CHAPTER – III

HISTORICAL BACKGROUND OF BANKING IN INDIA

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3.1 INTRODUCTION :

The concept of Lead Bank is a noteworthy development feature in Indian Banking. The introduction of the scheme makes a beginning of new method, new principles and new objectives of banking. While we are attempting to evaluate the working of the scheme, it is necessary to have brief account of Historical development of banking in India so that we will be in a better position to understand the situation in which this scheme has been introduced.

The account of development of banking in India is divided into two main periods comprising. :

i) Pre-Independence era and

ii) Independence era.

3.2 PRE-INDEPENDENCE ERA :

Indigenous banking is an-age-oldtradition in India. The evidence regarding the existance of money-lending operation in India is found in literature of Vedic times.[1] But the methods of lending in olden times were different from those of modern western banking system. In buddhist period[2] we find the evidence of baners in all impertant trade centers and the chief activity of the banker was to lend money to traders merchant adventures and to Kings who needed finance for war and other reasons. Most of loans were given on faith, without any security. Hundies or indigenous bills of exchange came into use from the 12th century. Indigenous bankers played prominant role in lending money finance to internal and foreign trade in cash or bills.

Consequently, agriculture and internal track in rural areas are still dependent to a large extent upon the services of the indigenous bankers. Many of these indigenous bankers also serve as middleman between the internal traders and the banks, discounting the hundies of the farmers and re discounting them with the latter.

AGENCY HOUSES :

In the 17th century the English traders who came to India, established contacts with the indigenous bankers by borrowing funds from them. They had no capital of their own and depended mainly on the public for finance. Though they had no capital of their own/they found it was more profitable to conduct banking business other than their usual business of trade and commerce, and during this period indigenous banking started declining in the country Consequently, when uniform currency was established throughout the country during the period 1835 indigenous bankers lost their money changing business. Many of indigenous bankers now serve as middlemen between traders and banks, discounting inland hundies for the traders and re discounting them with the banks.

The English agency houses in Calcutta and Bombay were the bankers to the East India company and European merchants in India. They had no capital of their own and depended mainly on deposits f from the public for finance. These agency houses failed as they combined banking with trailing, the two functions which hardly go together. Trading and commercial losses affected the solvency of the agency houses.

PRESIDENCY BANKS :

The Bank of Bengal, Bank of Bombay and Bank of Madras established in 1809, 1840 and 1843 respectively in India were also known as "Presidency Banks." The bulk of the shares of these banks was subscribed by Europeans and all of them were given monopoly to handle the business of Government. They were also allowed to issue notes upto a limited extent but in 1862 their fight of noteissue was taken over by the Government.[4]

The Bank of Bombay became involved in the wild speculation and suffered serious losses, and was voluntarilly would up in 1868. Them Presidency Banks Act imposed certain restrictions upon these banks with a view to safe guard the interests of Government and Public which deposited with them.

IMPERIAL BANK OF INDIA :

The three presidency banks were amalgamated in 1921 to form the imperial bank of India. The Bank was authorised to hold government balances and manage public debt, besides performing various other commercial bank functions. The State Bank act was passed in 1955 and R.B.I. Nationalised institutions, acquired a substantial holding of the shares of the imperial Bank of India. The objects of converting the imperial Bank of India into State Bank of India are stated to be extension of Banking facilities on large scale, more particularly in the rural and semi urban areas and for other public purposes.

INDIAN JOINT STOCK BANKS :

The real stimulus for the establishment of joint stock banks was provided by the an Act passed in 1813 which removed all restrictions on Eurppeans setting in India. Several Banks were established on the basis of unlimited liability mainly by the English agency houses, but half of them failed by 1860 owing to speculation and mismanagement permitted by cureless auditing of their accounts although these also were managed by Europeans.

In 1860 an act was passed permitting the starting of joint stock banks on the basis of limited liability it was essential to large business companies to secure the large amounts of capital that they needed, but soon afterwards the banks were deprived the right of note issue. During the American Civil War (1861-65) large number of banks and other financial companies had taken part in the speculation but all of them failed in short time and distroyed public confidence. During the period of 1973-93, currency confusion caused trade uncertainties and created unfavourable atmosphere to the establishment of new banks. During the period of Swadeshi movement in the country number of Banks with Indian Management were established, viz. Punjab National Bank 1895, Bank of India and Bank of Canara 1906, Bank of Baroda 1968, Central Bank of India 1911 etc.

During the period of 1913-17, 87 bank failures had happened. The majority of them were small and weak. The failures did much to weaker public confidence in Indian Joint Stock banking and check the growth of banking habits in India. The causes of the crisis are, many of the directors and managers of these banks were incapable men, and had little knowledge either of the principles or of the practice of banking. The shareholders, as a rule were too ignorant or aputhetic to exercise their rights and duties and to control either the directors or managers fraud and criminal mismanagement, many of smaller banks kept still smaller cash reserve even the liquid assets of many of the banks were small.

Of course, above maintained causes of the banking crises and failures did not apply to all the Indian joint stock banks. Many of them, especially the larger and older ones, conducted their work on sound lines.

In fact, we must note that this was a real beginning of modern Indian banking in its true sense. The European acquinted us with this new technique of banking, no doubt but the Indians did realised its importance and took initiative in establishment of commercial banks since the Swadeshi movement. This marks a new era in Indian Banking.

<u>RESERVE BANK OF INDIA</u> :

The need of a Central Bank was felt since long but the Government was not favourable to its establishment. Till the 1935 the Central Banking functions were devided between the Government of India and Imperial Bank of India.

There were so many defects in the Indian Banking system and for removing many of the defects in Indian Banking and Credit system, and secure its development on sound basis, the establishment of Central Bank of India was necessary.

The Central Bank was found necessary for maintaining the purchasing power of the rupee internally and externally. The Reserve Bank has been found necessary for removing the structural instability of banking system in India. Untill 1935 the system had no solid basis, and was much liable to be upset by sudden demands for the withdrawal of funds or by financial crisis. For satisfying the demands of the depositers for the withdrawal fully and promptly and to restore the public confidence the establishment of Reserve Bank was felt necessary. The Hilton Young Commission[5] found that the existing system of monetary control in India was exceedingly unsatisfactory, for there were two authorities controlling monetary conditions in the country the Government of India, through the controller of currency controled the volume of currency, while the Imperial Bank of India attempted to control the credit system in India. Between these two authorities, there was no coordination as regards policies affecting currency and credit in country. The commission therefore, recommended the establishment of Reserve Bank of India. They recommended further that the R.B.I. should be shareholders' bank and that it should be free from the control and influence of the legislature. Finally in 1935, The Reserve Bank of India was established as the Central Bank. It was originally a private owned bank and started its operations from 1st April, 1935.

This is another remarkable achievement, turn of banking business, affecting country's future course of economic activities and whole of the banking system, alongwith currency, final system in the nation. The British Government though foreign deserves very many thanks for this ephoch making improvement.

EXCHANGE BANKS :

The Indian Commercial Banks have failed to develop exchange business. The imperial Bank was the only commercial bank conducting foreign exchange operations since 1935. Due to the absence of Indian Banks, foreign banks entered in this profitable business. The foreign banks are operating in India. These banks are competing with Indian Banks not only in financing foreign trade but also in the internal banking business. The Reserve Bank is controlling the foreign banks under the Banking Regulations Act of 1949. The India Banks are expanding their exchange operations in the recent period. However, their progress is not satisfactory.

3.3 INDEPENDENCE ERA :

Soon after the independence the Government of India has taken so many steps for all round development of banking business in India. For avoiding cut throat competition, to ensure balanced development and to safe guard the interest of depositers, for avoiding the concentrations of wealth and power in few hands, subsequently the Reserve Bank of India had shown keen interest in Agriculture Credit, providing long term credit to farmers and also to bring coordination between cooperative banks, commercial banks and other financial institutions for the above purposes, the Government has taken the following steps.

BANKING REGULATION ACT, 1949. :

Formerly joint stock banking in India was governed by the companies act 1913, Banks were required to fulfil certain formalities in the matter of preparation of the balance sheet twice a year and so on.[6] The need for such act was felt to check the harmful treatment by the managers of banks and also to sageguard the interest of the deppsiters and he the interest of the country in general. Special provisions contained in companies act 1913 relating to banking which were felt inadequate. Since banking as a business has certain distinct features, it was felt necessary to pass a separate Act concerning only the banking companies. Accordingly, the banking companies act was enacted in 1949. In 1966 in order to cover the cooperative banks, the name of the act was changed as the "Banking Regulation Act 1949."

NATIONALISATION OF RESERVE BANK OF INDIA :

The Hilton Young Commission recommended that the R.B.I. should be shareholders' bank and that it should be free from the control and influence of the legislature. Finally the R.B.I. was established as the Central Bank. It was originally shareholders' bank. But it was clearly realised that the Reserve Bank of India had completely failed to act in interest of domestic stability and public welfare. Further more due to Trade depression situation during the war period, problems arise due to foreign trade and need for economic planning it was stated that the central bank should be state owned and state managed. It was also stated that private ownership central bank should be nationalised.

After the independence of the country, the demand for the nationalisation of the Reserve Bank was made and also taking into consideration the worldwide tendency towards nationalisation of Central Banks after the Second World War. and to establish a close integration between the policies of Reserve Bank and those of the Government of India. Subsequently, to bring about closer cooperation between the Bank and the Government. In 1947-48, the Government of India has been on the threshold of formulating far reaching pplicies for the planned economic development. Huge funds were required for development purposes, much of which would have to be raised by the Government, through taxation, borrowing and deficit financing. Finally of private sector would be the responsibility of the commercial banks and other financial institutions. Raising and using the huge funds for development purposes would create infationery pressures. The R.B.I. would have to play dyanamic role in raising financial resources and also controlling infationery pressures.

In 1949, then the Finance Minister declared that as early as possible, the bank will be nationalised. According to the decision, the Reserve Bank of India (transfer to public ownership) bill was introduced in the parliament. The act was made by the parliment for giving public ownership to the Bank in the September 1948 and since 1st January, 1949, the Reserve Bank is functioning as the state owned and state managed Central Bank of the country.

NATIONALISATION OF IMPERIAL BANK/STATE BANK OF INDIA :

The Imperial Bank was established in 1921 through the amalgamation of the three presidency Banks namely, The Bank of Bombay, Bank of Calcutta and Bank of Madras. During the period there was no central bank for the country and Central Banking functions were divided between the Central Government and Imperial Bank. Imperial Bank was the biggest commercial Bank. After the establishment of Reserve Bank of India, all the Central Banking functions were taken away from the Bank. The opinion of the other banks of the general of public continued to be against the Bank during this period also. After the independence the public opinion was not favourable to the Bank, but the intensity of the criticism against the Bank diminished. The demand for nationalisation was made first in 1948 when Reserve Bank of India was nationalised. The directors and the shareholders of the Bank were against nationalisation but the Government was favourable for the nationalisation.

Further more, the nationalisation of Imperial Bank was necessary due to the following ppints. :

1. Most of the shares of the Imperial Bank was purchased by Europeans. There was no provision for purchase of shares by Indians. The policies of the banking were for securing more and more profit rather than economic development of the country and moreover profit of bank taken away from India.
2. Even after Independence profit making remained as the important of the Bank. Rural Banking Committee asked to open 400 branches during the period 1950 to 1954 but the

rural branches opened by the bank only 63. This shows the apathy of the bank towards the credit needs of the rural sector.

3. Due to close relation with the Government it had acquired prestige position in the money market and making use of this prestige for competiting with other commercial banks. However, other banks could not compete with it, to avoid such undesirable and unfair competition.

4. The Bank was discriminiting between the Indian traders and the European traders. The facilities given to the European were denied to Indian Companies.

5. The Bank was given permission to conduct foreign exchange business. From 1935 and was better position to expand this line of business. However, adequate attention was not given to this aspect.

6. The management of the Bank in the hands of selected few.

The Rural Credit Survey committee appointed by the Reserve Bank of India studied the problem of rural finance and suggested that the Imperial Bank of India with its vast assets should be used by the Government to help the rural sector with a special purpose of stimulating banking development in rural areas. The Imperial Bank was nationalised in 1955 and was named State Bank of India.

When the Imperial Bank Nationalised and converted into State Bank of India, after the 1955 there was been a steady increase in the assets and liabilities of the State Bank. Likewise, the advances to Industry trade and agriculture had risen from Rs. 106 crores to 11,760 crores. The State Bank of India has also followed a various branch expansion policy during this period. The number of branches had increased from 500 in 1955 to over 6600 in 1983, of which nearly 48 per cent are located in rural areas. The number of small scale units financed by SBI stood at 4 lakhs at the end of 1983. SBI financed to landless labourers, tenent etc.

<u>SOCIAL CONTROL OF BANKS</u> :

The communists and socialists in the country had often stressed on the nationalisation of the whole banking system. The nationalisation of the banks was considered panacea for ill banking system in the private sector. It was though that nationalisation of banks will enable these banks to play important role in the economic development of the country and would help to end the monopoly in the few hands. However, Government was not willing to nationalise banks due to administrative and other difficulties. But in order to derive benefits of nationalisation without nationalising banks, the legislative measure of social control of banks was introduced by enacting the Banking Laws (Amendment) Act 1968.

According to this new act, not less than 51 per cent of the to total number of the members of the Board of Directors of a Bank to consist of persons who have specialised knowledge of particical experience in agriculture, rural economy, small scale industries, cooperation, economics etc. The act reconstituted the Board of Directors. The act specifically provides that no new loans should be extended to Directors of Companies or firms in which they are interested. Under the new Act of 1968 Government has power to take over any bank in the country even without resorting to legislation. The Government has also powers to nationalise any bank if it is for the better provision of credit. This new shheme of control was expected to ensure more purposeful distribution of credit.

The social control scheme was accepted by Indian banks in the right spirit. They had started this Act by taking suitable action. The professionalised their management and reconstitued their Board of Directors, banks prepared schemes of adequate funds to priority sectors and small scale industries. They achieved credit target well in advance. However, enough trial was not given to this scheme, within six months of social control scheme Government of India nationalised 14 Leading Banks in the country.

BANK NATIONALISATION :

The commercial banks were owned and controlled by a very small number of shareholders who determined the pattern of allocation and investment of bank finance according to their industrial interest. This was aginat the principal of the Indian Constitution. Private Commercial banks also failed to branches in rural area. The Directors, use the reasources for their interest and to build up their huge industrial empires. The commercial banks failed to use their resources for priority sector of the Indian economy.

Taking in consideration the various objectives as. Removing the control of few hands to help the weaker section of the community and backward area, extending banking facilities in unbanked rural areas. Providing adequate credit to agriculture, small scale industry, and professionalising bank management, furthermore, the social control of banks without nationalisation provided no guarantee that the Directions issued by Reserve Bank would be faithfully carried out by banks. While some banks did try to held the farmers and small industries, but it was inadequate and unsatisfactory. So the bank nationalisation became necessary to accelerate the attainment of the objectives of social control. Accordingly, the Government of India nationalised 14 top commercial banks in July 1969.

After nationalisation banks have made a good attempt to fulfill the various objectives and the expections of the people to a great extent. The major achievements of nationalised banks are in the realm of branch expansion. During the period of 16 years from 1969, the total no. of branches increased from 8,260 to 51,390. There is a remarkable increase in deposit mobilisation and disbursement credit in rural areas, most significant aspect of this new awareness is the introduction of "Lead Bank Scheme" under which every leading bank is actively engaged in conducting economic survey of the specific district and identify the bankable area for branch expansion, after nationalisation, public sector banks have been increasingly motivated towards helping various priority sector, which was neglected by the private banks. Credit facilities have also been extended for agriculture operations, Land improvement and development, distribution of fertilisers etc. The tremendous expansion of the banking sector and the dynamic role they play in economic development are directly the result of nationalisation.

LEAD BANK SCHEME :

With the nationalisation of 14 banks the Government took the initiative for extending the banking system to rural areas and was looking for a scheme of rapid branch expansion. The National Credit Council Study Group under the Chairmanship of Prof. D.R.Gadgil first conceived of the "Area Approach"[7] for branch expansion. Nationalised bank were expected to adopt area for increasing banking facilities to encourage local enterprise in agriculture and increase the productive efficiency of small industries. The Committed of Bankers(known as the Nariman Committee) appointed by the Reserve Bank of India in 1969 accepted the " area approach" and gave the practical shape to it under the title of "Lead Bank Scheme" and towards the end of 1969. Reserve Bank of India finalised a Lead Bank Scheme for all the 338 district in the country.

The Lead Banks had carried out studies of limited areas within the district and on the basis of such studies some development schemes had already been drawn up for comprehensive credit plans for their lead district. Lead Banks have also constituted district level consultative committees comprising representatives of scheduled commercial banks and other financial institutions to help identifying bankable scheme. The Lead Banks have also been given the responsibility to obtain complete details of villagewise distribution of physical rural development agencies, incorporate the same in the Annual Action Plans and ensure that the specified branches of the participating banks accept the responsibility for processing and sanctioning applications of the identified beneficiaries from the villages allocated to them.

REGIONAL RURAL BANKS :

When emergency was declared in June 1975, the Prime Minister, announced the economic programme which was aimed "divising alternative agencies to provide institutional credit to landless labourers, rural artisans and small and marginal farmers, in the context of steps being intiated, also under the programme, to liquidate indebtedness of those classes of people."[8] A working group by the Government of India under the Chairmanship of Mr. Narashimanham examined the question in detail and the Regional Rural Banks ordinance came into force with immediate effect from 26th Sept. 1975. Later on the Regional Rural Banks Act was passed in 1976 giving legal from to the emergency ordinance. Thus the R.B.B. have now come to be established under the R.R.Bs Act. 1976.

The main objective of R.R.Bs is to provide credit and other facilities to the small and marginal farmers, agriculture labourers artisons and small enterpreneurs in Rural areas. Nearly 90% of loans by the R.R.B. were given to the weaker section of the community in rural areas. Since their establishment, the R.R.Bs. have done substantial work in identifying poor beneficiaries under the 20 point programme and other special programme meant for the weaker sections of the rural community, especially members of the scheduled castes and render them financial assistance. The R.R.Bs. have also adopted the policy of differential rates of interest in the case of weaker sections of the rural community, and physically handicapped persons. The "Dantwala Committee" on RRB appointed by Reserve Bank of India also recommended that the, with some modification in their organisation and functioning the RRBs can become a very useful component in the totality of rural credit structure and also stated that RRBs are well suited for the purpose of "progressively fulling up the credit gap in the rural sector.".

THE BANKING COMANIES ACT 1980 :

An ordinance was announced by the President of India on 15th April 1980 nationalising six more Banks. It provided for the acquisition of six more scheduled commercial banks having demand and time liabilities exceeding Rupees 200 crores each on March 14, 1980. The same has now been converted into "The Banking Companies Act, 1980."[9] The Banks taken over by the Government under the provision of this act are :

The Andhra Bank Ltd.

Corporation Bank Ltd.

The New Bank of India Ltd.

The Oriental Bank of Commerce Ltd.

The Ounjab and Sind Bank Ltd. and

Vijaya Bank Ltd.

The act provides compensation to each of the existing banks maintained above. The main provisions of this Act relate to the establishment of the new banks, business, share capital and management of these banks.

NABARD :

Since its inception, Reserve Bank of India had shown keen interest in agricultural credit and for mentioning the separate department for that purpose Reserve Bank of India in consultation with Government setup a committee to Review Arrangement for Institutional Credit for Agricultural and Rural Development(CRAFICARD) in 1979.[10] under the chairmanship of Shri. B.Shivaraman.

The CRAFICARD recommended in its report setting up of National Bank for Agriculture and Rural Development. The objectives of NABARD to give undivided attention to the problem of providing all type of production and investment credit to various rural sectors like agriculture, small scale and cottage industries, as also to handicrafts, to artisans and to other allied activities in an integrated manner. The basic idea was that there should be "National Bank" to pay undivided attention to all regions of country in the manner of rural credit and other needs related to agriculture and rural development. It was felt that if there is banking institution at the national level, the above objectives would be achieved.

The Government of India accepted the above recommendation of CRAFICARD, consequently on this acceptance. The National Bank for Agriculture and Rural Development Bill was passed by Parliment in December, 1981 and the National Bank for Agriculture and Rural Development (NABARD) came into existence in July, 1982.

The NABARD provides refinance assistance to the State Cooperative Banks, The Regional Rural Banks or any other Financial Institution approved by Reserve Bank of Insia. The refinance assistance by NABARD to these financial institution can be given for to carry on agriculture operations or marketing of agriculture produce, to carry on any activity in the field of agriculture development and for production and marketing activities of rural artisans or of small scale industries in the tiny and decentralised sector, village and cottage industries and to those engaged in the field of handicrafts and other rural crafts.

Settling up of the NABARD is a major event and an important mile stone for the development of agriculture and rural industries with a view and to bring about progress of rural areas where nearby 70% of Indias total population lives.

3.4 <u>CHANGING ROLE</u> :

Banking system occupies an important place in the nations, economy. It is essential for expansion of trade, commerce and industry. Banking system includes the different types of banks operating in the country. We can discuss the changing role of Indian banking as under :

Indigenous bankers and money lenders were operating in India long before the introduction of modern banking. Hundies come into use in India from 12th century. However, these historical evidence to do not indicate that we had a well organised banking system in the early period. The modern banking started in India since 17th century with the arrival of English traders. The rapid progress of banking noticed during the British period. The evolution of modern banking goes to the period when the agency houses were established by English traders, for financing trade. The agency houses were established at Bombay, Calcutta and Madras and were operating as banker to East India Company. Thereafter, European traders started establishing joint stock banks in India. The first such bank in India was established in 1770. known as "Hindustan Bank". But this bank failed during 1832. At that time the Bank of Bengal(1804) Bank of Bombay(1840) and Bank of Madras(1843) were established. These Banks were called presidency banks and were given the right of note issue in the respective regions. The above three presidency banks were conducting Government business upto 1920 and were meeting the banking needs to some extent. In 1921, one more development took place and it was the amalgamation of the presidency banks and the formation of imperial Bank of India. This imperial bank was operating partly as commercial bank and partly as the Central Banking functions were divided between the Government and imperial Bank. But after the establishment of Reserve B_nk of India, Central Banking functions were taken away from this bank.

After the independency , the Indian Banking system recorded rapid progress, Government nationalised the Reserve Bank of India in 1949. There was also demand for nationalisation Imperial Bank, Finally, "Rural Credit Survey Committee" suggested the nationalisation of imperial Bank and its convertion in State Bank of India. This suggestion was accepted by the Government and accordingly the State Bank of India was established in 1955. After independence there is significant change from the traditional banking to a modern banking system with the need to achieve rapid socio-economic progress. The activities of banks have increased rapidly in the last decade. To meet effectively and efficiently this increasing burden of work, many banks have started to make organisational changes. Such changes include the introduction of new administrative procedures, decentralisation of authority and introduction of sophisticated performance budgeting systems. Another significant development in recent year has been the introduction of credit planning by Indian Banks to allocate their available funds among various sectors according to the priorities in terms of overall national policies.

To achieve the socio economic objectives, all the big commercial banks have opened a network of branches in the unbanked or under banked areas of the country to reduce the regional imbalances in banking facilities, the main thrust of branch expansion in the post independence period has been on improving of banking facilities in rural areas.

The rapid development of banking habit is also evident by the considerable increase in the use of cheque in recent years. There has been a marked increase in the volume of credit provided by the Indian Banks to different sectof of the economy in recent years.

Before nationalisation of Banks in 1969, large and medium industry and wholesale trade accounted for over 78 per unit of the Bank Credit. By November 1983 the share of these sectors had declined to about 43 per cent, correspondinately, the share of priority sectors, shown significant increase. Banks extending credit to small borrowers which are neglected by the society. Banks are making special efforts to assist weaker section to enable them to undertake self employment ventures or acquire income generating capital assets to improve their standard of living.

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