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The Dictates of Prudence

New approaches bring new problems in their wake. The stated objective of bank nationalization in 1969 was to expand the spread and reach of banking. This objective was pursued with exemplary doggedness but, as the spread and reach of banking expanded, an important new problem came to the fore: the viability of banks. This was partly because of the deterioration in the quality of lending that was inherent in the large amount of loan operations, and partly because of inadequate appreciation of the need for instituting mechanisms for internal controls. It fell to the Reserve Bank of India to rectify these. One of the important approaches it adopted was closer inspection of accounts.

INSPECTION OF BANKS

The inspection machinery in the RBI had been set up following the Banking Companies Act, 1949.[1] Vide Section 22 of the Act, the Bank had to satisfy itself whether:

(i) the banking company is or will be in a position to pay its present or future depositors in full as their claims accrue; and

(ii) the affairs of the banking company are not being or not likely to be conducted in a manner detrimental to the interests of its present or future depositors.

By the beginning of the 1970s, the RBI's practice of pointing out areas that required urgent action was more or less stabilized. This was often done even before a formal report had been submitted and banks were asked to take remedial action. Weaker units that appeared incapable becoming viable were asked to consider merging with other suitable institutions. Sometimes the Bank even deputed an 'observer' to keep an eye on things.

[1] Renamed in 1966 as the Banking Regulation Act, 1949.

Usually, though, informal observation was the norm. The Bank could also demand full access to all the papers.

With the advent of 'social control' of banks in 1967, the instructions to inspecting officers underwent a change. The purport was clear: if the loans were for social purposes, go easy. Thus the Department of Banking Operations and Development (DBOD), in a circular in June 1968, emphasized that 'although the time-honoured considerations of safety of funds lent and protection of the depositors' interest are not meant to be ignored, particular attention should be devoted to the examination of the advances portfolio of banks from the point of view of a socially oriented deployment of their funds.' The inspecting officers were also asked to assess how sincere banks were in giving loans to the priority sector.

If this was unorthodox, more was to follow after the nationalization of fourteen major commercial banks in 1969. In his inaugural address to a conference of heads of the DBOD from various centres in March 1970, Governor Jha highlighted the changes in the role of the Reserve Bank. His message was clear: the Bank's main duty was to ensure the flow of adequate credit to the neglected sectors of the economy in the country, and not only to look to the safety aspect of funds but also to see that the funds were not lent to a borrower who was likely to misuse the credit by diverting it for speculative or other purposes. He also said that inspectors could play a vital role in ensuring that the declared policies of the government were implemented. The proceedings of the conference stated:

> The scope of these inspections will cover, apart from the standard drill, the following aspects: the efforts and the performance of each branch in respect of deposit mobilization and advances to priority/neglected sectors vis-à-vis the performance of the branches of other banks at that centre, and the delegation of adequate powers to branch agents and their judicious use and profitability position (the attainment of social objectives should be consistent with profitability).

Consequently, four types of inspections were decided upon:

(i) Inspection to assess the financial position

(ii) Centre-wise inspection of branches

(iii) Ad-hoc inspections to examine implementation of selective credit controls, frauds, complaints, etc.

(iv) Inspection to examine the systems and performance of banks.

A major consequence of the expansion of banking was that it became virtually impossible to carry out inspection as frequently as had been the case earlier. So the DBOD issued detailed guidelines to cover all branches of commercial banks once in three years, as opposed to at least once a year. But foreign and private banks were to be inspected once a year; this was later relaxed in the case of banks with deposits of over Rs 50 crore. The public sector was effectively let off the hook.

This was also a period that saw a spurt in fraud within public sector banks. On 25 June 1971, Finance Minister Y.B. Chavan wrote to Governor Jagannathan:

> I have been very much perturbed over the spate of frauds in recent weeks in some of the public sector banks. You will agree that what is at stake in these bank frauds is not merely the large sums of money involved, but also the reputation and the image of public sector banks in general and the trust and confidence reposed by the public in the banking system of the country.

Chavan went on to add that one common feature in these frauds was the direct involvement of bank employees, largely facilitated by the non-observance of the instructions laid down for safeguarding banks' funds. He concluded:

> As the matter is one of great public importance, I feel that the Reserve Bank alone can undertake a quick study in depth, of the extant practices and procedures in the public sector banks, to identify the deficiencies that give scope to frauds, with a view to eliminate such deficiencies.[2]

[2] In a secret note dated 6 May 1970 to Shri A. Baksi, Secretary, Department of Banking, Ministry of Finance, Government of India, Shri B.N. Adarkar, Governor of RBI wrote: 'The internal working of commercial banks in India has so many deficiencies that it is a matter of surprise that the number of frauds actually occurring is so small. Over the last few years, we have been trying to improve the working in many respects, but this is a task which will take some years to be fully accomplished. My four years of hard work in the DBOD were not enough. There are a number of areas where it is essential to improve our inspection procedures and also bring about radical changes in the internal working of banks. . . . I would ask you to appreciate that given the limitations of personnel and the importance and urgency of developing the social aspects of banking, the Reserve Bank could not possibly do all it wished by way of cleaning up the internal working of banks. In fact, it was the Reserve Bank's excessive preoccupation with mere policing that had led to the development work being somewhat neglected prior to the introduction of social control. I recognize, however, that both development and improvement of personnel and procedures must now be pursued simultaneously and with equal vigour.'

DBOD initiated prompt action and a team of four officers, including an officer from the Organization and Methods Division, was formed. The first study of systems and procedures was taken up in Central Bank of India towards the middle of August 1971. The second study was undertaken in Allahabad Bank towards the end of January 1972.

Centre-wise inspection of branches had a brisk take-off. The main purpose of these inspections, as stated earlier, was to assess the performance of the branches of different banks at the same centre in the context of achieving social objectives, and to relieve the financial assessment type of inspection from the burden of inspecting too many branches. The scope and coverage of the inspection were designed accordingly; these included, apart from an examination of the affairs of the bank branches, an assessment of the business potential at the centre, as also a study of local problems with the assistance of knowledgeable agencies at the centre and pragmatic suggestions for their solution. The inspection team for a particular centre functioned under a leader, who directed and supervised inspections of branches. The leader also contacted representative bodies (if any) of borrowers in the neglected sectors, concerned state government departments/agencies and officers in charge of a few offices of the banks operating at the centre, and held discussions with them so as to elicit, *inter alia*, information on aspects such as deposit potential, credit gaps, customer service and specific local problems.

During the early 1970s, officers of the DBOD were deputed for training, from time to time, to courses and seminars organized by the Indian Institutes of Management, Calcutta/Ahmedabad, National Institute of Bank Management, Bombay and other training institutions, including those of the commercial banks, to equip them for effective implementation of the new pattern of inspections. Besides, revision of the existing *Inspection Manual* was taken up and a proposal mooted for opening offices of the DBOD in states where they did not exist. Officers of the Reserve Bank who were functioning as additional directors, under Section 36AB of the Banking Regulation Act, 1949, in banks that were working under directions and under formal observation, were instructed to watch the performance of the developmental activities of the banks and not merely the progress of implementation of the directions issued to them. The first batch of centre-wise inspections was carried out in 1970 on an experimental basis. The inspecting officers prepared initial branch inspection reports in free style and the leader of the team prepared the consolidated report on the centre, based on the reports of the inspecting officers.

In November 1970, the Efficiency and Development Sub-Committee, while approving the proposal for opening more offices of the DBOD, directed that the O&M cell in the Reserve Bank should study the forms, inspection procedures and other items of work handled by the regional offices of the DBOD with a view to improving operational efficiency, and set up a model so that the new offices could be started on that basis. The preliminary study showed that about 80 per cent of the officers of the regional offices were deployed for inspections, and that the major part of the inspection work was on account of the centre-wise inspections introduced at that time. Hence the study initially concentrated on this type of inspections. The first phase of the study relating to centre-wise inspections was taken up in February 1971, and the O&M division submitted its detailed report in July 1971. For the purpose of the study, the O&M team associated itself with centre-wise inspections carried out at Vizianagaram and Cannanore, and also scrutinized about 100 centre-wise inspection reports from various regional offices. The report, *inter alia*, observed that the existing instructions on the scope of centre-wise inspections provided that it should cover certain specific aspects 'apart from the standard drill'.

According to the O&M study team, the insistence on a 'standard drill', which involved a scrutiny for assessing the financial position, had, in actual practice, tended to make the centre-wise inspection an extension of the inspection under Section 35 of the Banking Regulation Act, both in methodology and content. The study team stated that tighter scrutiny of the financial position uniformly applicable to all categories of banks was not necessary in the changed context obtaining then. It suggested that the scrutiny for assessing the financial position in the case of branches inspected under the centre-wise scheme should be limited to the minimum extent necessary, so as to have only a general feel of the state of affairs at the branches concerned. On this premise, the study team suggested certain modifications in the existing procedure, which, *inter alia*, involved:

(i) discontinuance of narrative reports and introduction of a standardized format for reporting
(ii) sample check for scrutiny of advances as against item-wise scrutiny of individual accounts
(iii) discontinuance/reduction of work involved in voucher auditing, balancing and reconciliation of books, and scrutiny of drafts payable, bills payable, payment orders, sundry deposits and suspense accounts
(iv) elimination of items of physical verification, like petty cash, parcels, documentary stamps, bills, and simplification of cash verification.

It was assessed that the suggested modifications would save inspection time to the extent of about 44 per cent. The study team also suggested that the leader of the centre-wise inspection team should not be tied down with a heavy inspection schedule, so that he had ample time to guide and supervise the work of the other members of the team, to contact government agencies and other representative bodies responsible for developmental activities, and to ascertain the potentialities, credit needs and special problems of the centre.

The various recommendations of the O&M study team, including the form suggested for branch inspection, were discussed with DBOD officials and revisions, as mutually agreed, were carried out. In a note submitted by the DBOD in this regard on 5 October 1971, it was emphasized: 'Some of the recommendations made in the O&M report emerged out of the suggestions made by the officers of central DBOD at the time of informal discussions with the O&M team.' Further, regarding the format of the branch inspection note, which, incidentally, was a major innovation in the newly suggested pattern of centre-wise inspection, it was unequivocally made clear:

> The statistical parts as well as the questionnaire of the format originally designed by the O&M Division were based on our existing instructions regarding centre-wise inspections. Besides suitably modifying the statistical outline, we have since revised the questionnaire extensively in the light of our experience and new thinking. The revised format has been shown to the O&M Division and they have cleared it with a few minor changes here and there.

The DBOD, apparently, was unwilling to give the entire credit for the innovation to the study team.

The draft circular laying down the instructions and guidelines for centre-wise inspections was shown to R.A. Gulmohamed, V.D. Thakkar and L.C. Mistry of Dena Bank, Bank of Baroda and Union Bank of India, respectively, and their suggestions were incorporated before it was submitted to the Deputy Governor of RBI, Hazari. The circular, addressed to the various offices of DBOD, was issued on 5 October 1971. Apart from forwarding the format of the branch inspection note, it also contained exhaustive guidelines for examination of various aspects of the working of the branches. The regional offices were advised to forward a copy of the consolidated report on each centre-wise inspection to the central DBOD. The listed irregularities/deficiencies, etc., of a major nature were to be pointed out to the concerned banks and their comments called for. If the banks' comments indicated that they were seized of the matter and were taking appropriate steps, such cases were not to be pursued at least till the time of the next inspection, which would take up the issue of compliance with the recommendations/comments pointed out by the inspection team that preceded it.

The guidelines for centre-wise inspections underwent periodic modifications, including certain revisions in the format of the branch inspection note, in the subsequent years, in light of the issues raised and the experience gained during the inspections. In the late 1970s, with the Lead Bank Scheme dominant in the exercises for preparation of district-wise credit plans, the regional offices of the DBOD were advised that, on completion of centre-wise inspections in a district, a district-wise note examining the role played by banks in the development of the district as a whole should be prepared and forwarded to the central DBOD. This note was to contain the district profile with details such as population, occupational pattern, developmental programmes, etc., as also the number of commercial bank offices, their distribution in rural, semi-urban and urban areas, their deposit potential, their credit dispensation (especially to priority and weaker sections), etc. These instructions were issued in March 1977. Given the arduous amount of work involved, it became apparent that the instructions could be carried out in full. A decision was therefore taken to discontinue the scheme of centre-wise inspections, following a conference of the regional in-charges of the DBOD, held in Bombay on 6 and 7 August 1979. It is thus unlikely that any extensive use of district-wise notes was made in the preparation of the district credit plans, systematic formulation of which commenced only in 1980. Besides discontinuance of the centre-wise inspections, the systems inspections were also wound up with the introduction of the new scheme of annual appraisal inspections of banks in 1978. The latter was introduced at the instance of Government of India, with a focus on the working of the public sector banks.

The scheme of centre-wise inspections, which was implemented from May 1970, till the time of its discontinuation in 1979, had covered 6,867 centres served by 13,875 offices of commercial banks, while the systems inspection, which was introduced in 1971, did not make much headway and had completed studies of only six banks in the public sector and three banks in the private sector by the time of its winding up in 1977.

The centre-wise and systems inspections were replaced by annual appraisal inspections that would complement the statutory financial inspections, which normally take place at relatively large intervals of time. Put together, these inspections would reveal the overarching concerns relating to the functioning of each bank. In the report on the activities of the DBOD submitted to the Central Board in 1978, the unveiling of the scheme of annual appraisal was referred to follows:

> Having regard to the fast developments taking place in the field of banking and the need for the Reserve Bank to assess how the banks are discharging their responsibilities and to enable the Bank to issue suitable instructions and guidelines, it was considered necessary to make an assessment of the affairs of the banks at short intervals, say, once in a year. Accordingly, it has been decided to institute a new type of inspection, viz., Annual Appraisal of banks, under Section 35 of the Banking Regulation Act, 1949. It is proposed to undertake, under this system, a quick and overall assessment of the working of banks. In a way, it can be construed as a sort of management audit and emphasis will be laid on examining the organizational set-up, manpower planning, machinery for supervision and control over branches, management of funds, credit etc. of banks. This type of inspection will thus embrace the study of systems and procedures followed by banks. Initially, it is proposed to restrict this type of inspection to all the twenty-two banks in the public sector and eight larger private sector banks.

During the quarter April–June 1978, inspection of one public sector bank in the Bombay area was taken up on a pilot basis under the scheme. Besides the bank's head office, sixteen regional managers' offices and seventeen major branches spread over the country were also inspected. It was decided to schedule more banks for inspection on a regular basis, and to issue suitable guidelines on the basis of the experience gained. Subsequently, after a conference of the heads of the regional offices of DBOD in August 1979, it was decided that annual appraisal of a bank would cover only a few important controlling offices and branches, besides the head office/central office. Apart from an appraisal of the standards of management, the inspection would cover a broad assessment of the financial position of the bank on the basis of the records available at its head office/central office. A decision was also taken to carry out financial inspection of public sector banks as and when they fell due, alongside the annual appraisal of the bank for that particular year. The same inspection team deputed to conduct the annual appraisal of a bank was required to carry out the financial inspection of the bank as well, in such cases, and both the inspections had to be carried out with reference to the same date.

As the annual appraisal inspections of public sector banks was taken up at the instance of the central government, the inspecting officers were initially advised to prepare a self-contained note for forwarding to the government. Later, in July 1980, it was decided to forward to the government a copy of the inspection report itself. At a conference of the heads of the regional offices of DBOD in February 1981, it was decided to introduce an innovative technique for monitoring the progress of annual appraisal and financial assessment inspections, namely, the PERT (Performance Evaluation and Review Technique) Chart. The PERT Chart was devised with the help of the Management Services Department, mainly with a view to reducing the time-lag between the commencement of inspection of a bank, and the forwarding of the inspection report to the government and the bank concerned. The technique broadly relied on breaking up the entire process of inspection into various identifiable components and estimating the time requirement for completion of each of them, on the basis of past experience and/or experts' guesstimates.

At one of the meetings of the Committee of the Central Board, towards the end of the reference period of this study, Governor I.G. Patel pointed to the desirability of an outside Working Group to examine the Reserve Bank's system of inspections. Accordingly, a Working Group under the chairmanship of V.G. Pendharkar, retired Executive Director of the Bank, was appointed in December 1981, to review the existing system of inspection of commercial banks, regional rural banks and urban cooperative banks, with particular reference to the objectives of the banking and credit policy of the Bank, and the scope, coverage, methodology and periodicity of inspections.

Foreign Banks

The inspection procedure—including taking up surprise inspections, the audit element, and the examination of various items of assets and liabilities—adopted in the case of foreign banks was similar to that of the financial inspection of Indian banks. However, apart from assessing the progress made by a foreign bank in regard to mobilization of deposits and in granting of advances to the priority sector, and its role in financing import/export trade in India, the inspecting officer was also expected to critically assess the functioning of the local board/committee (which the foreign banks were asked to constitute in 1968 on the lines of the reconstituted boards of Indian banks) and the progress made by the bank in Indianization of its staff. Other aspects examined by inspecting officers included the extent of 'own funds' deployed in Indian business, the credit–deposit ratio, the booking and transfer of profit, provisioning for bad debts, compliance with exchange control regulations, etc.

Foreign Branches of Indian Banks

After the failure, in 1950, of the Exchange Bank of India and Africa Ltd, which had a network of branches in foreign countries, it became necessary to regulate the opening of overseas branches of Indian banks with a view to ensuring the maintenance of a satisfactory financial position and the observance of sound banking traditions by foreign branches. These objectives reaffirmed the vital importance of safeguarding the prestige of Indian banks abroad and the larger interests of the country. Accordingly, Section 23 of the Banking Regulation Act, 1949, was amended in 1950, so as to require every banking company incorporated in India to obtain prior permission from the Reserve Bank for opening a branch in a foreign country. It was also considered necessary that foreign branches of Indian banks be subjected to inspections by the RBI in order to ensure that the deficiencies in their working were removed, and that they continued to work satisfactorily and be in a position to meet the demands of depositors as and when their claims accrued. As the Reserve Bank had no statutory powers in this regard, Section 35 of the Banking Regulation Act, 1949, was suitably amended in 1959, empowering it to inspect, at any time, the branches of Indian banks operating in foreign countries.

The first round of inspections of foreign branches of Indian banks, which commenced in 1961, was over by 1962. Although it was originally envisaged that foreign branches, once in three years, the second round of such inspections was postponed from time to time, mainly on account of the then prevailing tight foreign exchange position and because, from the data provided to the Reserve Bank, it was observed that they were working satisfactorily. In 1968, the branches of three Indian banks in Ceylon were inspected, followed by inspections in 1969, 1970 and 1971 of some more branches in other countries. Certain fraudulent transactions of large amounts and several grave irregularities at the London branch of Central Bank of India came to light in 1970, about which we shall provide more details later in this Chapter. In this backdrop, it was decided that inspection of overseas branches of Indian banks should be conducted with greater frequency than in the past; however, the decision did not get implemented to the extent contemplated.

The policy of inspection of foreign branches that was evolved in 1960 emphasized that inspecting officers of the Reserve Bank should not be unduly critical of locally prevalent practices that the branches of Indian banks in foreign countries might be forced to follow, in order to compete with other banks there. Strict adherence to norms obtaining in India were not, therefore, to be, insisted upon, and practices followed by other banks were to be the guiding factors in deciding policies and procedures. The inspection of foreign branches of Indian banks by the Reserve Bank essentially aimed at finding out whether these offices were functioning efficiently and on a profitable basis, and whether their working in general was on sound lines. The working losses of foreign branches, as also losses arising out of their bad debts, were adjustable against profits earned in the foreign country concerned over a period, and were eventually reimbursable from Indian resources, which meant loss of foreign exchange. The inspection aimed at finding out how the working of these offices could be improved so as to avoid such losses and secure higher foreign exchange earnings for India.

DEPOSIT INSURANCE

The origin and early years of the Deposit Insurance Corporation (DIC), a wholly owned subsidiary of the Reserve Bank of India, are detailed in the second volume of the *History of the RBI*. When the DIC commenced operations in 1962, 287 banks registered with it as insured banks. By the end of 1967, the number of insured banks was a mere 100, largely as a result of the Reserve Bank's policy of reconstruction and amalgamation of small and financially weak banks so as to make the banking sector more viable. Up to 1967, the liabilities of the Corporation were invoked in the case of eleven banks;[3] and the licenses of three of these banks, viz., Habib Bank, National Bank of Pakistan and Bank of China, were cancelled for reasons other than financial viability. As at the end of 1966, the amounts paid or provided for in respect of these eleven banks amounted to Rs 56.83 lakh of which Rs 39.85 lakh, had been recovered by the DIC and the overall risk experience of the Corporation was 'favourable'.

[3] The Bank of China, Calcutta (1963); Bank of Alagapuri Ltd, Alagapuri (1963); Unity Bank Ltd, Madras (1963); Metropolitan Bank Ltd, Calcutta (1964); Unnao Commercial Bank Ltd, Unnao (1964); Cochin Nayar Bank Ltd, Trichur (1964); Latin Christian Bank Ltd, Ernakulam (1964); Southern Bank Ltd, Calcutta (1964); Shree Jadeya Shankarling Bank Ltd, Bijapur (1965); National Bank of Pakistan, Calcutta (1966); Habib Bank Ltd, Bombay (1966).

Important events that took place during 1967–81 were: the amendment of the Deposit Insurance Corporation Act in 1968 to extend the insurance scheme to deposits with cooperative banks; the strong growth and consolidation of the deposit insurance fund consequent upon the expansion of bank deposits; the progressive increase in the coverage of insured deposits; and, finally, the merger of the Credit Guarantee Corporation of India Ltd with the DIC, leading to the formation of the Deposit Insurance and Credit Guarantee Corporation of India, with the 'twin and cognate' objectives of giving protection to small bank depositors and providing guarantee cover to credit facilities extended to certain categories of small borrowers belonging to the weaker sections of society. We shall discuss each of these in what follows.

Cooperative Banks

The need for insuring deposits with cooperative banks was considered during the course of the deliberations on the draft scheme and also after the enactment of the Deposit Insurance Act, 1961, but was not acted upon because, while the Reserve Bank did not possess the authority to regulate and inspect the affairs of cooperative banks, state governments were unwilling to cede the power to wind up or reconstitute such banks. A detailed account of this is given in the second volume of the *History of the RBI*.

In course of time, with some state governments showing an inclination to favourably consider the RBI's point of view, the Deposit Insurance Corporation (Amendment) Bill, 1967, was introduced in the Lok Sabha on 17 July 1967. The Bill proposed to extend the deposit insurance scheme to state, central and larger primary non-agricultural credit societies, i.e. urban cooperative banks with paid-up capital of Rs 1 lakh or more. The Bill was passed by both the Lok Sabha and Rajya Sabha, and it received the assent of the President of India on 27 December 1968. To extend deposit insurance to cooperative banks, the state governments, on their part, were required to amend their respective cooperative laws to the effect that, *inter alia*, the winding up, reconstruction or amalgamation of a bank could be undertaken only with the written approval of the Reserve Bank. The Bank could wind up a cooperative bank by not granting licence or if it considered that continuance of the cooperative bank was prejudicial to the interests of its depositors. Moreover, on winding up a bank, the liquidators of the insured bank or the transferee bank would be under obligation to repay the Deposit Insurance Corporation the sums due to it as its share of recoveries. Given the nature of the tasks involved in the state governments amending their cooperative laws, the Deposit Insurance Corporation (Amendment) Act provided that it could be brought into force in stages on different dates in the various states and union territories.

In 1968, the position of cooperative banks was somewhat ambivalent. The Banking Laws (Application to Cooperative Societies) Act, 1965, that came into force from 1 March 1966, required cooperative banks to obtain a licence from the Reserve Bank to undertake banking business. However, the cooperative banks that were in existence on the said date were permitted to carry on banking business till they were granted a licence or were informed that a licence could not be granted to them. It was in this context that the RBI took up the task of persuading salary earners' societies to restrict their deposit collection to members. As a result, several salary earners' societies, which were earlier classified as primary cooperative banks, were reclassified as non-banking societies and excluded from the purview of the Banking Regulation Act upon their agreeing not to receive deposits from non-members. The available statistics as on 30 June 1967 indicated that deposits in cooperative banks formed 14.7 per cent of those in commercial banks, and that deposits in these banks assessable for insurance premium formed 9.7 per cent of those in commercial banks.

It must be noted that under the federal structure delineated by the Indian Constitution, cooperation is a state subject, and the powers relating to cooperative banks are vested with state governments. The amended Section 2(gg) of the DIC Act, defining an 'eligible cooperative bank', required state Governments to transfer these powers to the Reserve Bank to avail of the advantages of deposit insurance.

The powers sought to be transferred to the Reserve Bank from state government were rather sweeping. While some states readily agreed to the Bank's proposals, there were some detractors. Maharashtra, where the cooperative movement was well established, had initial hesitation and sought assurances regarding prior consultations with the state government if reconstruction, amalgamation or winding up of a cooperative bank had to be undertaken. The state of Madras was not in favour of giving powers over cooperative banks to the Reserve Bank nor were the states of Kerala and West Bengal, which felt that deposit insurance would not be of any significant help. Nevertheless, over time, state governments realized the benefits of deposit insurance to cooperative banks, and amended their laws to extend the facility in their states.

The state of Maharashtra was predictably the first to amend its cooperative laws, followed by the states of Madhya Pradesh and Andhra Pradesh, and the union territory of Goa, Daman and Diu amending their

Cooperative Societies Act on the lines suggested by the RBI. Government of India issued the necessary notification bringing into force the provisions of the Deposit Insurance Corporation (Amendment) Act, 1968, in relation to the three states and one union territory, with effect from 1 July 1971. These states and union territory accounted for 382 out of the 1,318 co-operative banks in India. The state of Jammu and Kashmir and the union territory of Delhi soon followed in their wake.

The extension of deposit insurance to cooperative banks in various states was largely due to the determined efforts of the Agricultural Credit Department (ACD) of the Reserve Bank in pursuing the matter with the various state governments, and also in undertaking the groundwork necessary for the Deposit Insurance Corporation to enrol the cooperative banks as insured banks. Specifically, the role of the ACD covered: (i) verifying, in consultation with the Legal Department of the Bank, whether the amendments to the cooperative societies acts passed by the state governments were in order, vesting the necessary powers with the Reserve Bank to make co-operative banks eligible for deposit insurance; (ii) furnishing to the DIC a list of existing cooperative banks in the state/union territory which had applied for a licence and was not refused a licence so as to enable the DIC to register them as insured banks within a month of its coming into force; (iii) eliminating from the list such cooperative banks as had become defunct but could not be taken into liquidation by refusing a licence to them, if possible, before registering them as insured banks; and (iv) furnishing statements to the DIC showing the total insurable deposits of co-operative banks in the concerned state/union territory and the extent to which they are likely to be covered by the existing limits of insurance. Thus, the larger burden of the task of extending deposit insurance to states devolved on the ACD, with the DIC merely issuing the registration letters, calculating the premium payable and ensuring the adequacy of resources and reserves in bringing the cooperative sector into the scheme of insurance.

The Reserve Bank's perspective was that even if the state governments amended their cooperative societies acts, it was neither 'possible or desirable' for the RBI to recommend to the DIC to extend the facility of deposit insurance to all existing cooperative banks in the concerned states. The amended Act of 1968 defined the expression 'existing cooperative bank' as one that either held a licence or was not denied a licence, but did not include a defunct bank. Prior to extending insurance cover, the Bank felt that it would be necessary to 'eliminate the risks involved in including banks which are sub-standard'. Sub-standard banks were those that had suffered an erosion in their net worth and had an aggregate of paid-up capital and reserves less than Rs 1 lakh, and were not in a position to pay their present or future depositors in full as their claims accrued. Technically, they were defined as those banks that did not comply with the provisions of Section 11(1) and 22(3)(a) of the Banking Regulation Act, 1949, as applicable to cooperative societies. The policy pursued by the ACD was to weed out sub-standard banks before recommending to the DIC, extension of the deposit insurance scheme to the state. The instruments for 'weeding out' included refusal or cancellation of a licence, or a process to rehabilitate the banks as early as possible. The programme of rehabilitation would be aimed at strengthening their share capital by additional collection or by government contribution, as well as recovery of overdues. Such programmes were to be drawn in close consultation with the state governments, state cooperative banks and the managements of the banks concerned, to ensure that they complied with the provisions related to minimum net worth. For those beyond redemption, steps would be initiated, in consultation with the state government, to refuse a licence, cancel a licence or liquidate the bank. The other aspect considered by the ACD was the completion of formalities by primary cooperative banks or salary earners'/employees' credit societies for being declared/notified as non-banking institutions. The ACD would use its leverage with state governments to ensure that such societies completed the prescribed formalities and got themselves declared as non-banking institutions. The rationale to hold back the extension of deposit insurance till weak banks were weeded out and salary earners' societies were removed from the banking fold was to coopt the support of state government authorities for the incentives associated with the scheme.

This policy of weeding out sub-standard cooperative banks was not without its share of problems. When the three states of Maharashtra, Madhya Pradesh and Andhra Pradesh, and the union territory of Goa, Daman and Diu amended their respective cooperative acts in 1970, before the provisions of the DIC Act were brought into force with effect from 1 July 1971, four primary cooperative banks were taken into liquidation at the instance of the ACD.[4] There yet remained twenty-one sub-standard banks in these states. By early 1972, these had increased to twenty-four of which eight were central and sixteen were primary cooperative banks; in addition, there

[4] These were the Barsi Merchants' Cooperative Bank Ltd, the Manmad Merchants' Cooperative Bank Ltd, the Kalyan Peoples' Cooperative Bank Ltd in Maharashtra, and the Jhabua Nagrik Sahakari Bank Ltd in Madhya Pradesh.

were fourteen primary cooperative banks that were at the margin. The reason why some of the sub-standard banks were not 'weeded out' was partly because of an assurance given in the Parliament at the time of the enactment of the Banking Laws (Application to Cooperative Societies) Act, 1965, that, in administering the provisions of the Act, the special needs and requirements of cooperative banks would be borne in mind by the Reserve Bank. The sub-standard primary cooperative banks were deemed to be 'existing cooperative banks' under the DIC Act, 1961. In other words, they were not denied a licence to operate. Where central cooperative banks were concerned, it was felt that liquidation or winding up of any district central cooperative bank (DCCB) would create an institutional gap in the existing cooperative banking structure, impeding the flow of credit to the primary societies and thus adversely affecting agricultural production. The issue of rehabilitation of weak DCCBs was also discussed at the Planning Commission at its meeting of 25 October 1971, where it was felt that the Reserve Bank should go ahead with their rehabilitation. It suggested government contribution to the share capital of DCCBs, outright grants and/or long-term loans by state governments, to aid their rehabilitation.

Notwithstanding the efforts of the Bank in extending deposit insurance to cooperative banks in the states, the progress was rather slow. It was extended to Jammu and Kashmir in 1973, to Delhi and Pondicherry in 1974, to Kerala and Tripura in 1975, to West Bengal and Rajasthan in 1976, to Karnataka in 1977, to Orissa in 1978, to Uttar Pradesh and Gujarat in 1979, and to Tamil Nadu in 1980. Often the scheme was extended pending the completion of formalities, as in the case of Uttar Pradesh and Gujarat, and it was felt that the existence of a few banks involving limited liability for the Corporation need not stand in the way of extending the scheme to the states. By the end of 1981, deposit insurance was made applicable to cooperative banks in thirteen states and three union territories.[5] With this, all commercial banks (82 commercial banks and 106 regional rural banks) and 1,459 cooperative banks stood registered as insured banks under the scheme. This covered about 13.77 crore accounts with aggregate assessable deposits of about Rs 35,004.43 crore.

[5] These were the states of Andhra Pradesh, Gujarat, Jammu and Kashmir, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Tamil Nadu, Tripura, Uttar Pradesh and West Bengal, and the union territories of Delhi, Goa, Daman and Diu and Pondicherry.

Increasing Capital

Bringing cooperative banks into the scheme of deposit insurance entailed insuring over 1,000 banks, as against 88 banks in 1968. Anticipating the higher establishment costs that the increased workload would involve, the Act amendment of 1968 empowered augmentation of the authorized capital of the Deposit Insurance Corporation from Rs 1 crore to Rs 5 crore. Increasing the authorized capital was necessary, as the establishment costs of the DIC were met from the general fund, and not the deposit insurance fund that was earmarked exclusively to meet claims in respect of insured deposits. The source of the general fund was from capital and reserves. On 1 January 1972, the share capital of the Corporation was raised from Rs 1 crore to Rs 1.5 crore. The structure of the board of directors, too, was changed to accommodate eight directors in lieu of five, as was the case earlier. The capital was further raised to Rs 2 crore in 1975, in view of the anticipated establishment expenses arising from the proposed extension of the scheme to the states of Kerala, Karnataka and West Bengal. The capital structure next underwent major changes, as we shall see later, when the DIC took over the assets and liabilities of the Credit Guarantee Corporation to form the Deposit Insurance and Credit Guarantee Corporation in 1978.

Coverage of Deposit Insurance

The question of raising the coverage of insured deposits came up for discussion at a cabinet meeting held on 12 December 1967. It was felt that 'the limits of Deposit Guarantees should be raised and a larger volume of deposits should be covered by the Guarantees'. The minutes of the meeting were conveyed by S.S. Shiralkar, Additional Secretary, Ministry of Finance, to RBI Governor L.K. Jha; it led to raising the deposit insurance cover from the then existing level of Rs 1,500 to Rs 5,000 from 1 January 1968. As a result, the percentage of insured deposits to total assessable deposits jumped up from 26 per cent at end-September 1967 to 50 per cent at end-September 1968, and the proportion of fully protected accounts to the total number of deposit accounts increased from 76 per cent to 91 per cent in 1968. The significant increase in the coverage of insured deposits instilled public confidence in the banking system, augmented deposits and fostered banking in unbanked areas. During the period of this study, the coverage of deposits was raised on four occasions and by twenty times, i.e. to Rs 5,000 per depositor per bank effective 1 January 1968, Rs 10,000 from 1 April 1970, Rs 20,000 from 1 July 1976 and, further, to Rs 30,000 from

1 July 1980. At the end of 1981, the number of secured accounts stood at 13.65 crores, representing 99 per cent of the total number of accounts, and the volume of insured deposits stood at Rs 25,859.20 crore, representing 74 per cent of aggregate deposits with commercial and cooperative banks. By 1981, deposits with 1,647 banks were insured with the Corporation, as against 96 in 1967. Of these, 82 were commercial banks, 106 were regional rural banks and 1,459 cooperative banks. The regional rural banks that were established under the Regional Rural Banks Ordinance, 1975, were registered as insured banks.

Claims against Insurance

During the period 1967–81, the DIC's deposit insurance cover was invoked in the case of three commercial banks and eleven cooperative banks. In 1969, Chawala Bank Ltd, a commercial bank with its head office at Dehra Dun (Uttar Pradesh) was amalgamated with the New Bank of India Ltd, under Section 45 of the Banking Regulation Act, 1949. The Corporation had to pay or provide for claims to the extent of the difference between the insured amount and the initial credit afforded by the transferee bank, out of the readily realizable assets taken over by it. In the case of Chawala Bank Ltd, this claim amounted to Rs 0.18 lakh, of which Rs 0.14 lakh was recovered in due course and the rest written off.

The amalgamation exercise of Bank of Bihar Ltd, a Patna-based commercial bank, and of National Bank of Lahore Ltd, a Delhi-based commercial bank with the State Bank of India was a protracted one. The Reserve Bank, the central government and the State Bank of India, in consultation with the DIC, made arrangements to pay the depositors in full, on the understanding that the Corporation would reimburse to SBI the difference between the *pro rata* payment of the balance due out of readily realizable assets under the scheme and the actual insured deposits. The Corporation provided for Rs 46.32 lakh in the case of Bank of Bihar and Rs 9.69 lakh in the case of National Bank of Lahore. Thus the total liability that was paid or provided for between 1967 and 1981 amounted to Rs 56.19 lakh in respect of the three commercial banks, of which Rs 37.73 lakh was recovered by the Corporation by the end of 1981.

The Corporation provided for about Rs 191 lakh for deposit insurance claims in the case of eleven cooperative banks, of which ten were in Maharashtra and one in Karnataka. These were: Bombay Commercial Cooperative Bank, Bombay (liquidation); Malvan Cooperative Urban Bank Ltd, Malvan (liquidation); Ghatkopar Janata Sahakari Bank, Bombay (liquidation); Bombay Peoples' Cooperative Bank Ltd, Bombay (liquidation); Aarey Milk Colony Cooperative Bank Ltd, (liquidation); Ratnagiri Urban Cooperative Bank Ltd, Ratnagiri (amalgamation); Vishwakarma Cooperative Bank Ltd, Bombay (amalgamation); Prabhadevi Janta Sahakari Bank Ltd, Bombay (amalgamation); Kalavihar Cooperative Bank Ltd, Bombay (amalgamation); Ramdurg Urban Cooperative Credit Bank Ltd, Ramdurg (liquidation); Vysya Cooperative Bank Ltd, Bangalore (amalgamation). Only Rs 11 lakh was recovered till 1981.

Nationalized Banks

When the fourteen major banks were nationalized, a question arose as to whether deposits with banks owned by the central government need to be insured, and the significance of the DIC in the changed context. Whether or not nationalized banks should be excluded from deposit insurance was not a new issue; it was considered at the time of the very inception of the scheme in 1961, in the context of the State Bank of India and its subsidiaries which had been taken into public ownership. The arguments then advanced were that the deposits of SBI and its subsidiaries were not legally guaranteed by the government and, if these banks were to function as commercial banks, there was no reason why they should be given any special status merely on the ground of ownership. In 1971, while these arguments were found to be still relevant, some additional arguments were made in favour of extension of deposit insurance to the nationalized banks. First, the possibility of any of these banks having to face financial difficulties and being merged with the stronger of the nationalized banks could not be ruled out in eventualities like large-scale default, industrial sickness, fraud, etc. Besides, the Companies (Acquisition and Transfer of Undertakings) Act, 1969, did not provide any guarantee to the depositors of the nationalized banks. Second, if the exclusion of nationalized banks was officially permitted, foreign banks operating in India would also like to opt out of the scheme and the Corporation would not have any justifiable reason to force them to continue in the scheme. Third, if the nationalized banks were exempted from the scheme, it would give the impression that deposits in such banks alone were safe, placing other banks at a disadvantage.

CREDIT GUARANTEES

One of the features of the 1967–81 period, in the context of institution-building, was the setting up of the Credit Guarantee Corporation of India Ltd, in 1971, to ensure that the credit needs of hitherto neglected socioeconomic sections were met. While deposit insurance had been introduced in India for protecting depositors and instilling confidence in the banking system, the establishment of the Credit Guarantee Corporation represented an affirmative action to induce banks to make credit available to priority and hitherto neglected sectors.

Credit guarantees had already been instituted by Government of India in July 1960 but in the context of lending to small-scale industries, and was administered by the Reserve Bank on an agency basis. The issue of credit guarantees then shot into prominence during the debates on social control and nationalization of banks. When RBI Governor Bhattacharyya, towards the end of his tenure, made out a case against nationalization in his letter of 2 June 1967 to Deputy Prime Minister Morarji Desai, he was also not quite in favour of a rigid and statutory system of directed credits whereby banks would be required to grant loans to small industries and agriculture up to certain prescribed limits. Instead, he viewed credit guarantee as an instrument to channel the flow of credit in desired directions set by national priorities. In his letter, Bhattacharyya observed:

> In order to facilitate the grant of loans by the commercial banks to the smaller individuals and establishments, our credit guarantee scheme for small-scale industries will however have to be decentralized; and clean loans of relatively small amounts may have to be guaranteed on a much larger scale. We are also tentatively of the view that the benefit of protection, in the form of a guarantee cover, should be made available directly to the non-scheduled commercial banks, urban cooperative banks and the relatively well-managed non-banking financial companies, like loan offices and nidhis, so that these institutions can play a much larger role than at present in the field of financing small industries.

Bhattacharyya's ideas were exploratory and were probably expressed to tone down the demands for nationalization and directed credit. By the late 1960s, however, the idea of credit guarantee had not only gained acceptance but also come to be viewed as an instrument of productive deployment of bank credit. The Reserve Bank, on its part, took to the idea very positively and instructed that the incremental rise in advances of scheduled banks to small-scale industries covered by the Credit Guarantee Scheme be taken into account in the calculation of the net liquidity ratio of individual banks so that the banks could gain in terms of refinance accommodation from the RBI. In February 1968, a further facility of refinance from the

Reserve Bank at concessional rates, to the extent of the incremental rise in their advances to small-scale industries covered under the Credit Guarantee Scheme, was made available to scheduled commercial banks. In March 1968, the Industrial Development Bank of India also announced a scheme of refinance in respect of term loans to small-scale industries by the approved credit institutions covered by the Credit Guarantee Scheme, at concessional rates.

As at the end of June 1968, the aggregate of credit guarantees totalled Rs 125 crore while the total sum paid on account of claims since the inception of the scheme amounted to Rs 12 lakh, of which Rs 6 lakh were recovered after settlement of claims, leaving a balance of Rs 6 lakh pending recovery. The cumulative guarantee fee received during this period amounted to Rs 83 lakh. These operations were conducted on behalf of the central government and, accordingly, the guarantee fee collected and recoveries made were passed on to the government even as the claims paid were charged to the government. The Reserve Bank, however, met the administrative expenses for the management of the scheme.

There were complaints from many small-scale industrialists that the fee levied, at 0.25 per cent of the amount of guarantee issued, was high, especially as the utilization of working capital advances generally averaged 50 per cent of the limits (i.e. the guarantees issued). The matter was reviewed by the Reserve Bank and it observed that the cushion of Rs 76 lakhs of guarantee commission realized was already available with the government and that the proportion of losses incurred was extremely small. It felt that a sizeable reduction in the guarantee commission would be 'a good token of the Government's and Bank's warm interest in the development of small-scale industries and would induce private sector banks and state financial corporations to go more actively than before to the aid of that sector'. The reduction in guarantee fee that the Reserve Bank, as the 'guarantee organization', proposed, and which the government accepted, was, in point of fact, sizeable and was applicable to credit institutions that agreed to cover, under the scheme, *all new loans* as well as renewals of existing loans to small-scale industries. K.N.R. Ramanujam, the chief officer of the Industrial Finance Department (IFD) of the Reserve Bank, proposed a reduction in the commission, from one-fourth of 1 per cent to one-tenth of 1 per cent, to the Secretary, Ministry of Industrial Development and Company Affairs. Ramanujam, in his letter of 17 July 1968, did anticipate that there could be 'a larger rise than hitherto' in the amounts under default and that, in the years ahead, the claims could outstrip the guarantee commission receipts, although he felt that the claims may not be significantly in excess of the overall receipts. The reduction would, nonetheless, be justified, as the 'Central Government and the Reserve Bank will be able to state with greater cogency that they are going all out to encourage large and liberal institutional lending to small industries'. He indicated that the rate of guarantee commission would be kept under periodic review in light of the emerging trends of amounts under default.

Interestingly enough, a few banks resisted the move to cover *all* advances to small-scale industries under credit guarantees to take advantage of the reduction in the guarantee fee, and preferred, instead, a selective approach with the considerably higher fee of 0.25 per cent per annum. Indian Overseas Bank was particularly keen to leave out advances for cashew decortication from the purview of the guarantees on financial considerations. The Reserve Bank was 'unable to comprehend' IOB's stance when 'other banks … have taken a policy decision to bring all their advances to the small-scale industries under the Credit Guarantee Scheme and are seeking guarantee cover in respect of their advances to cashew industry as well'. It came to light subsequently that other banks, while having agreed to do so, were not in fact covering cashew and tobacco curing advances under the scheme. IOB's resistance was not taken kindly to by the Bank. The IFD, which was administering the scheme, in a communication to the Department of Banking Operations and Development (DBOD), felt that the latter should take up

> the matter with the Custodian of the bank and impress upon him that for the purpose of extending credit to small-scale units on a more liberalized basis, it is necessary for the bank to fall in line with the decision taken by the other major banks and place all its advances to the small-scale sector under the guarantee scheme.

The Bank's rationale, as elaborated in a circular issued on 8 April 1970, was that 'the success of the scheme, which is run on the principles of insurance, depends on the diversification of risks covered and as such it is essential that all eligible advances should be covered under the scheme'. There is little evidence to suggest that the possible impact of such a measure on the incentive for risk-taking was deliberated upon at any length. Nor whether the effort to provide risk support to particular categories of advances led to complacency across the entire spectrum of lending to small-scale industries.

Credit Guarantee Scheme in Unlicenced Banks

When an exception was made for including unlicenced central cooperative banks in the scheme in 1966, similar demands were received from unlicenced scheduled banks. This was a time when the Reserve Bank was in the final phase of its reconstruction and amalgamation of financially weak commercial banks, and, logically, it was felt that the feasibility of extending facilities to such banks as were expected to qualify for a license within a period of five years could be examined. The Industrial Finance Department recommended that 'unlicenced scheduled commercial banks whose financial position and methods of operations are, in the opinion of the guarantee organization, satisfactory' could be included. On this criterion, the names of two unlicenced scheduled commercial banks, viz., Benares State Bank and Oriental Bank of Commerce, were recommended to the government for inclusion, as these banks were expected by the DBOD to qualify for licences within five years.

When scheduled unlicenced banks were deemed eligible, how could one stop unscheduled unlicened banks from demanding that the same criterion be applied to them? The matter came up for serious examination in the context of a meeting that Parmananda, chairman, Bank of Behar, an unscheduled unlicenced bank, had with Governor Jha in December 1968. The former pleaded that his bank was unable to take advantage of the Credit Guarantee Scheme for small-scale industries and was consequently unable to utilize its resources to its best advantage. Deputy Governor Adarkar's noting dated 23 December 1968 on the subject is worth quoting.

> I suggest we may examine the possibility of extending these facilities to the Bank of Behar as well as to other banks in similar position where their ability to grant loans to small-scale industries is restricted as a result of the facilities of the Credit Guarantee Scheme being denied to them on the ground that they are not yet licenced. We may have to wait considerably before the affairs of these banks improve sufficiently to enable us to licence them and in the meanwhile an important objective of policy, viz., aid to small-scale industries, for which the small banks are likely to be most useful, may suffer. In view of the higher priority now attached to this objective, the matter may need sympathetic consideration.

Adarkar instructed that a list be prepared of banks not eligible for the facilities of the scheme, but which could be recommended for availing them on the basis of certain criteria, such as the area of the bank's operations, its business prospects, the percentage of sticky advances, etc. In response, the IFD evolved certain eligibility criteria for covering unlicenced scheduled and unscheduled banks under the Credit Guarantee Scheme:

(i) the management of the bank was in competent hands;
(ii) the system and procedure followed by the banks were sound; and
(iii) the advances made in recent periods were conducted generally satisfactorily or, if there were sticky advances relating to a recent period, the undesirable features in such advances were the result of factors beyond the control of the bank and despite the safeguards observed by it.

In early 1969 there existed twelve unlicenced scheduled banks and fifteen unlicenced non-scheduled banks. The DBOD was requested to recommend banks for inclusion in the Credit Guarantee Scheme on the basis of the criteria drawn up by the IFD. After excluding banks that were under liquidation, amalgamation, with the Custodian of Enemy Property, etc., the DBOD arrived at a list of sixteen banks. Of these, the position of ten banks was satisfactory in that they could, in the DBOD's opinion, pay depositors in full as and when claims arose. Of the other six banks, most had their paid-up capital substantially eroded and, while most of their deposits were intact, they did not appear to be in a position to pay depositors as and when claims arose. The DBOD, however, added that the sixteen banks recommended did not satisfy the criteria of managerial competence and operational efficiency indicated by the IFD and, but for the weaknesses in their management and methods of operation most of these banks would have been licenced and automatically included in the list of approved credit institutions. The DBOD also felt that the banks'

> advances operations in the recent period, by and large, do not disclose major irregularities. The deposits of practically all these banks are on the increase and considering their resources and the areas of their operations they are capable of playing a useful role in financing small-scale industries. *In view of the fact that all the central cooperative banks numbering 346, whether licenced or not, have been included in the list of approved credit institutions, it is suggested that we may consider the cases of the above 16 commercial banks also for inclusion in the approved list (italics added)*. Having regard to their overall position and resources and also because their affairs are under constant observation by the Reserve Bank, these banks are not likely to undertake any

> undue risk or make serious lapses in the matter of granting and conducting advances to small-scale industries.

On the specific case of Bank of Behar, the DBOD observed:

> The bank's management does not appear to have either been sincere or capable of improving its affairs. The quality of staff is generally poor. The defects in the bank's working have become chronic and their rectification would take considerable time. However, this bank is the only Bihari bank and the Government of Bihar is keenly interested in it. Its deposits, which show an increasing trend, amount to Rs 14.27 crore as on 29.11.1968. Recently an officer of the Department of Banking Operations and Development has been appointed as a special officer in the bank to assist its Chief Executive Officer in toning up the administrative machinery and bringing about the desired improvement in its affairs.

The opinion given by the DBOD to the IFD, which was operating the Credit Guarantee Scheme for small-scale industries on behalf of Government of India, did not lead to an immediate decision. IFD kept the matter pending for some time before accepting the DBOD view.

Credit Guarantee Corporation of India

After the nationalization of fourteen major Indian banks in July 1969, Prime Minister Indira Gandhi took the initiative of meeting with the custodians of the nationalized banks to discuss the lending pattern of the banks. The meeting, which took place on 30 September 1969 at New Delhi, indicated that 'a simple but wide-ranging scheme of guarantees or comparable facilities for lending by banks in fields which have remained relatively neglected so far, such as retail trade, small business, minor repair industries, small farming and the self employed sector' should be formulated. A Working Group with S.S. Shiralkar, Additional Secretary, Department of Banking of the Finance Ministry, as convenor was constituted to 'to examine and make detailed recommendations for the Government's consideration, regarding the scope and provisions of the proposed various schemes of insurance'.[6]

[6] Report of the Working Group on the Insurance of Loans and Advances granted by Commercial and Cooperative Banks to certain Priority Sectors. The other members of the Group were R.K. Seshadri, K.P.J. Prabhu, T.A. Pai, K.M. Nanjappa, H.E. Chatelier, Y.V. Sivaramakrishanayya and C.D. Datey.

The Group considered the issue of increasing the volume of lending to small borrowers, as distinguished from 'other more substantial and credit-worthy constituents of the banking system', and gave the rationale for the need to bring some of the neglected sectors into the organized banking sector. Essentially, the Group felt that small borrowers who were outside the purview of the banking system were charged interest rates that were 'unjustified by any standard', and bringing them into the banking fold would help reduce costs, foster investment, generate employment and, in general, catalyse development. For instance, a drastic reduction in the cost of credit to the retail sector was expected to bring down retail margins and, thus, reduce prices; credit to small servicing and repair units could go a long way in ensuring that equipment like pump sets, tractors and other machinery in the rural sector were not left unused for want of repair facilities; and credit to engineers for small-scale industries would help solve the unemployment problem and enhance production. In short, provision of credit would help increase production, facilitate cheaper flow of trade and distribution of goods, and help mitigate unemployment.

The Group noted that while, in the wake of social controls and nationalization of banks, lending to the priority sector had been marked by a considerable increase, the magnitude of the problem was enormous. Lending to the neglected sectors would, in the long term, lead to accretion of deposits with the banking system, but the risks of lending to these sectors in the transitional period could be appreciable. The Group expressed apprehensions as to whether the banks could, on their own, undertake the risks entailed in realizing the new social objectives. Moreover, considered that it would not be feasible for existing insurers to cover these risks on a voluntary basis, given the magnitude of the expected volume of lending. The Group felt that these risks, as affecting particular banks or lendings in particular areas, could be uneven, and came to the conclusion that the risks could be pooled and covered under a common and centralized guarantee scheme. As regards administration, the Group held the view that all eligible loans under the scheme should be guaranteed automatically and in bulk, and the statistical returns of the outstanding loans and defaults on the basis of which the guarantee cover was to be provided should be simplified to the extent possible. To obviate the 'moral hazard' problem, it was felt that the extent of guarantees could be limited to 75 per cent of the loss in all cases, to 'ensure that the eligible institutions granting loans continued to be interested in the appraisal of the loan applications on business principles and also in the subsequent supervision of the loan accounts'.

The scheme was intended to be self-supporting. A guarantee fee of 0.5

per cent on the outstanding amount of loans was suggested, which, however, was to be subjected to review from time to time. Interestingly enough, the guarantee fee of the small-scale industries scheme then was lower, at one-tenth of 1 per cent on sanctioned limits. The Working Group suggested an amendment to the Deposit Insurance Corporation Act, 1961, to enable the DIC to take over the responsibility of the guarantee scheme in addition to deposit insurance. This, however, was not accepted by the government. It opined that it was desirable to entrust the responsibility for credit guarantees, *for the time being,* to an entity that could be incorporated under the Companies Act, 1956. Furthermore, the Working Group suggested that the guarantee cover in the case of all sectors, including small-scale industries, should ultimately be provided by one independent organization. Thus, the existing credit guarantee scheme for small-scale industries, which was administered by the Industrial Finance Department of the Reserve Bank on behalf of Government of India under Section 17 (11A) of the Reserve Bank of India Act, should be taken over by the new organization. It was, however, felt that this issue be deferred and taken up 'at the appropriate stage', after the scheme for other sectors had been implemented. The 'appropriate stage' arrived after about ten years, when the small-scale industries scheme was finally integrated with the DIC in 1981.

The Group submitted its report in 1969. After some recommendations of the Group had been modified by the government, a new institution called the Credit Guarantee Corporation of India Ltd (CGCI) was constituted as a public limited company, promoted by the Reserve Bank, with 71 scheduled commercial banks contributing to its share capital. The objective of the CGCI was to afford a measure of protection to banks and other financial institutions against risks, if any, in meeting the credit needs of smaller borrowers in the priority and hitherto neglected sectors, such as farming, small-scale industries, small business ventures, road transport and self-employed professional or technical service or productive enterprises. The Corporation was registered under the Companies Act, 1956, on 14 January 1971, and it received the certificate of commencement of business on 29 January 1971. The CGCI was notified as a financial institution for the purpose of enabling State Bank of India and the Reserve Bank to become members of the company. The board of directors of the Corporation consisted of six members, of whom two (including the chairman) represented the Reserve Bank and the remaining four represented scheduled commercial banks. R.K. Hazari, Deputy Governor, was appointed the first chairman of the Corporation; R.K. Seshadri, Executive Director, Reserve Bank, T. Varadachary, managing director, State Bank of India, K.P.J. Prabhu, custodian, Canara Bank and P.F. Gutta, custodian, Union Bank of India, were appointed as directors; W.J.F. Vaz was appointed the first manager of the Corporation. The preliminary spadework for setting up the Credit Guarantee Corporation of India, as well as the administrative arrangements, were made by the Reserve Bank.

Schemes

The CGCI, in its first year of operations, introduced three separate guarantee schemes, each of which provided to the eligible credit institutions, guarantee cover automatically and in bulk, for all their loans, advances and other credit facilities. The first scheme formulated by the Corporation was termed the Credit Guarantee Corporation of India (Small Loans) Guarantee Scheme, 1971, and it was extended to scheduled commercial banks with effect from 1 April 1971. The scheme covered credit extended by scheduled commercial banks to transport operators, fertilizer dealers, traders, professional and self-employed persons, owners of business enterprises, and farmers engaged in cultivation and allied agricultural operations.

The second scheme, called the Credit Guarantee Corporation of India Small Loans (Financial Corporations) Guarantee Scheme, 1971, was introduced from 1 July 1971. This scheme was essentially an extension of the first scheme to state finance corporations. It focused on credit extended by these corporations to transport operators, hoteliers and enterprises generating or distributing electricity or any other form of power, as well as enterprises managing or developing industrial estates.

The third scheme, called the Credit Guarantee Corporation of India (Service Cooperative Societies) Guarantee Scheme, 1971, extended guarantees to scheduled commercial banks as well as certain select state and central cooperative banks. The scheme came into force from 1 October 1971 and guaranteed credit facilities to service cooperative societies assisting artisans and workers engaged in any form of industrial activity. The eligible state and central cooperative banks were those in the states to which the Deposit Insurance Corporation Act, 1961, had been extended. In the first year, 61 of the 72 scheduled commercial banks and 21 of the 99 eligible cooperative banks joined the scheme.

Variants of these three schemes formulated by the CGCI, together with the original scheme for small-scale industries which was being administered by the Reserve Bank on behalf of Government of India, constituted the core of credit guarantees in India. The report of the Working Group on the Integration of Credit Guarantee Schemes for Small-Scale Industries and Other Small Borrowers was submitted in 1981, and the scheme for small-scale industries was integrated with the schemes of the Deposit Insurance Corporation and Credit Guarantee Corporation.

The Twenty-point Economic Programme announced by the Prime Minister in July 1975 envisaged a more strategic role for the banking sector in economic development. Under the programme, the small loans guarantee scheme was required to be given a thrust. Accordingly, amendments were made to enlarge the scope and benefits of the guarantee, essentially to cover loans for consumption needs and housing. The provisions of the small loans guarantee scheme were liberalized with effect from 1 October 1976, to extend the guarantee support for certain credit facilities granted by banks to the weaker sections of the society. Advances for consumption needs and purchase or construction of houses or tenements, wholly or mainly for dwelling purposes granted directly to the various categories of borrowers already covered by the scheme, were brought within the purview of the guarantee.

Regarding the extension of guarantees to cooperative institutions, the Corporation had, at its very onset in 1972, constituted a Working Group to examine the feasibility of extending the guarantee schemes to credit facilities granted by cooperative credit institutions. The Group, which submitted its report in 1975, felt that it would not be practicable or necessary at that stage to cover the risk in respect of credit provided through cooperative credit institutions for agricultural purposes. It suggested that the situation could be reviewed after five years, after taking into account the progress made by cooperative banks in bringing down their level of overdues as well as the level of bad and doubtful debts. The Group, however, recommended that the guarantee schemes could be extended to state, central and primary urban cooperative banks, which were eligible for deposit insurance cover in respect of their advances to the non-agricultural sector, on terms and conditions similar to those applicable to commercial banks. In pursuance of these recommendations, the Corporation took steps to sound out the relevant cooperative banks and seek their response. As participation in the Corporation's guarantee schemes was voluntary, it requested the eligible cooperative banks to indicate their willingness to join a scheme that may be formulated on lines similar to the small loans guarantee scheme but excluding cover for advances to agriculture. The response was, however, poor, notwithstanding the follow-up by the CGCI and the Agricultural Credit Department of the Reserve Bank. Hardly one-tenth of the cooperative banks indicated their unqualified willingness to join such a scheme, perhaps deterred by the prospect of having to furnish information regarding the quantum of their advances in the specified categories that were required to be covered.

The issue of extending guarantees to cover advances granted by cooperative credit institutions at the primary level for agricultural and allied activities was reviewed by a Working Group constituted in 1979, with Dr M.V. Hate, Executive Director of the Reserve Bank, as chairman. At the instance of the Hate Working Group, certain pilot studies of the cooperative institutions in several states and union territories were conducted by the Reserve Bank of India. The Group submitted its report in November 1980 and recommended the extension of guarantee cover to agricultural credit societies and land development banks at the primary level in a 'phased manner', keeping in view the then existing administrative capacity of the DICGC and the very large number of institutions that needed to be covered. The Hate Working Group also recommended that guarantee cover be extended to urban cooperative banks for their advances to the non-agricultural sector. The recommendations of the Group were not implemented during the period under study. However, on the basis of its recommendations, the Small Loans (Cooperative Credit Societies) Guarantee Scheme, 1982, was formulated, to cover advances granted by cooperative credit institutions at the primary level for agricultural and allied activities.

The Problem of Claims

The expansion of credit guarantees brought with it the problem of claims. The annual report of the Credit Guarantee Corporation for the year 1977 claimed an 'impressive increase of 33.2 per cent in the advances covered by the CG schemes', but took note of the fact that the 'rising trend in the inflow of claims noticed in the earlier years became very much pronounced in 1977, the claims received during the year exceeding both in number and amount, the total claims lodged in all the previous years'. This marked a recognition of early warning signs of an impending crisis relating to the claims arising from the guarantee schemes. The CGCI responded to the incidence of mounting claims in two ways: on the one hand, by processing the claims expeditiously and, on the other hand, by responding to the adverse impact on the financial viability of the Corporation. In 1977, the administrative machinery was strengthened and the processing of claims further simplified. To address financial issues, emphasis was placed on the verification of claims of paid accounts and recovery of the amounts due from the borrowers. The Reserve Bank's inspecting officers were asked to look into this aspect in some detail. They were asked, in the course of their normal inspection of the concerned offices, to scrutinize the claims of paid accounts and, *inter alia,* verify the particulars furnished in the claim applications, ascertain the steps taken to recover the dues from the borrowers after settlement of the claims, and examine whether the recoveries due to the Corporation by virtue of its subrogation rights were remitted correctly and promptly. The correctness of the compilation of statements of guaranteed accounts and computation of guarantee fee thereon was also to be verified by them. In some instances, the Corporation deputed its own officers to scrutinize the books and other records of some claimant institutions. The energetic efforts on this count paid dividends and the Corporation realized a sum of nearly Rs 10 lakh as its share of recoveries during 1977, as against Rs 2 lakh recovered during the previous two years.

Deposit Insurance and Credit Guarantee Corporation

It was essentially the concern about the financial viability of the CGCI that hastened the decision on the merger of the CGCI with the DIC. This was foreseen by the Shiralkar Working Group, while recommending the scheme for credit guarantees. The Group had suggested that the guarantee fund should be in a position to draw upon the deposit insurance fund in case of need. The merger of the two institutions was imminent since the objectives of the two institutions were cognate in that both sought to protect banks and their depositors. It was considered advantageous as 'the resources of the Deposit Insurance Corporation were greater than those of the CGCI in relation to the risks carried by the respective organizations'. The Deposit Insurance Corporation (Amendment and Miscellaneous Provisions) Bill, 1978, seeking to provide for the acquisition of CGCI by DIC, was introduced on 21 February 1978, passed in the Lok Sabha on 29 April, received the assent of the President on 27 May and was enacted as the twenty-first Act of 1978. The provisions of the Act, except Section 9, came into effect from 15 July 1978.

With the merger of the two institutions, the name of the Corporation was changed to Deposit Insurance and Credit Guarantee Corporation (DICGC). The Act provided for an increase in the authorized capital of the Corporation from Rs 5 crore to Rs 15 crore. The paid-up capital of the Corporation was raised to Rs 10 crore after obtaining an additional contribution of Rs 8 crore from the Reserve Bank of India. With this, the entire capital of the DICGC stood allotted to the Reserve Bank. In the organizational context, the Act provided for the chairman of the Corporation to be either the Governor or a Deputy Governor of the RBI. K.S. Krishnaswamy, Deputy Governor, was appointed as chairman of the newly formed Corporation in place of I.G. Patel, the Governor. With the enlargement of the functions of the Corporation, and as provided for in the Act, the strength of the board was increased from five to nine.

Section 22 of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, as amended, provided for the transfer of liabilities and assets of the Credit Guarantee Corporation and the constitution of the credit guarantee fund. The Credit Guarantee Fund was constituted on 15 July 1978, i.e. the date of the take-over of the undertaking of the Credit Guarantee Corporation of India. The DICGC, thus, had three funds: the existing deposit insurance fund, which was dedicated to deposit insurance and funded by premium income; the credit guarantee fund, dedicated to the credit guarantee function of the Corporation and funded by guarantee fees; and the general fund constituting the share capital and reserves out of which the establishment and other expenses were met. Under Section 25A, introduced by the Amendment Act of 1978, amounts in one fund could be transferred to the other fund or be utilized for other purposes. In 1979, for the first time, the Corporation voiced concern about the finances of the credit guarantee fund. The annual report for the year stated that

> the guarantee fee income is proving to be inadequate in relation to the claim liability devolving on the Corporation. Thus, the guarantee fee for 1979 at Rs 10.76 crore fell short of the total amount of claims received during that year at Rs 11.30 crore by Rs 0.54 crore. It is, therefore, necessary to take steps to improve the financial viability of the guarantee schemes.

This was in contrast to the officially stated position of 1978 that there was no need to raise the guarantee fees even though the claims were large and posed administrative problems in their expeditious disposal. The shift in the viewpoint a year later was prompted also by the fact that the guarantee cover was to be raised to 90 per cent (from 75 per cent) in respect of advances granted under the differential rate of interest scheme and on account of credit facilities for the consumption needs of small borrowers.

Integration of Schemes

In line with the recommendation of the Shiralkar Committee in 1969 that the credit guarantee scheme for small-scale industries, which was then administered by the Reserve Bank on behalf of Government of India, be integrated with the new schemes, which the Committee envisaged as being undertaken by the Deposit Insurance Corporation, the process of integration was initiated in 1979. A Working Group was set up by the government with representatives from the government, Reserve Bank and the Corporation, 'to examine the draft outline of the proposed integration, along with the modalities of integration, question of existing liabilities, expansion of the scope of the existing schemes and all other connected matters'. The Working Group submitted its report to the government in September 1979 and the integration was effected in 1981. Accordingly, the credit guarantee functions of the credit guarantee organization wing of the Industrial Finance Department of the Reserve Bank were terminated on 31 March 1981, and the functions were transferred to the DICGC, which introduced its own Small Loans (Small-Scale Industries) Guarantee Scheme with effect from 1 April 1981.

Till the integration, the DICGC had operated from one office at Bombay. With the integration, the regional offices of the IFD at Bombay, Calcutta, Madras and New Delhi became the branch offices of the Corporation. The head office of the Corporation was established at Bombay, consisting of the erstwhile credit guarantee organization wing of the central IFD and the sections of the Corporation that were connected with central office functions. The head office was to broadly confine itself to policy functions, board matters, investments, introduction/modification of insurance/guarantee schemes, settlement of claims beyond prescribed limits, liaison with the Reserve Bank and central government, and overall control and supervision of the regional set-up. The branch offices would administer the insurance/guarantee schemes. The complement of staff of the credit guarantee organization of the IFD stood transferred to the Corporation. As the Reserve Bank was not receiving any reimbursement from the government for the cost of administering the earlier scheme, the Corporation requested the Bank to bear the expenditure for staff and premises in the initial stages.

Under the new scheme, the guarantee fee was enhanced by 0.25 per cent so as to bring it in line with that being charged for the other schemes of the DICGC. With the increase in guarantee claims and expansion that took place, the administrative costs marked a considerable rise. As these were being met out of the general fund, the Corporation had raised its paid-up capital from Rs 2 crore to Rs 10 crore in July 1978, when the Deposit Insurance Corporation took over the erstwhile Credit Guarantee Corporation. Even this proved inadequate in view of the large increase in the volume of operations. It was felt that the income from the general fund would fall short of the anticipated expenditure and the capital of the Corporation was raised from Rs 10 crore to Rs 15 crore with effect from January 1981, which was the maximum permissible level of authorized capital under the DICGC Act, 1961. The central government was requested to amend the Act to raise the permissible level to Rs 50 crore. In the meanwhile, the Reserve Bank made available staff, premises, furniture and fixtures, and other office assistance necessary for carrying out the new credit guarantee functions free of cost to the Corporation for a period of two years, commencing 1 April 1981. Pending amendment of the Act, the Bank placed two interest-free deposits, of Rs 15 crore and Rs 10 crore, with the Corporation in 1982, which were to be adjusted against the Reserve Bank's contribution to the additional capital when the enactment was completed. The Act was eventually amended and the capital raised to Rs 50 crore in May 1984.

The issue of extension of guarantee cover to advances granted by cooperative credit institutions, which has been mentioned earlier, resulted in the formation of another scheme for cooperative credit societies. The Corporation constituted a Working Group under the chairmanship of M.V. Hate, Executive Director of the Reserve Bank and a Director of the DICGC, to consider this issue. The report of the Group, submitted in November 1980, *inter alia,* recommended extension of credit guarantee support to agricultural credit societies and land development banks at the primary level in a phased manner in the context of the very large number of institutions to be covered and the present administrative capacity of the Corporation. The Group also recommended that guarantees may be extended to cooperative urban banks for their advances to the non-agricultural sector. The recommendations were accepted and another credit guarantee scheme relating to the cooperative sector, viz., the Small Loans (Cooperative Credit Societies) Guarantee Scheme, 1982, providing guarantee cover to select primary agricultural credit societies (PACS), primary land development banks (PLDBs) and branches of state land development banks (SLDBs), in respect of their lendings for agricultural and allied activities, was formulated. Select institutions were invited to join the new scheme from 1 January 1983. The expansion of the schemes had financial implications that were not foreseen with clarity.

ANNEXURE

Fraudulent Transactions at the London Branch of Central Bank of India

A major instance that invited unsavoury comments regarding the supervision of foreign branches was the surfacing of certain fraudulent transactions involving a substantial amount of foreign exchange at the London branch of Central Bank of India in April 1970. The branch had been inspected by the Reserve Bank way back in 1960.

It transpired that the manager of the London branch of Central Bank of India, Sami J. Patel, issued certain fraudulent guarantees on behalf of some parties—viz. Wexler and his companies, Houry and his companies, and C.M. Shah and his companies—guaranteeing payment on due dates of bills in deutsche mark to a total value of DM 10.5 million. Subsequent investigations by the Reserve Bank as well as the Central Bank of India revealed that the fraud, which was being perpetrated for some time past, involved mobilizing of money against accommodation bills, initially in sterling and subsequently in deutsche mark, from 1967 to early 1970. The modus operandi in regard to sterling was to have certain accommodation bills drawn in sterling by some of the constituents of the bank, with the bank issuing the requisite guarantees and/or making endorsements to have them discounted in the London market (not with the Central Bank of India). These guarantees/endorsements were unauthorizedly issued/made by Sami J. Patel, and were signed by himself and another officer of the bank. The bills were being regularly drawn (i) by National Sales Corporation Ltd on City of London Garages Ltd (T.W. Wexler and his son, B.W. Wexler, were directors of both concerns), (ii) by Worldwide Shipping Co. Ltd on G.E. Houry & Son Ltd (these were concerns of G.E. Houry), and (iii) by Montex Ltd on C. Ramon & Co. Ltd (both these were concerns in which C.M. Shah was interested as director). The discount proceeds were generally being received and credited, and the bills on due date were being met by debit to the concerned constituents' accounts. None of these discount transactions figured in the books of the bank as they should have if the transactions had been handled by the bank in the usual course; nor was there any indication that the bank received any payment in the form of commission for such execution of guarantees/endorsements. It was, therefore, obvious that Sami J. Patel had obtained monetary benefit out of these fraudulent transactions. During the period 1967 to 1969, Patel had, through such unauthorized guarantees/endorsements, enabled negotiation in the London market of sterling bills to the tune of about £1,855,400.

Later, due to tight money market conditions in the London market and the credit squeeze, Patel and the constituents of the bank, who were raising money in London against the bank's guarantees/endorsements, could not continue these operations to their advantage. They, therefore, struck upon a plan for carrying out similar operations in the German market, where money conditions at the time were relatively comfortable. The modus operandi was to have accommodation bills (similar to those in the case of the sterling bill operations) drawn by the associate companies in the Wexler, Houry and Shah groups, except that in these cases the sets of bills were drawn in deutsche mark and made payable at a small private bank in Hamburg, Alexander Levy & Co., and its successor institution (after October 1969), L. Behrens & Sohne. The bills found their way, through a party called M. Di Racca and his companies, to a Swiss bank called Ingeba and some German banks, including B.F.G., Global & Wolbern. The fraud came to light in April 1970 with bills discounted and pending payment aggregating DM 10.50 million; the outstandings in respect of the Wexler, Houry and Montex groups were DM 6,500,000, 2,000,000 and 2,000,000, respectively. The foreign banks involved sued the Central Bank of India as guarantor for recovery of their dues; the drawers and drawees were also made defendants.

The magnitude of the fraud created ripples in the banking industry and became a subject of active debate in India, in the Lok Sabha, Rajya Sabha and the media. The role of the head office of the Central Bank of India as well as that of the Reserve Bank of India in supervising foreign branches of Indian banks came under scathing criticism. In a letter addressed to B.N. Adarkar, Governor of the Bank, on May 1970, A. Baksi, Secretary, Department of Banking, Ministry of Finance, commented:

> In particular, serious misgivings have arisen why branches abroad of Indian banks appear to be left on their own and not subjected to anything like adequate supervision and surveillance from India, particularly from the headquarters of the bank concerned and the Reserve Bank. It appears difficult to avoid altogether the impression that the internal audit of branches abroad by the headquarters of the bank is very weak, if it exists at all; … Furthermore, how much responsibility the Reserve Bank has assumed so far and is able to assume now in the matter of checking that the branches abroad of Indian banks function properly is not clearly known. To take the last point, for instance, we ourselves are not sure why the London branch could not be visited by Reserve Bank Inspectors for so many years.

He desired that the Reserve Bank examine all facets of the problem and send a report to the government. He followed this up with another letter addressed to the Governor two days later, indicating that the Reserve Bank might undertake a special scrutiny, without delay, of the affairs of the Central Bank of India. In response to these letters, Adarkar wrote two separate letters to Baksi, both on 26 May 1970: one explaining the aspect of Reserve Bank's supervision of foreign branches of Indian banks, and the other regarding the steps being taken to investigate the fraud in question.

On the subject of inspection of foreign branches, it was explained that the last round of such inspections were carried out in 1960–62. Referring to the delay in taking up the next inspection, Adarkar pointed out:

> During the discussions on the subject at the Central Board meeting in

> October 1961, a decision was taken at the instance of the then Governor, Shri H.V.R. Ienger, that such inspections need not be carried out more often than once in three years. The reasons given were (1) that they were expensive and (2) that by and large the foreign branches were found to be working on the right lines. In February 1965 this question was taken up again and the then Deputy Governor, Shri C.S. Divekar, and Executive Director Shri D.R. Joshi, decided that the matter be deferred for some time. In November 1967, the position was reconsidered and in February 1968 a decision was taken to resume the inspections of foreign branches.

However, priority in this regard was given to the branches in Asia and Africa, as it was presumed that the branches in London and the UK would be in charge of senior and responsible officials, and could, therefore, be taken up after the inspection of the Asian and African branches. Elaborating on the other important commitments that engaged the attention of the Reserve Bank on a priority basis during this period, Adarkar referred to the Bank's main preoccupation for a number of years, up to 1965–66, of bringing about the elimination or mergers of a number of small banks which were then tottering or in a semi-solvent state; the enhanced emphasis on the Bank's policy of reorganization and development from 1967 onwards; as also the need to generate a tempo of development work in order that social control might show results within a reasonable period of time, in terms of branch expansion and increased lending to agriculture and small-scale industries. All these required deployment of the services of the Bank's senior and experienced personnel, and the shift in emphasis resulted in lower priority being accorded for some time to mere policing work. He hastened to add that it should not be presumed that such work was neglected, but the more expensive type of inspections (like inspections of foreign branches), where experienced personnel had to be deployed for long periods, were undertaken on a modest scale. Moreover, no amount of policing by the Reserve Bank, which in any case had to be carried out on a selective, sample basis, could be an effective substitute for the bank's internal management, especially when the bank concerned was one like the Central Bank with a vast network of branches. Concluding the first letter, Adarkar stated:

> I would ask you to appreciate that given the limitations of personnel and the importance and urgency of developing the social aspects of banking, the Reserve Bank could not possibly do all it wished by way of cleaning up the internal working of banks. In fact, it was the Reserve Bank's excessive preoccupation with mere policing that had led to the development work being somewhat neglected prior to the introduction of social control.

The second letter to Baksi dealt with the various steps initiated by the Reserve Bank to look into the London branch fraud.

The first official from the Reserve Bank to visit London in connection with the fraud, in the second week of June 1970, was P. Krishna Iyer, a senior officer of DBOD, who was deputed as officer-on-special duty with the Central Bank of India. He was soon followed, by the end of that month, by M. Narasimham, Secretary to the Reserve Bank's Central Board and representative of the Bank in the internal management committee of the Central Bank of India. While these officials were engaged in assessing the situation and providing the necessary feedback to the Bank and the government, the financial inspection of the branch under Section 35 of the Banking Regulation Act, 1949, by a Reserve Bank inspection team led by K.K. Ray, was taken up on 20 June 1970. In his book, *Some Reminiscences*, M. Narasimham recalls the initial reaction of the Bank of England to this episode thus:

> When I went to London to meet the officials of the Bank of England, I met the then head of the Discount Office and over a cordial lunch he pontificated on the importance of credibility of institutions in the City of London and said that one bad apple could spoil the entire basket and the Bank of England was concerned that no City institution defaulted on its payments.

As the official was not convinced by the explanations offered by Narasimham, the latter had to meet the Deputy Governor of the Bank of England, who was in charge of the discount operations and related functions. The Deputy Governor maintained the threatening posture of taking 'severe action against errant institutions', despite Narasimham pointing out to him that the 'Central Bank was not sinning but sinned against'. During the discussions, the Bank of England executive went so far as to indicate that the option of ordering the closure of the Central Bank's branch was not ruled out. Narasimham then explained that the major banks in India, including Central Bank of India, had only recently been nationalized, and any such action by the Bank of England could have political repercussions at home and give a handle to those who were critics of bank nationalization. He requested the Bank of England to bear this in mind, emphasizing that the Central Bank branch was a victim of a fraud.

However, these arguments did not make much headway, as Narasimham noted.

> At that point, I told him that we in the Reserve Bank had reasons to believe that a couple of British banks were also transgressing our exchange control regulations. But we had held our hand in view of the cordial relationship between the British and Indian banks and between the Bank of England and the Reserve Bank and that we were expecting the Bank of England to bear the same sentiments. He tried to get me to name the banks, which I refused to do on the ground of confidentiality of relationships.

Narasimham added that while this approach worked, the head of the Discount

Department at the Bank of England did not conceal the feeling that what Narasimham said seemed to be close to a veiled threat.

The London branch of Central Bank of India, which was opened in the early 1950s, was under the charge of Sir Cecil R. Trevor, former Deputy Governor of the Reserve Bank and designated as London Adviser, until his retirement in 1967, when Sami. J. Patel was appointed manager of the branch. Patel enjoyed the confidence of Sir Trevor and earned excellent reports from him, which enabled him to maintain a high profile.

Apart from the dishonest behaviour of an overly trusted official, the Central Bank of India management was also found to have been lax in heeding the early warning signals. The head office supervision of the branch was woefully inadequate. During the years 1960 to 1965, no branch audit was carried out. While one senior executive each had visited the branch and examined certain aspects of the working of the branch in 1966 and 1968, a formal audit of the branch was carried out only in August 1969. Even this detailed audit did not bring out the fraudulent transactions in question. However, the officer who visited the branch in 1968 and the auditor who went a year later had pointed out serious irregularities in the manner of functioning of Sami J. Patel. The head office, inexplicably, chose to softpedal the issue. This aspect was succinctly brought out in one of the notes recorded by Krishna Iyer:

> However, for quite some time, even before the recent disclosure of the huge frauds, it was within the knowledge of the Head Office that affairs of the branch were conducted in a most unbusinesslike way and were far from satisfactory. The fact that notwithstanding the above and the findings of Mr Premani, who was specially deputed from India in 1968 to look into the affairs of the branch, which indicated an extremely irregular manner of handling of the affairs of the branch, Mr Patel continued to enjoy the confidence of the higher-ups in the Head Office and no serious action against him was taken for the various irregularities perpetrated by him, speaks eloquently of the patronage he must have enjoyed at certain powerful quarters in the bank's management.

Immediately prior to the surfacing of the fraud in April 1970, P.C. Mewawala, general manager from the head office of the bank, visited London in March, to enquire into the reported irregularities at the branch, as desired by V.C. Patel, custodian of Central Bank of India. During his visit, Mewawala asked Sami J. Patel to submit his resignation, citing various irregularities, *inter alia*, including several instances where he had exceeded the powers bestowed on him and instances of suppression of details by not recording his actions in the books of the bank. Patel submitted his resignation on 9 March 1970, which was accepted. The action by the head office of the bank, when it was finally taken, proved to be far too late.

During the court proceedings of the suit filed against Central Bank of India by the three foreign banks, a demand was raised by the solicitors of the German banks that the inspection reports of the London branch of Central Bank of India by the Reserve Bank be produced. On receiving the request through the Central Bank of India, the Reserve Bank advised the former in August 1972 that the inspection reports were sent to that bank on a strictly confidential basis and that the Reserve Bank had been taking the stand that the inspection reports of a functioning bank should not be disclosed to the public, as their disclosure, especially out of context, would be contrary to public policy and interest. It was also pointed out that it was considered objectionable to disclose the inspection reports in the proceedings pending against the Central Bank of India in London.

However, the London solicitors of Central Bank of India (M/s Herbert Smith & Co.) felt that such a letter would be insufficient to fend off the demand for production of the Reserve Bank inspection report in the court. Later, in consultation with the Legal Department, the Bank issued a direction to the custodian of the Central Bank of India under the provisions of Section 35A of the Banking Regulation Act, 1949, signed by Deputy Governor R.K. Hazari, advising the bank:

> Now therefore in exercise of the powers conferred under Section 35A of the Banking Regulation Act, 1949, the Reserve Bank of India, being satisfied that it is in the public interest so to do, hereby directs that the Central Bank of India shall not disclose or cause to be disclosed in any manner the reports on inspection of Central Bank of India or of the Central Bank of India Ltd carried out from time to time, as well as the correspondence between the Reserve Bank of India and the Central Bank of India or the Central Bank of India Ltd relating to such inspections.

After protracted litigation, over a period of almost three years, Central Bank of India, on 12 January 1973, entered into an out-of-court settlement with the three foreign banks—B.F.G. (Bank fur Gemeinwirtschaft Aktiengesellschaft), Ingeba (Internationale Genossenschaftsbank Aktiengesellschaft) and Global (Gerling Global Bank Aktiengessellschaft)—for an aggregate amount of £ 680,000 in respect of claims and £ 70,000 towards the cost of actions.

Thus, an instance of obvious indiscretion on the part of the head office of a bank in handling the affairs of a foreign branch and the crucial delay in taking appropriate action translated into a substantial loss of foreign exchange for the country.