

BANKING DEVELOPMENTS

The Reserve Bank inherited a fragile and unwieldy banking structure when the Banking Companies Act, passed in 1949, entrusted it with the responsibility for overseeing the health of India's banking system. This piece of legislation replaced the Banking Companies (Inspection) Ordinance and the Banking Companies (Restriction of Branches) Ordinance, both of which were promulgated in 1946. The earlier volume of the Bank's history has dealt at some length with the history of this enactment, its more important features, and the considerations weighing with the Bank and the government in giving it final shape. Here we may merely note that, though many years in the making, the Act was passed in the midst of a severe banking crisis in Bengal and a less severe one in Punjab which saw several small banking companies bite the dust, and its principal object was to protect the interests of depositors through timely regulation of the working of banking companies. As originally passed, the Banking Companies Act authorized the Bank to license banks, inspect them regularly and act on the basis of inspection reports, call for periodic returns from banks, determine their policy on advances, prohibit banks from undertaking particular transactions, and assist in proposals to amalgamate them. The Banking Companies Act revealed many inadequacies in practice and had to be amended at frequent intervals during the next few years. But at the time they were passed, the act and the ordinances preceding it significantly augmented the Bank's powers of regulation and supervision over commercial banks, which until then derived solely from section 42 of the Reserve Bank of India Act dealing with the Bank's powers to include or exclude a bank from its second schedule.

The immediate effect of the Banking Companies Act was to expand the responsibilities of the Bank in two directions: (a) supervising the working of banking companies and detecting and correcting deficiencies in their functioning, and (b) licensing banks. Inspections, needless to stress, soon became a routine and ongoing responsibility of the Bank. The second responsibility, that of licensing banks, was a particularly demanding one in the early years. Until the passage of the Banking Companies Act, there was no system of licensing banks. Under this Act, however, a new bank was obliged to obtain a licence before commencing business. But existing banks, which were required to apply for a licence within six months of the Act coming into force, could carry on business until they were formally refused one. As a result, the Reserve Bank had to review the working of each bank to determine its eligibility for a licence. The Bank found many institutions wanting in important respects, but rather than deny them a licence and force their closure, it preferred to help remedy their working and monitor the improvement in their affairs. Therefore, at least for the first few years after the Banking Companies Act came into force, inspections and licensing went hand in hand in the case of a majority of banks, the former providing the Reserve Bank the means to acquaint itself with the condition of individual components of the banking system, and the latter helping to give the system of inspection some extra teeth until amendments to the Banking Companies Act added progressively to its powers to re-order the affairs of weak, unviable, or badly-managed banks. It was, however, as an instrument of banking consolidation that its licensing powers came fully into play during the years covered by this volume. Therefore, while the first of the two chapters in this part of the volume discusses the Bank's regulatory activities and initiatives, a fuller discussion of the licensing of banking companies is reserved for the second chapter which deals largely with the Bank's contribution to consolidating the Indian banking system.

The Banking Companies Act was amended on no fewer than ten occasions between 1950 and 1967. Many of these amendments are of relatively minor significance even though some had the effect of increasing the extent of the Reserve Bank's powers over commercial banks;¹ while some others, dealing with the amalgamation or liquidation of banking companies are discussed in the chapter on banking consolidation. Though ownership was not yet so controversial as it was soon to become, banking legislation in our period also grew more attentive towards certain features of organization, management, and control of banks in India. In the chapter which follows, we will be

¹ For a comprehensive list of such amendments, see *Trend and Progress of Banking in India*, an annual publication of the Bank.

concerned mainly with legislative measures which either significantly augmented the Bank's powers of supervision and control over banking companies or were intended to ensure that the latter undertook measures which, while protecting the interests of depositors, redounded to the credit of their institutions and to the overall strength of the Indian banking system. In September 1965, the Banking Companies Act was amended to extend certain of its provisions to cooperative banks. These developments, which originated initially as an adjunct to efforts to extend insurance cover to deposits of cooperative banks, later took on a life of their own and are also discussed in the first chapter.

In 1963, the Reserve Bank of India Act was amended to give the Bank powers to regulate the deposit activities of non-banking financial and other companies. These amendments, which complemented the Bank's powers in relation to banking companies and were welcomed by joint-stock bankers feeling threatened by the rapid growth of non-bank deposits, were intended to protect holders of the latter class of assets and help assert the central bank's influence over a rapidly expanding segment of financial intermediation in the Indian economy. The Bank began to deploy these powers in 1966 but the steps it took in this direction remained experimental in form if not in intent, with discussions about the most effective ways in which to regulate the activities of non-banking companies continuing until the end of the period covered by this volume. While the larger part of the next chapter deals with the regulation of the country's banking system, both commercial and cooperative, it is convenient to round it off with a brief account of the Bank's efforts to tackle the challenge posed by non-banking companies during the 1960s and bring them under some form of control.

The second chapter traces the evolution of the legacy the Bank inherited from the past in the form of a fragile and unsound banking structure. It contains an account of the banking crises in some parts of the country at the outset of our period and subsequently, the Bank's response to them, and its attempts to place Indian banking on a sounder footing. The collapse of the Palai Central Bank in August 1960 was widely regarded as an instance of regulatory failure. The Reserve Bank's handling of the affairs of this institution is discussed in an appendix. Apart from triggering a public controversy and a banking crisis in Kerala, the Palai collapse spurred the Bank's determination to strengthen the banking system and safeguard against similar crises in the future. Deposit insurance, which the Bank introduced in 1962, was an important outcome of these events, and is also discussed in this chapter. To help place the Bank's exertions in perspective, the second chapter concludes with a brief survey of Indian banking growth during our years.