank officials that the block development officer would obtain loan applications from villagers and forward them to banks with endorsements of two functionaries, namely, the village accountant and himself, and that banks on that basis should disburse the loans straightaway to such people without observing the usual formalities like enquiry, spot inspection, etc. Moreover, the assistant commissioner threatened the branch officials that if they did not carry out his instructions, he would 'take action' against them. The Reserve Bank pointed out that, while officials of the government 'can and should help' bank officials in identifying genuine borrowers, the branch manager was duty-bound to satisfy himself that the applicants fulfilled the conditions laid down in the scheme in all respects, and that the final decision to sanction or reject a loan application rested solely with the branch manager concerned. 'Both the Government of India and the Reserve Bank of India are vitally interested in ensuring that banks increase their lending under the scheme, but if the standards of lending are diluted, banks will only be faced with the difficult problem of recoveries later.' The Bank requested the Chief Secretary to explain the position to the district officials and other officials of the state government and instruct them to refrain from interfering with the normal functioning of bank branch managers in the districts; if the district officials had any problems, difficulties or grievances against the banks, they were to take up the matter with the Reserve Bank either through him or the Finance Department of the state government. A copy of the letter was endorsed to Government of India.

On account of the serious implications of the attitude of the Karnataka Industries Minister, the Reserve Bank reported the incident to the Ministry of Finance, Government of India. P.N. Khanna, in a letter dated 20 October 1976 to Kum. K.L. Mital, Joint Secretary, Department of Revenue and Banking (Banking Wing), informed her of the Minister's threat and added, whatever may be the justification for the Minister's dissatisfaction with the performance of banks in lending under the scheme in the district, his observations at the meeting were bound to have a demoralizing effect on the branch managers functioning there. The letter did not seem to have much impact on the state government, as the events that unfolded subsequently revealed.

The Karnataka government decided, in January 1976, to extend the benefits of the Differential Rate of Interest Scheme to those districts in the state that were not covered under the scheme by agreeing to provide subsidy to public sector banks on advances granted to eligible borrowers for the difference between their normal lending rate and 4 per cent.

Going a step further, in October 1976, the Karnataka government, by an

order, directed all Indian private sector banks to lend at 4 per cent to eligible borrowers in the eleven districts covered by the central government's DIR Scheme and offered to provide interest subsidy in the remaining eight districts not covered by the scheme.

The Reserve Bank reported to the Government of India the action taken by the Karnataka government in directing Indian private sector banks to implement the DIR Scheme. As a follow-up, B.C. Patnaik, Deputy Secretary, Department of Revenue and Banking, wrote on 24 February 1977 to the Secretary, Planning Department, Karnataka government, that in the absence of any decision by the central government it might not be advisable for the state government to ask the Indian private sector banks (other than those having lead responsibility authorized to operate the scheme) to implement the scheme, and suggested that the instructions already issued by the state government needed to be reconsidered. Alternatively, the state government could subsidize the difference between the normal rate and the fixed rate of 4 per cent to the Indian private sector banks in the eleven districts covered by the DRI Scheme, as has been done in the case of eight other districts. The state government seemed to have agreed with the views of Government of India.

The implementation of and progress achieved under the scheme were reported by the Reserve Bank management to the Central Board of Directors at the latter's request. The ideas presented by the Central Board at its meeting held on 15 October 1980 and subsequently by the Committee of the Central Board, provide a glimpse of the concerns of the management as well as the enlightened membership of the Board that represents a broad spectrum of society. That is why it is reported here. The note to the Board observed that, while the banking system as a whole had almost achieved the target of 1 per cent of aggregate advances at the end of December 1979, the percentage of overdues to demand in most banks was very high. It ranged between a low of 62 per cent (Indian Overseas Bank) to 96 per cent (State Bank of Indore), as on 31 December 1979. Some of the causes of high overdues were cited as practical difficulties in verifying the income of the weakest sections of the society as well as in conducting viability studies, non-availability of alternate source of repayment in case of failure of ventures financed by them and diversion of credit to consumption purposes, and banks' complacency in regard to recovery as individual loan amounts were very small.

The discussions of the Board and its Committee on the working of the scheme underscored the need for improving its implementation. Not permitting RRBs and cooperative banks to extend advances under the scheme

created anomalies, but it would be more anomalous if RRBs were allowed to lend directly under the scheme and obtain refinance from their sponsoring banks. The Board felt that the utility of the scheme would be enhanced if integrated assistance in the form of supply of inputs and marketing facilities were provided to the beneficiaries with the help of voluntary organizations, in addition to the provision of credit at concessional interest rates. The Board also suggested that the rate of interest should first be enhanced reasonably, in view of the higher cost of funds to banks. It considered that the low recovery of dues under the scheme was because of the guarantee cover from the DICGC up to 90 per cent and banks therefore made little effort to recover advances. The Board suggested that, as in the case of other borrowers, the DICGC should offer only 75 per cent coverage to advances under the DRI Scheme. More important, the Board viewed the need to examine whether the ceiling fixed was adequate for financing the productive activity of the borrowers, while evaluating the scheme. Also, it should be ensured that funds advanced were in fact utilized for the proposed economic activity.

At another Central Board meeting at Bombay, on 27 August 1981, the Board pointed out that while many were eligible to benefit under the scheme, the scheme itself could not be extended to a large number because the lending rate was fixed at a low level of 4 per cent. This meant that there was no incentive for banks to increase lending under the scheme. The government, according to the Board, could select certain schemes, such as housing, meant for the benefit of poor families, and link it with the DRI Scheme.

In retrospect, the Board's views seemed to be more of academic value, since the government's views on the scheme did not show any change after the 1978 revision of guidelines. Besides, the scheme was subsequently extended to RRBs on both agency and refinance basis, and to LAMPs.

THE SCHEME AND OVERDUES

The Ministry of Finance monitored the progress of the scheme every now and then. In fact, in 1979, concerned over the slow progress, the Ministry enquired of the Reserve Bank whether more stringent measures could be adopted to compel the banks to increase their advances under the scheme. K.B. Chore, chief officer, in his letter dated 15 June 1979 to Kum. K.L. Mital, Joint Secretary, explained that the Bank was closely watching the progress by means of periodical returns and progress reports. According to the returns received from banks, only six banks lagged behind in achieving the erstwhile target of 0.5 per cent as on 31 December 1978. The banks had

TABLE 2 Advances under the DRI Scheme by Public Sector Banks

As at end-December	No. of borrowal accounts (in lakhs)	Amount of loans outstanding (in crores)	Percentage of DRI loans to total loans and advances at the end of previous year
1972	0.26	0.87	0.02
1973	2.30	10.06	0.22
1974	3.13	13.35	0.23
1975	4.65	20.99	0.31
1976	10.05	47.24	0.56
1977	13.92	67.99	0.61
1978	16.20	89.99	0.74
1979	20.72	139.49	0.98
1980	25.10	193.56	1.04
1981	29.25	257.00	1.17

TABLE 3 Position of Recovery of DRI Loans of Public Sector Banks

(Rs lakh)			
End-December (1)	Demand (2)	Overdues (3)	3 as % to 2 (4)
1978	2931	2170	74
1979	4039	2815	70
1980	5967	4130	69

Source: RPCD office note dated 26 October 1982 in file C453 (U)

given various reasons for the shortfall (which were relevant to shortfalls in priority sector lending as well), such as their operation in backward areas, lack of infrastructure facilities, poor credit absorption capacity of the borrowers, etc. Since a sizeable proportion of their lendable resources were locked in sick units, any increase in credit to the priority sector and in loans and advances under the DRI Scheme would adversely affect the banks' profitability. The Reserve Bank, therefore, was not inclined to take any punitive-cum-inducement measures at that time but proposed to continue with persuasion, sustained monitoring and continuous review of progress in achieving the desired norms. Moreover, the Bank suggested that the nominees of the government and the RBI on the boards of banks that had not achieved the norms so far might be asked to discuss the matter in detail with the chairmen of the concerned banks whenever the opportunity opened up, and to provide feedback.

The facts, however, were somewhat different from the perception of the government, regarding the progress of the scheme in the first ten years of its existence. In terms of the percentage of DRI loans to total credit, there was continuous improvement year after year, although the absolute amounts remained relatively small. The following table shows that in terms of percentage of total loans and advances, DRI loans moved up from a negligible proportion to over 1 per cent by the end of 1981. (The Reserve Bank as a facilitator played its role admirably and acted in concert with the government enabling the banks to fulfil the social responsibilities cast on them.)

One of the objectives of the scheme was that, over a period of time the beneficiaries would graduate into borrowers at normal rates of interest and contribute to the recycling of funds by making regular repayments; thereby, the benefits could be extended to an increasingly broad segment of eligible borrowers. However, owing to certain structural rigidities in the scheme, the quantum of overdues assumed disquieting proportions over time.

Besides the high level of overdues as compared to demand, overdues were high in the states that had granted a comparatively larger share of loans under the scheme, e.g., Uttar Pradesh (65 per cent), Gujarat (61 per cent), Maharashtra (66 per cent), Karnataka (70 per cent), Bihar (80 per cent) and Tamil Nadu (67 per cent). The high level of overdues adversely affected the ability of banks to recycle blocked funds and, as such, the benefits of the scheme could not reach correspondingly larger number of borrowers.

NATIONAL INSTITUTE OF BANK MANAGEMENT STUDY

The DRI Scheme was one of those on which the government bestowed considerable attention during the 1970s. To have a qualitative review of the scheme from an objective academic institution, the government entrusted a study to the National Institute of Bank Management (NIBM) in November 1980, an interim report of which was sought within three months from 19 February 1981, the date on which the main theme and focus of the study was determined.

The final NIBM study, submitted to Government of India in December 1982, was based on a field survey of DRI borrowers from 72 selected branches of eighteen banks in thirty-four districts of sixteen states which yielded data on 1,600 borrowers, and data on 4,300 borrowers received from forty-three branches of banks. Interestingly, about 10 per cent of the total borrowers were estimated to be ineligible to borrow under the scheme. Small businesses and dairying were the main activities in which the DRI

borrowers were engaged. In a large number of borrowal accounts, the loan amounts, the amounts needed for particular purposes, the term and periodicity of repayment had been mismatched, thus sowing the seeds of borrower delinquency and non-fulfilment of the objectives of the scheme from the very beginning. Almost one-half of the borrowers felt that the loan amounts were inadequate and did not match the minimum viable level of activity. At the end of June 1981, 50 per cent of the loans disbursed during 1972–81 were outstanding from 70 per cent of total borrowers; and 30 per cent of total borrowal accounts had been closed on full repayment. Repayments by ‘small business’ borrowers were better than by other groups; loan amounts of Rs 201–2,000 resulted in better repayments than those in other loan-sizes; direct lending to borrowers without the involvement of government agencies resulted in better repayment; repayment behaviour of subsidy recipients was worse than that of those who did not receive subsidies; and lending for periods of thirteen to thirty-six months resulted in better repayment than lending for shorter or very much longer terms. The study also noted that the majority of borrowers had recorded positive changes in their financial position; the non-DRI debt of these people had ‘possibly’ declined to the extent that the DRI loan had replaced the money-lender.

A disturbing outcome of the NIBM study was that it showed that a large number of borrowers were incurring high costs over and above the interest cost for securing DRI loans; many of them did not know the exact interest rates on DRI loans and a large number of them were prepared to borrow at higher rates of interest. The study felt that most of the activities financed by DRI loans yielded a return high enough to be able to afford a rate higher than the 4 per cent rate of interest.

The outcome of the NIBM study corroborated the Reserve Bank’s own assessment of the scheme. The Bank’s role in the conduct of the DRI Scheme was subsidiary but critical, in that its views and comments played an important role in shaping the government’s policies on the matter. But, by 1981, it was clear that the scheme would not progress further unless the banking system was willing to incur additional costs in meeting the target, and in implementing the scheme in the spirit in which it was conceived. Yet, it was one of the few instances where the viability/profitability of banks in lending was openly discussed. It was also one of the instances where the Reserve Bank and Government of India acted in concert to enable banks to fulfil the social obligations cast on them.