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Progress of Banking System in India

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Abstract

Banking in India has been in practice since time immemorial. The origin of banking in India can be traced back to as early as 500 BC. Vedas and Manusmrities also witness the existence and working of banking system in IndiaThe present paper aims at appraising the banking development in India during British period and pre and post nationalization. In the last, paper pin point some fruit full suggestion to improve the banking system in country.

Introduction

Banking in India has been in practice since time immemorial. The origin of banking in India can be traced back to as early as 500 BC. Vedas and Manusmrities also witness the existence and working of banking system in India. From the laws of Manu it appears that a money-lending and allied activity has assumed considerable importance. The deposit banking in some form had come into existence by the second or third century of Christian era.[1] During the Smriti period the business of banking was carried out by Vaish Community. "The bankers in the Smriti period performed most of these functions, which the modern time banks perform; such as accepting of deposits, granting loans as a banker and treasurer to the state and issuing and managing the

[1]S.C. Panondikar Banking in India (New Delhi) Oriented longman Limited, 1969, p.3.

currency of the country".[2] Similarly, during the Ramayana and Mahabharata era banking had become ful-fledged business activity.[3]

The literature of Budhist period supplies ample evidence regarding the existing of "Shresth", "Seths", "Shahukars" and bankers in all the important trade centers which had Widespread influence in the life of community. The famous French traveler J.B. Travermer wrote in seventeenth century that every Indian village had money changers called "Shroff" and who according to him acted as a banker to make remittance of money and issue letters of exchange. During the medieval period too.Shahukars continued to carryout the banking business. According to Preston "it may be accepted that the system of banking eminently suited India's then requirements and was enforced in this country many centuries before the Science of banking become an accomplished fact in India".[4]

During the Muslim period indigenous banking[5] received a great set back as the Muslim rulers believed in Quran injunction which regards that the taking of byaz or interest as a great Sin (Haram).[6] The other equally important factor which adversely affected the development of banking during the Muslim period was instable political situation. But during the reign of Jahangir and Shah Jahan banking prospered without any interruption and large banking hours were established at important trade centres in the country. It appears from the writings of Muslim historians that during the Mughal period Hundis or indigenous bills of exchange came into existence. Hundi business played a prominent role in lending money financing internal and external trade and providing financial assistance to rulers during the time of crisis.[7] During that period indigenous banks assumed and immense importance as many of them wielded great influence over the economy of the nation.

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[2]M.C. Vaish Modern banking, Jaipur RABSA publication, 1984, p.158.
[3]Ibid, p.168.
[4] W.E. Preston, "From the Remote past the Ensnared future" In S.G. Panandikar, op.cit., p.4.
[5]Indian Central Banking Inquiry report, Vol. I part I, 1934, p.73.
[6] M.C. Vaish, op.cit., p.170.
[7]J.N. Mehta, "Changing scenario of rural credit Agriculture banker", New Delhi, Vol.9, No.1, 14 Jan-March 1986.

But later on during the fanatic reign of Aurangzeb banking had revived during ththe time of his grand father again suffered a set back. People started lending money to their friends and neighbourers rather than going to the bank and on the other hand indigenous banks combined their business with trade which proved fatal for the development banking system in that time.

Development of Banking During the British Period

With he arrival of Britishers in India, revolutionary change took place in all the facets of Indian economy life. The banking system too not remained immune from this radical change.[8] In fact, with the establishment of East India Company, the down fall of Indian banking system began, as the Shahukars could not make necessary changes in the method of their working to suit the changed economic conditions of India.[9] In the meantime, Industrial Revolution took place. It had a great impact on Indian economy and it can also be attributed as one of the most important factor responsible for the worst position of Banking system in India. People were getting employment opportunities in the factories and the did not remain dependent upon "Shahukars" or "Seths".[10] At the same time Shahukars too were reluctant to make changes in their methods of operation. In the way the existing banking system headed towards it complete break down.[11] However the need was felt for the modern banking system.

The seeds of modern commercial banking on British pattern, were sown during the time of East India Company as the company greatly felt the need of banking concerns. First attempt in this direction was made during the last decade of eighteenth century. The English Agency Houses[12] in Calcutta and Bombay financed the movement of crops, issued papers, money and paved the way for establishment of joint-stock[13] banks also. The earliest of these was the

[8]R.N. Pandey, Commercial Banks and Rural Development (New Delhi, Deep and Deep Pulication, 1989), p.66.

[9] V. Desai, "Restructuring of Bank in India". The Journal of India, Institute of Banker (New Delhi), Vol. 27,No.- 3:47.

[10]S.K. Basu, Industrial Finance in India (Calcutta University Press, 1961), 4th ed. p.46.

[11] V.R. Desai and Mutalik Development in India (Bombay :Manaktalas Publishers, 1967), p.12.

[12] In the beginning the Commercial Banks used to be termed as Agency House.

[13] Joint-stock Banks are those banks which are registered under the Indian Companies Act. They are normally called as commercial banks which specialists in financing internal commence, trade and industries.

Hindustan Banks which was established in 1770 by one of the Agency House in Calcutta.[14] But it was closed in 1832 when the firm of Alexander and Company with which it was mainly connected failed. The Bengal Bank and General Bank of India were established in 1775. But latter was liquidated in 1791 due to its inability to earn profits and the farmer failed little earlier owing to a severe run.

In the beginning if nineteenth century special efforts were made to develop modern banking institutions. The Bank of Bengal first of the Presidency Banks was established in 1806 as the East India Company considered it necessary to facilitate of operation of English trades. In order to have control over the bank the company contributed ₤ 50,000 to the bank and in return obtained the right to appoint three of its Directors.[15] The real stimulus for the establishment of Joint-stock Banks was provided by an act passed in 1813 which removed all restrictions on European setting in India. As a result several new banks were established. They financed internal trade and issued notes. A few of them also financed industry and conducted exchange business. But many of them failed during the banking crisis of 1829-33, due to mismanagement and frauds in their accounts. During1840 and 1843 the bank of Madras and Bombay the second and third Presidency Banks respectively were established with the Share Capital of 30 and 50 lakhs.[16]

The East India Company by giving some amount to these banks obtained the right of appoint some of their directors. Their secretaries and treasurers used to be the members of the Indian Civil Service. Both the banks were allowed to issue currency notes up to certain amounts. The bulk of the shares of all these three banks were subscribed by the Europeans. To enable the large business houses to secure large amounts of capital as per their needs a new Act permitting the setting up more banks was passed in 1860. In 1862 the right of Presidency Banks to issue Currency notes was taken over by the government and as compensation they were given the governmental balances in the presidency towns free of charge. To safeguard the interests of government and the general depositors new restrictions were imposed on the Presidency banks by the government. They were prohibited from dealing with foreign bills. Lending for more than six moths and from lending on security of immovable property. It was also realized that there

[14] S.G. Panandikar, op.cit., p.18.
[15] Guru Datt, Indian Banking Post and Present (Lucknow, Self Publishers] 1960 , p.16.
[16] S.G. Panadikar and B.M. Mithani Banking In India (Calcutta Orient Longiman, 1975), p.46.

should be only one bank for the whole country. From 1860 to 1874 the possibilities of conversion of the Bengal bank into a "Bank of India" remained under the active consideration of the government.[17]

In the meantime the secretary and treasurer of Bengal Bank, placed before the Government of India a proposal regarding the amalgamation of all three Presidency banks. But the Government of India did not favourite. The Allahabad Bank and Alliance Bank of Simla were established in 1885and 1875 respectively. Both the banks were establish under the European Management. The Oudh commercial bank, started in 1881 was first bank of limited liability[18] managed by Indians. It was followed by the Punjab National Bank set up in 1894 and the Peoples Bank of India established in 1901 both of these banks were started chiefly through the efforts of LalaHarKishanLal.[19]

In 1899 again some witnesses before the "Fowler Currency Committee" advanced for the establishment of Central Bank but the Government of India under Lard Curzon did not favour this scheme. On the other hand he presidency banks too desired to retain their individuality and opposed their amalgamation. The "Chamberlin Currency Commission" in 1913 suggested the appointment of an expert committee to examine the whole issue.[20] At the same time public opinion in India strongly urged for the creation of Central Bank. Keeping this in view the Presidency Banks withdrew their opposition and consequently the Imperial Bank of India was set up in 1920 by amalgamating all three Presidency banks along with their branches and total paid up capital of Rs.3314 crore.[21]

The Swadeshi Movement started in 1903 gave an immense stimulus to banking and during this period the number of banks with capital and reserves of over five lakhs increased

[17]H.L. Bedi and other Theory and Practice of Banking (Nagpur, JeevandeepPrakashan, 1984), p.46.

[18] In this case, the liability of the members did not exceed the inpaid amount if any or the shares held by them. Thus a shareholder could not be called upon to pay anything if he had already paid the full face value of share to the company. T.S. Grewal, Introduction to Accounting (New Delhi : S. Chand and Company, 1985), p.450.

[19]LalaHarKishan was the nationalist who did a lot for the development of Indian Enterprise in Banking. He was one of the twenty-one members of Indian Central Banking Enquiry Committee appointed by the Government of India on 22nd July, 1929 to investigate into the existing conditions of banking and make recommendations for the sound banking development in the country.

[20] V.R. Desai and Mutalik,op.cit. p.39.

[21]S.K. Mishra and Puri, Indian Economy (ombay Himalayas Publishing House, 1983), p.843.

from nine to eighteen. These banks have total paid up capital[22] and reserves[23] of Rs. 4 crore and total deposits of Rs. 22 crore[24]. The continuous increase in capital and deposits is evident from the following table :

Table IV.1 : Banking Development from 1906-1913

Year	No. of Banks	Capital and Reserve in Lakh	Deposit in Lakh	Cash balance	Ratio of cash balance to deposit
1906	9	190	1150	149	13
1907	11	292	1400	194	14
1908	14	309	1626	245	15
1909	15	354	2049	279	14
1910	16	376	2566	280	11
1911	18	412	2599	382	14
1912	18	426	2726	400	15
1913	18	364	2259	400	18

Source : M.C. Vaish, Modern Banking (Jaipur RABSA Publication, 1976), p.71.

It is obvious that during the first decade of twentieth century, a good number of banks were started in India. But the development of banking was hectic and lopsided because majority of these banks were set up at important port towns like Bombay and Calcutta. Apart from these banks, there was an increase in the number of smaller banks too some of the prosperous banks of the present time like the Bank of India. The Indian Bank of Madras, the Bank of Mysore and the Bank of Baroda were set up during the Swadeshi movement period, Indian banks which were set up during the same period but subsequently failed were the Indian Specie Bank, the Bengal National Bank, the credit Bank of India, Bombays Merchant Bank and

[22] Paid up capital means people money collected by company in the form of shares to any amount.
[23] Reserve means an amount kept in reserve by the company out of the profit made.
[24] S.K. Basu, op.it. p.115.

Upper Bank of India etc.[25] Before these banks could establish themselves on sound footings first world was broke out. These banks with moderate financial resources and unexperienced management could not face the uphill task. There were bank failures on large scale. The failures of several banks led to the lack of the confidence of the people which consequently gave a considerable set back to banking development in India.[26]

The period between 1913-24 was period of crisis of Indian banking as 161 banks failed during this period. Year-wise failures of banks can be seen from Table IV.2.

Table IV.2 : Failures of Indian Joint Stock Banks during 1913-1924

(Rs. in lakhs)

Year	Number of Banks Failed	AuthorisedCapital	Total Capital	
			Subscribed	Paidup
1913	12	27400	16456	2514
1914	42	79070	24548	10902
1915	11	5660	779	450
1916	13	23090	2090	423
1917	9	7650	3576	2526
1918	7	20950	486	146
1919	4	5260	647	403
1920	3	1040	768	725
1921	7	7040	581	125
1922	15	101555	2726	330
1923	20	218690	99236	46547
1924	18	63031	2646	1134

[25]S.K. Basu, Theory and Practice of Development Banking (New York, Asia Pulishingouse, 1965), p.64.
[26]H.L. Bedi and others, op.cit.p.6.

Total	161	522316	154519	67225

Source : M.C. Vaish, Modern Banking (Jaipur RABSA Publication, 1976), p.173.

During 1925-36, there was a wave of bank failures including those of peoples of Northern India and Tata Industrial Bank of Simla established in 1932. The Peoples Banks of Northern India failed on account of adverse economic conditions in Punjab in which its work was concentrated. The Tata Industrial Bank of Simla was merged with Central Bank of India because it had combined long-term credit to industries with ordinary commercial banking business and had financed both current and annual deposits instead of financing and farmer by issuing bonds. It was managed by the European most of whom had no experience of India. The Joint Stock Companies (Amendment) Act of 1936, also could not solved this problem and in the same year forty banks failed[27]. According to Central Banking Enquiry Committee the combining of non-banking business with banking business, dishonest management, incompetent directors, indulgence in speculative types of investment injudicious advances, creation of long time-term loan on the basis of short deposits, inadequate paid up capital and reserves and poor liquidants this period.[28]

Apart from these causes, the other factors responsible for the deluge were the absence of any coordination between the joint stock banks in the country. The presidency banks preferred to remain aloof from the rest of banking units. For instance, the Bank of Bengal refused to lend to other commercial banks. There was no Central Bank to act as a leader and to guide the other joint stock banks at that time.

The need for the creation of the Central Bank was felt as early as the beginning of twentieth century and in 1920 it was intended to develop Imperial Bank of India of full-fledged Central Bank. However, the Hilton young Currency Commission recommended in 1926 for the creation of a separate bank to be called as the Reserve Bank of India. This bank besides acting as a Central Bank would leave the Imperial Bank free not only to continue but also to extend commercial is banking activities the need for which was greatly felt throughout the country at that time. The Commission further recommended that Reserve Bank of India would be share

[27] V.R. Desai, Mutalik, op. cit., p.96.
[28] M.C. Vaish, op.cit., p.174.

holder institution and in order to eliminate the danger of political pressure on the Board of the Bank the members of the Central and political legislatures be debarred from serving as directors of the bank. Consequently the Reserve Bank of India was inaugurated with a Share Capital of Rs. 5 crores in April 1935[29].

Banking Progress during 1939-49

During this period the progress of banking was quite significant and total number of scheduled banks including Imperial Bank of India increased from 1.035 in 1938 to 2717 by the end of 1950. Their deposits also increased from Rs. 238 crores in 1938 to 1093 crores at the end of 1950.

The progress of banking process is evident from table IV.3.

Table IV.3 : Offices of Scheduled Banks[30] including Imperial Bank of India during 1938-1950

Year	Imperial Bank of India	Other Scheduled Banks	Total
1938	358	677	1035
1939	381	798	1179
1940	390	860	1250
1941	401	954	1355
1942	392	974	1366
1943	398	1400	1798
1944	419	1977	2396
1945	426	2454	2880
1946	358	2441	2799
1947	362	2565	2927
1948	367	2534	2901

[29]S.L.N. Sinha (Ed.) Reform of the Indian Banking System (Madras: Orient Longman Limited, 1972), p.21.

[30] A scheduled bank is one which is included in the second schedule of Banking Regulation Acts. Those Banks : (a) which have paid up capital and reserves of not less than 5 lacs, and (b) which satisfy the RBI that their affairs are not being conducted in a manner detrimental to the interest of depositors are included in the second schedule. These banks are required to maintain a certain amount of reserves with RBI and they in turn enjoy the facility of financial accommodation and remittance facilities in concessional rates from the RBI.

1949	377	2411	2788
1950	382	2355	2717

Source : Reserve Bank of India Trends and progress of Banking of India 1951, p.72

The Indian Banking has witnessed a substantial growth during this period. The reason for the rapid expansion of commercial banking was the banking growth of enormous growth of funds were made available for their investment. These funds could not be used for establishing industrial concerns, on account of the great difficulty of obtaining machinery and other industrial equipments while there was no such difficulty in the way of establishing new banks. The main banks established during this period were United Commercial Bank, Calcutta and Bharat Bank Delhi sponsored by the houses of Dalmia and Birla respectively.

The opening of offices in the areas for way from the main bank activities, indiscriminate branch expansion, opening of branches in already served areas unhealthy competition among banking offices in some areas and centres and undesirable manipulation of bank accounts etc. where the main defects prevalent in the banking system at that time. Consequently many banks failed. The number of banks which went under liquidation during 1934-46 is evident from the table below given.

Table IV.4 : No. of banks which under liquidation during 1939-49

Year	*No. of Banks*
1939	90
1940	102
1941	77
1942	49
1943	51
1944	22
1945	26
1946	27
Total	444

Source : Currency and Finance, Reserve Bank of India, 1944-45, p.12.

Need of Nationalisation of Bank

The role of the public sector banks in commercial banking has been greatly enhanced through progressive nationalisation of banks. The first bank to be nationalised was the R.B.I. the country's Central Bank from 1 Jan. 1949. The Imperial Bank of India was established in 1921 pursuant to the Imperial Bank of India Act 1920. It took over three presidency banks as going concerns with all their assets liabilities and management. The bank could safely get a good response and confidence of the public in the banking system. The working results of Imperial Bank studied from the year 1921 to 1954 revealed that its capital remain unchanged at Rs. 5.63 reserves went up by 53 percent deposits by 274 percent advances by 89 percent and investment by 1135 percent upto the year 1946.In 1955 transfer of assets and liabilities of the Imperial Bank of India to it formed the State Bank of India but the 10 State associated banks were left out. The State associated banks did not like to amalgamate because differences in the standard of working scales of pay of staff etc. However, after sometime State Bank submitted a proposal to the State associated bank for making them subsidiary bank under the Act of 1959 these banks were :-

1. State Bank of Hyderabad
2. State Bank of Bikaner
3. State Bank of Saurastra
4. State Bank of Jaipur
5. State Bank of Patiala
6. State Bank of Mysore
7. State Bank of Indore
8. State Bank of Travandre

Objective of Bank Nationalisation

In July 19, 1969, 14 major Indian commercial banks were nationalised by presidential ordinance. Each bank was having the total deposit of not less than Rs. 50 crores at the end of June 1970.

The purpose of nationalisation set forth in the Act is "to serve better the needs of development of the economy in conformity with national policy and objectives and for matters

connected there with or incidental these to". The consideration which impelled the Government to take the momentous decision for bank nationalisation were mentioned by the Prime Minister in her Statement in Parliament on July 21, 1969,

1.

The Government had experimented the bank performances with the introduction of social control of banks with effect from 1st February 1969. With the main objectives of achieving a wide-spread of bank credit, preventing its misuse directing its flow of priority areas and making it a more effective instrument of economic development followed by the nationalisation of 14 major Indian Scheduled Commercial banks which constitute the most important landmark in the banking history of the country. These banks are as follows :

1. The Central Bank of India Ltd.
2. The Bank of India Ltd.
3. The Punjab National Banks
4. The Bank of Baroda
5. The United Commercial Bank Ltd.
6. The Canera Bank Ltd.
7. The United Bank of India Ltd.
8. The Dena Bank
9. The Union Bank of India
10. The Allahabad Bank Ltd.
11. The Syndicate Bank
12. The Indian Overseas Bank
13. The Indian Bank Ltd.
14. The Bank of Maharastra

The new ordinance raised the rate of compensation was result of which the total amount of compensation was raised from Rs. 84.4 crore. The new ordinance also gave the option to the shareholders of the nationalised bank to accept compensation either wholly in cash in bands

or in cash plus bond. The ordinance also did not interfere with the right of the banks concerned from carrying on any other business including banking.

Commercial banks are classified into two categories : Scheduled and non scheduled banks.

A Scheduled Bank is so called because it has been included in the second 14 major banks has certain special features of its own.

Firstly this step was not based upon the implementation of the recommendations of any Commission or Committee statutorily constituted by the Government or the Reserve Bank of India. In fact if anything it reflects is the district of the activities of the Bank Commission, which was appointed on January 29, 1969 and in whose terms of reference thus question of nationalisation was implicitly included on the part of the Government. In fact the term of reference of the banking Commission was comprehensive enough to enable it to recommend to the Government, the nationalisation of the banking system in the country.

Secondly, the scheme of social control over the bank was put into force only on February 1, 1969 and it was only proper on the part of the Government to allow sufficient time to this new scheme to show its effects. The scheme of social control was comprehensive enough to achieve the result of nationalisation without actually nationalising the banks.

Government was considered vital for the expansion and diversification of banking services. The six more Indian scheduled banks were nationalised in April 1980.These banks are :

1. The J.K. Bank Ltd.
2. New Bank of India
3. Punjab and Sindh Bank
4. Vijaya Bank
5. Bank of Rajasthan Ltd.
6. Corporation Bank

Challenges faced by Banks on advent of Payments Banks: RBI has announced 'on tap' bank licensing policy to allow more and more private banks. Licenses have been given to big

corporate houses to start 'Small Banks' and 'Payment Banks'. More and more private capital and FDI are being encouraged. Associate Banks and other Public sector banks are sought to be merged on the plea that they are small and hence not viable. A payment bank is a differentiated bank that will undertake only certain restricted banking functions that the Banking Regualtion Act of 1949 allows. These activities include acceptance of deposits, payments and remittance services, internet banking and function as business correspondent of other banks. Initially, they are allowed to collect deposits up to Rs 1 lakh per individual. They can facilitate money transfers and sell insurance and mutual funds. Besides, they can issue ATM/debit cards, but not credit cards. They cannot set up subsidiaries to undertake non-banking financial services activities. Payments banks will reach out to people in rural areas. Payments bank will ensure more money comes into banking system. Payments Banks will pose more challenges to RRBs in terms of capital and business module.