A significant development of the early 1960s was the establishment of the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI) in 1964. The former was intended to provide long-term capital to industry; the latter was designed to provide a safe haven for small savers. The Reserve Bank’s initiative in setting them up is discussed in Volume 2 of the history of the Reserve Bank of India. By the end of the 1960s both institutions had begun to function well. In the 1970s, a certain amount of tension developed between the Bank, these institutions and the government. Coordination was the major irritant and the eventual consequence of this tension was the ‘delinking’ of IDBI and UTI from the Bank in 1976. It is to that story that we now turn.

There were four areas of linkage in the relationship between the Reserve Bank and the two financial institutions. From the Bank’s point of view, these were: management participation, staff and organizational support, financial support and policy support. The first two of these were not critical and were taken for granted since IDBI and UTI, after all, had been set up by the Bank. It was in respect of the latter two that the relationship became a little fraught owing to their flexible nature. This happened despite the fact that the Bank’s participation at the highest management level in the two institutions differed. The RBI Governor was ex-officio chairman of the IDBI, and a Deputy Governor acted as vice chairman. The Bank and the IDBI had an identical board of directors. In the case of UTI, although the chairman, executive trustee and four other trustees were nominated by the Bank, the chairman was not from the Bank. Also, the executive trustee was of the rank of Executive Director of the Bank. This created some anomalies. The financial and policy support, also, was influenced by the culture that the Bank exported to the institutions via its clerical and officer-level staff.
THE RESERVE BANK AND IDBI

The relationship between the Reserve Bank and the IDBI was unique. As a promoter, the Bank was responsible for developing IDBI. Besides providing infrastructure support, the Bank subscribed to the capital of IDBI, and provided loans and advances by setting up the national industrial credit (long-term operations) fund, with allocations from the profits of the Bank. As a lender of last resort, it provided accommodation to the IDBI against eligible securities to meet shortfalls in its resources. Since their board of directors was identical, the IDBI derived the benefit of the Bank’s perceptions about industrial finance. The authorized capital of IDBI was Rs 50 crore and the issued capital Rs 10 crore. Its authorized share capital remained unchanged at this level up to the time of its delinking from the Bank in February 1976. Its issued capital, however, increased from time to time and at the time of delinking was Rs 50 crore. Apart from share capital, the Bank also provided funds to IDBI from the national industrial credit (long-term operations) fund, for the purchase of and/or subscription to eligible financial institutions.

When the IDBI was established, the Reserve Bank created an additional post of a Deputy Governor to focus exclusively on its operations and on matters relating to industrial development. It did not, however, interfere in the day-to-day work of the IDBI. The Bank also played the role of a regulator. As interest rate determination was under its jurisdiction, the interest rate structure of IDBI was guided by the instructions and directives that were periodically issued by the Bank.

The operations of IDBI, in terms of its statutory provisions, had two aspects: assistance to other financial institutions, and direct assistance to industrial units either singly or in participation with other financial institutions. After the devaluation of the Indian rupee in June 1966, IDBI decided to give priority to import-substituting and exporting industries. But when, in 1967–68, the economy went through a recessionary phase, the IDBI altered its earlier set of priorities and cooperated with government policies for promoting industrial revival. It therefore relaxed its policy of selectivity.

It decided to give immediate attention to large projects because of their employment potential and high forward and backward linkages, and to finance medium and small–medium projects on a more liberal scale. No ‘worthwhile’ project was to languish for want of finance. The IDBI also liberalized its refinance policy and, in consultation with the Reserve Bank,
lowered the interest rate. It started providing assistance to small-scale units at concessional interest rates.

During 1968–69, IDBI added a new dimension to its policies when it began to provide loans for the expansion and diversification schemes of public sector undertakings, as long as they qualified under certain general and specific criteria. It also widened the scheme of rediscounting machinery bills to include machinery sales to public sector industries, electricity undertakings and road transport corporations. It persuaded banks to cut their discounting rate by 1 percentage point and to pass on the benefit to purchasers of machinery.

In December 1968 there was another important development relating to export credit. Since 1964, IDBI had been administering refinance for medium-term export credit by commercial banks. The scheme was introduced by the Refinance Corporation for Industry Ltd in January 1963. Under this scheme, the risk was borne by the borrowing banks for a period of up to ten years. With a view to increasing its involvement in export credit, the IDBI formulated a new export credit scheme. Under the new scheme, the IDBI entered into a participation arrangement with eligible commercial banks for providing term finance and guarantee facilities to industrial concerns both in the public and private sectors, for export of capital and engineering goods and services. Export credit was provided at both the pre-shipment and post-shipment stages for periods exceeding six months, and performance and financial guarantees were provided on behalf of exporters. IDBI charged a concessional rate of 4.5 per cent on its portion of credit, while participating commercial banks charged their own rates on their portions, not exceeding 6 per cent—the ceiling rate prescribed by the Reserve Bank. Table 1 provides information about IDBI’s direct financial assistance under various facilities during the period 1964–76.

The IDBI, apart from being a financial institution, assumed developmental and promotional functions as well, as envisaged in the IDBI Act. An important focus area was balanced regional development. The government had consulted the National Development Council on the subject, as well as the Planning Commission, which had appointed two Working Groups with the objective of locating industries in backward regions. In this, IDBI played an important role by providing consultancy and cheaper finance. It also formulated schemes for the development of entrepreneurial and managerial talents, particularly for small-scale industries, and agreed to refinance at a concessional rate to financial institutions for their lendings in specified backward regions. In line with the recommendation of the Industrial Licensing Policy Enquiry Committee, IDBI introduced a
provision for converting loans into equity, and actively participated in the management of industrial concerns that received substantial term loan assistance. IDBI thus started appointing its nominees on the boards of the assisted companies.

In 1972, the IDBI Act was amended to widen the definition of an industrial concern, so as to include concerns engaged in the maintenance, repair, testing or servicing of machinery, vehicles, vessels, motor boats, trailers or tractors and fishing. The amendment brought within the purview of IDBI’s assistance, small concerns engaged in these activities. It also enabled the IDBI to extend refinance facilities to state finance corporations (SFCs) and banks that provided assistance for setting up of industrial estates. IDBI thus enlarged its role in the development of small-scale industrial units.  

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Direct Financial Assistance (July 1964 to June 1976)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
</tr>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>1. Assistance to new projects</td>
<td>252</td>
</tr>
<tr>
<td>2. Assistance for expansion/diversification</td>
<td>91</td>
</tr>
<tr>
<td>3. Assistance for modernization/rationalization</td>
<td>16</td>
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<td>4. Supplementary* assistance to industrial concerns</td>
<td>84</td>
</tr>
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<td>5. Subscription to right issues of assisted concerns</td>
<td>–</td>
</tr>
<tr>
<td>Total</td>
<td>363</td>
</tr>
</tbody>
</table>

*Assistance for (i) meeting over-runs in project costs arising from delays in implementation, rise in cost of machinery and building materials, shortfall in estimated cash resources, etc.; (ii) relieving strain on cash resources of companies which had earlier utilized working capital funds for acquisition of fixed assets; (iii) financial reorganization, etc.

Note: Figures in bracket indicate assistance sanctioned at concessional rates.

Source: Annual Reports of IDBI, various issues.

1 After the amendment, the IDBI was allowed to provide direct finance (i) to export houses or any person exporting products of industrial concerns even though the exporter might not be an industrial concern; (ii) to any person in India for the execution of turnkey
In November 1972, IDBI approached the International Development Agency (IDA) for a line of credit that would enable it to meet the requirements of rupee finance as well as foreign exchange required for purchasing capital equipment from abroad. The IDA sanctioned credit worth US$ 25 million on 9 February 1973. This was utilized for refinancing loans granted by SFCs to industrial concerns for setting up new industrial projects and also for the expansion, diversification, modernization and renovation of existing units in cases where a portion of the loan was for financing import of equipments from abroad/or technical know-how in special cases. The total project cost, however, was not to exceed Rs 1 crore.

One of the major functions assigned to IDBI was coordination with other financial institutions. Accordingly, it set up the Inter-Financial Institutions Committee, which met once a month. But until IDBI was delinked from the Reserve Bank in 1976, the Industrial Finance Department of the Bank more or less ran the show the through annual conferences of SFCs.

It is worth dwelling on this subject because of its importance and the persistent problems faced by the SFCs. In July 1969, Deputy Governor Bakshi had submitted a comprehensive memorandum to the Bank’s Central Board on the subject. As follow-up, the Bank issued some guidelines.

L.K. Jha, in his inaugural address at the fourteenth conference of representatives of SFCs on 17 March 1970, outlined the Reserve Bank’s approach to industrial finance in general and SFCs in particular. He emphasized that it was necessary to clearly identify ‘possibilities and constraints’ in the development of backward areas and of small-scale industries, and that SFCs should ‘pay heed to social problems which could to some extent be redressed by the right pattern of development’. He suggested the setting up of industrial estates in industrially backward regions with a view to attracting industries. The conference proved to be a lively one, with several divergent views being expressed. But nothing significant emerged from it.

projects outside India; (iii) to extend credit directly to foreign buyers of Indian engineering goods; (iv) by way of offering lines of credit to foreign financial institutions to be utilized for import of capital goods from India; and (v) to extend refinance of term export credit granted for exporting eligible products manufactured by other concerns and to Indian residents executing turnkey projects outside India. The period of export credit was raised from ten to fifteen years, and the IDBI was allowed to subscribe to shares, bonds and debentures of financial institutions outside India. The amendment also enabled IDBI to assist in the setting up of development finance institutions in developing countries.

2 ‘State Financial Corporations: A Brief Assessment of Their Performance, Problems and Prospects’. 
The issue of coordination between SFCs and commercial banks was again raised at a conference of chairmen and managing directors of SFCs convened by the Finance Ministry in November 1971. It recommended the setting up of a Working Group headed by R.K. Talwar, chairman, State Bank of India (SBI), to examine various issues. Based on its suggestions, the Reserve Bank issued a circular in December 1974 to banks and financial institutions, stressing the need for working out mutually acceptable arrangements to avoid unhealthy competition in granting term loans. Coordination in respect of financial assistance to industrial units facing financial difficulties had been examined in detail. Two state-level coordination committees were constituted at the instance of the Finance Ministry, one of which was concerned with sick small industrial units and the other with modernization of small-scale industries. By 1976, these committees were set up in most of the states/union territories.

The Reserve Bank was concerned about the deterioration in the working of the SFCs. It kept stressing the need for strengthening their financial viability and operational efficiency. This issue came to the fore again when IDBI started negotiating the line of credit from IDA. In his inaugural address to the sixteenth conference of SFCs, Governor Jagannathan referred to the World Bank’s conditionality attached to lines of credit and observed that certain measures of financial discipline stipulated by the World Bank were ‘anyhow ones that we should be attaining in the interest of our own institutions’.

But the RBI was fighting a losing battle. Its involvement in the coordination of operations and policies of financial institutions was mainly to ensure that its credit policy as applicable to commercial banks would enable an extension of working capital by banks that would be consistent with the term financing that financial institutions provided. But its warnings and exhortations only succeeded in causing irritation in the circles of power, and after the delinking of the IDBI from the Bank in 16 February 1976, the functions were transferred to IDBI. IDBI then assumed the full-fledged responsibility for policy coordination work relating to SFCs and other financial institutions.

The IDBI’s interest rate structure was different for different types of loans. Direct finance, refinance and export credit were linked to the Bank rate and other guidelines and directives issued from time to time. The IDBI’s interest rate structure typically reflected its developmental and promotional function since it stipulated concessional rates for small-scale industrial units that were covered by the guarantee of the Credit Guarantee Corporation, and for loans provided in specified backward regions and backward
districts of developed states. The interest rates on export credit were fixed with a stipulation that the primary lenders did not charge more than the ceiling rate prescribed by the Bank from time to time. Thus, the IDBI's interest rate structure was a part of the framework of the monetary policy of the Reserve Bank and special concessional elements within it were a part of its promotional function.

**The Break**

The idea of delinking of IDBI from the Reserve Bank was first mooted by a study team headed by C.H. Bhabha of the Administrative Reforms Commission in 1966. It stated that ‘in the long run, specialized institutions like the IDBI, Agriculture Refinance Corporation, Unit Trust of India and the Deposit Insurance Corporation of India should build up their own managerial and technical competence. It will then be worthwhile to separate from the RBI altogether.’

A one-man working group under Manubhai Shah, who was a member of the Administrative Reforms Commission, also recommended delinking. Shah visited the Bank, had detailed interactions with officers of the Bank on the subject and went to elaborate his suggestions in his book, *The New Role of the Reserve Bank in India’s Economic Development*. He wanted the Bank to concentrate on monetary management and the formulation of credit policy. He also thought that development would be considerably facilitated if there were specialized institutions for different sectors. Jha was against delinking, so the Bank did not take any action on Shah’s report. The Administrative Reforms Commission also rejected it, saying, ‘In our view, the necessary coordination in the field of credit is best done by the Reserve Bank of India itself. We, therefore, feel that it would be a far better arrangement to set up the banks and organization suggested in the report as subsidiaries of the Reserve Bank.’

But things changed after nationalization in July 1969 and delinking again became a live issue, partly perhaps because the Reserve Bank was seen as being overly conservative. Delinking would provide the government with control over long-term funds and the capital market. With nationalization it had already gained control over short-term funds but the Bank was seen as something of a stick-in-the-mud. Eventually, legislation in the form of the Public Financial Institutions Law (Amendment) Bill was introduced in the Lok Sabha on 22 December 1973. The Joint Committee of both Houses of Parliament to which the Bill was referred submitted its report on 25 July 1975 but not before making some very scathing criticism. It took about a
year to finalize its report and invited memoranda from economists, administrators and bankers to express their views about the Bill. It also recorded the oral evidence of S. Jagannathan, R.K. Hazari, C.V. Nair of the RBI Officers’ Association, and others.

The Bank very clearly did not approve of delinking. While giving oral evidence before the Joint Committee, Jagannathan said:

Broadly, in the Reserve Bank and in the IDBI, we were not very clear as to the specific objectives which government had in mind and we expressed the view that we were not able to see much advantage in reconstitution proposed. We also thought that there were some substantial disadvantages in the delinking. We expressed the view, which I still hold, that the Reserve Bank no doubt has a lot of work to do, but delinking will not be helpful because the coordination task would become more difficult. The UTI and IRCI have got their own Boards, but, of course, IDBI has a common Board with the RBI. We advised that IDBI might be reconstituted with a separate Board but not necessarily delinked from the Reserve Bank.... It was our view that there was not any substantial advantage but there could well be many disadvantages.

Jagannathan also said that after delinking, the Bank would have no responsibility; or, as one member put it, the buffer may not be there. ‘The buffer, I think, is not meant to slow down. The buffer is meant to coordinate and I do think there would be some practical difficulties’. Jagannathan’s predecessor, L.K. Jha, had also not been in favour of delinking. According to Jha, ‘the Reserve Bank was adequately staffed and can tackle the task that it has’.

R.K. Hazari, Deputy Governor of RBI opposed the proposal but suggested changes in the IDBI’s management. He said:

As the head of the Agricultural Refinance Corporation, which is one of the institutions of the Reserve Bank, I do feel that the ARC pattern is perhaps much more suitable for a development bank than the present pattern of the IDBI. I think the Governor need not be Chairman of the IDBI; the Governor should be above institutions other than the Reserve Bank. It would be quite sufficient if the Deputy Governor of the Reserve Bank can be Chairman of the IDBI while ownership continues to vest with the Reserve Bank and he can have easy access to the resources
and staff. Certainly, it would be useful to have people other than
the Directors of the Reserve Bank as Directors of the IDBI. I
think the Board of Directors of the IDBI should be more broad-
based than it is now.

C.V. Nair highlighted the performance of IDBI as an associate insti-
tution of the Reserve Bank and cautioned that after delinking ‘there will
be a higher degree of bureaucratization and a higher degree of non-
professionalized management controlling the new IDBI’. Ashis K. Sen, gen-
eral secretary of the All-India Reserve Bank Employees’ Association, said
that ‘the purpose for which IDBI was set up has been served … there is no
need for separating this institution from the Central Bank of the country.
This will only jeopardize the progress of our country.’

Four members of the Joint Committee also recorded minutes of dis-
sent. K. Mathew Kurian and Dinen Bhattacharya described the Bill as a
retrograde piece of legislation.

The proposal to delink IDBI from the RBI and to convert the
IDBI as an apex financial institution, separated from the RBI
and functioning as a parallel institution under the administra-
tive control of the finance ministry, will destroy the very found-
ation of the credit structure which has been built up during the
last two decades…. The evidence before the Committee very
clearly indicate that the Bill has been misconceived and should
therefore be scrapped. The evidence further indicate that there
is no valid economic or administrative reason for delinking the
IDBI from the RBI. The reconstitution of the IDBI as proposed
in the Bill will not improve the operational efficiency of the IDBI,
nor will it create better machinery for developmental finan-
cing, better coordination of credit operations etc.

The two other dissenting members of the Committee, Indrajit Gupta
and Bhupesh Gupta, said:

This Bill, in our opinion, being limited to the question of cer-
tain structural changes only in the relationship between the IDBI
and the RBI, begs the main question viz. the credit policies of
the public financial institutions vis-à-vis various sectors of in-
dustry and areas of industrial development. The Bill does not at
all venture into any reformulation or redefinition of
government’s basic policies in the matter of financing, promot-
ing and developing industries. To that extent, the Bill is quite
### Table 2: IDBI’s Borrowings from Reserve Bank of India

(Rs lakh)

<table>
<thead>
<tr>
<th>Year</th>
<th>Purpose</th>
<th>Sanc-</th>
<th>Utili-</th>
<th>Repay-</th>
<th>Rate of interest (%)</th>
</tr>
</thead>
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<td>tions</td>
<td>zation</td>
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<tr>
<td></td>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
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<td>1964–65</td>
<td>For subscribing to bonds of SFCs and other</td>
<td>200</td>
<td>100</td>
<td>100</td>
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<td>92</td>
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<td>127</td>
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<td>108</td>
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<td>25</td>
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<td>Purpose</td>
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<td>Utilization (2)</td>
<td>Repayment (3)</td>
<td>Rate of interest (%) (4)</td>
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TABLE 2 (contd)
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<th>Year</th>
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<th>Sanc-</th>
<th>Utili-</th>
<th>Repay-</th>
<th>Rate of interest (%)</th>
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<td>1981–82</td>
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<td>1982–83</td>
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**Notes:**

1. Limits allowed for subscriptions to bonds of SFCs, etc., were utilized for purchase of debentures of ICICI.
2. No interest would be charged by RBI for a period of five years from the date of disbursement.
3. Amortization period varies with the purpose of borrowings as follows:
   (a) Subscription to bonds of SFCs: within 12¼ years (lumpsum)
   (b) Subscriptions to shares of SFCs, IFCI and IRBI: within 20 years (lumpsum)
   (c) Subscriptions to special debentures of ICICI: ten equal annual instalments commencing from the sixth year.
   (d) General business of IDBI: within 15 years (lumpsum).

inadequate and will have little or no impact on the actual credit map as it has emerged over the years.

The Bill was passed, as expected, by both Houses of Parliament, and IDBI was delinked from the Reserve Bank on 16 February 1976. The Bank’s holding of IDBI’s share capital was transferred to the government and its holdings in UTI were transferred to the IDBI. Thus UTI was also delinked from the Bank.

A new chairman, Raghu Raj, took over the IDBI and a new board was constituted. The interest rate structure of the IDBI, however, continued to be regulated by the Bank, which also continued to provide resources to the IDBI and act as a lender of last resort to meet financial requirements (Table 2). The government had won another battle—it had had its cake and eaten it too.

THE BANK AND UNIT TRUST OF INDIA

The Unit Trust of India (UTI) was a wholly owned subsidiary of the Reserve Bank but the Bank maintained an arm’s length relationship with it. It also avoided making general regulations that would hamper the growth of UTI.

UTI launched its operations with the Unit Scheme 1964 (US 64). To ensure that it could offer more schemes, a Committee was set up in 1965 consisting of a chairman, executive trustee, and trustees. On the basis of the Committee’s report, proposals were sent to the government through the Bank for amending the UTI Act. The amendments helped to diversify the schemes of saving.

In order to cater to different types of investors, the UTI introduced three saving plans. The first was the Reinvestment Plan (from 1 July 1966), the second was the Voluntary Savings Plan (introduced in July 1969) and the third was the Children’s Gift Plan (introduced in 1970). The Reinvestment Plan facilitated automatic reinvestment of income that was distributed to investors. The Voluntary Savings Plan facilitated investment in units by small investors through periodic contributions; as this scheme did not flourish, it was terminated in June 1974. The gifts of money made under the Children’s Gift Plan were invested in units and income on them was reinvested. For income tax purposes, this income formed part of the donors’ income.

On 1 October 1971, another scheme, namely, Unit Scheme 1971, was

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3 N.M. Wagle, H.T. Parekh, P. Bhinappa and V.G. Pendharkar were the trustees then.
launched in association with the Life Insurance Corporation of India (LIC). This was essentially the Unit-Linked Insurance Plan—a ten-year contractual plan under which a small part of the contributions was paid in half-yearly or annual instalments to the LIC and the balance was invested in units.

The investment policies of the UTI were promoted by securing the necessary support from banks or through amendments to the original UTI Act. In the initial years, when the UTI found it difficult to invest in the narrow share market, it had to invest in preference shares and debentures or in government securities in a manner that would give reasonable returns to unit holders. Although ‘reasonable returns’ was not defined, the fact that the UTI maintained a dividend rate of 7 per cent implied that the rate of return on the Trust’s investments would have to be higher than 7 per cent a year.

The original Regulation 36(1) of the UTI’s General Regulations placed a limit on UTI’s investments in the securities of any one company of 5 per cent of the total investible funds of the Trust, essentially to minimize risks in investment and to spread investments over a fairly large range of securities. Secured debentures, which gave assured yields and carried much less risk than ordinary shares, were issued in the 1960s and 1970s, mainly by well-established companies. Even though the debentures did not give voting rights, any investment in debentures by the Trust implied, given the overall limit on investments, a restriction in the Trust’s investments in preference and ordinary shares of the concerned company.

The overall limit on investment was considered a hindrance to achieving a balanced portfolio, and the UTI therefore suggested to the Reserve Bank to exclude ‘debentures’ from the word ‘securities’ in Regulation 36(1). Governor Bhattacharya was not happy with the suggestion because it sounded too general. The Trust, after a discussion with the Governor, decided to have a sub-regulation to Regulation 36(1). This exempted two types of secured debentures from the limits on investment: those that were issued by a company that had declared dividends on its equity shares for at least five years immediately preceding the year of UTI’s investment in them, and had declared a minimum of 6 per cent dividend on the paid-up value of equity shares in the year immediately preceding the year of Trust’s investment.

Governor Bhattacharya’s help to UTI came in another form as well. Faced with large borrowings by banks from the RBI to meet the demands for commercial credit, and with the inflationary pressures and deteriorating external payments position, the Governor was keen on tightening bank
credit. He therefore advised banks, at an annual dinner of the Bombay Bankers’ Association in 1966, to sell some of their debenture holdings to the UTI to meet their cash needs rather than borrow from the Bank. This seems to have worked since debenture holdings at end-June 1967 showed an increase of Rs 3 crore over the level of Rs 10.9 crore a year earlier, and as against a rise of Rs 1.6 crore in 1965–66 (July–June).

Regulation 36(1) required further modifications when, in 1969–70, the sales proceeds of units increased sharply. As noted by V.G. Pendharkar, during the first four months of 1969–70, sales amounted to about Rs 17 crore—almost as much as the total sales in the whole of the preceding year, and, despite UTI investing the proceeds through market purchases and subscriptions to new issues, there was still a balance of Rs 6 crore left by October 1969. This was temporarily invested in government securities that yielded a return of about 5.5 per cent against the Trust’s dividend rate of 7.1 per cent. Pendharkar noted that the situation warranted investment in higher-yielding industrial securities but new issues of preference shares and debentures were far lower in 1969 than in the earlier years. The UTI management, therefore, proposed to the Reserve Bank that its investment problem would be eased if the overall limit (i.e. of 5 per cent of total investible funds of the Trust or 10 per cent of the securities issued and outstanding of the company, whichever was lower) on investment in shares could be relaxed.

The modification it sought was the following: investment by UTI in the securities of any one company shall not exceed 4 per cent of the total investible funds of US 64 or 15 per cent of the securities issued and outstanding of the company, whichever was lower. The UTI also suggested that since the original UTI Act allowed only one unit scheme, it was necessary to add the words ‘in respect of every unit scheme’, as the 1966 amendment allowed the UTI to introduce more schemes.

R.S. Bhatt, chairman of UTI, sought the approval of Governor L.K. Jha on this amendment and spoke to him on several occasions on the matter. The Governor’s views on the subject were reflected in his noting to Executive Director R.K. Seshadri.

Basically we must accept the proposition that Unit Trust cannot afford to lower its returns and therefore it must be able to invest the bulk of its funds in channels which should give a higher dividend than the return which the Unit Trust gives. In the past, there was an abundance of new issues and the inflow of funds (to UTI) was also not particularly large. The position
now is different. So the plea for this relaxation is understandable.

However, Jha felt that by applying the regulation separately to each scheme the UTI might even own the majority of shares of any company if there were a number of schemes. While the suggested investment limit of 15 per cent for the securities issued and outstanding of any company would be quite a safe one for UTI as a whole, it might be too high if it is reckoned scheme by scheme. Jha’s noting helped the UTI to modify its proposal regarding Regulation 36(1) thus: ‘Investments by the Trust from the funds of Unit Scheme of 1964 in securities of any one company shall not exceed 5 per cent of the total amount of the said funds or 15 per cent of the securities issued and outstanding of such company, whichever is lower.’ This modification was duly accepted by the Reserve Bank.

Besides seeking the Reserve Bank’s advice on matters relating to its investment policy, the UTI sought its financial support in order to maintain its repurchases at a ‘stable’ level. The Trust repurchased units mainly to provide ready liquidity to investors. The repurchase price was always lower than the sale price. The Trust fixed the price differential each year. Till 1967–68, the maximum differential was fixed at 50 paisa per unit; it was reduced to 40 per cent in 1968–69 and in 1972–73, the differential was further reduced to 30 paisa per unit. Stability in the amount of repurchases was maintained partly through the method of fixing the sale and repurchase prices, and partly through short-term accommodation (for a maximum of 90 days) from the RBI. Governor Jha, in his response to a query from B.K. Nehru, Governor of Assam, in December 1968, enunciated the stability principle thus: ‘In its actual working the Unit Trust has maintained its repurchase stable, though to enable it to do so the Reserve Bank has had to make some small contributions which the law provides for.’

The Reserve Bank’s financial support to UTI in 1974–75 was a classic case of protecting the Trust from any financial crunch. When the government, as a part of an anti-inflationary package, restricted the rate of dividends to be paid by companies to shareholders to 4 per cent, the stockmarket fell into a deep depression. Repurchases of units exceeded their sales, causing a financial problem for the UTI. The RBI bridged the financial gap by making special financial arrangements for the purpose. This action on the part of the Bank was not merely that of a major contributor to the initial paid-up capital of UTI, but also that of a central Bank which believed in fostering and promoting the institutional infrastructure and maintaining the public’s confidence in the Trust at a high level.
The relationship between the Reserve Bank and UTI was terminated by the Public Financial Institutions Laws (Amendment) Act of 1975. The Act placed the Trust under the IDBI and transferred to it all the powers that the RBI had with regard to UTI. The formal delinking from the Bank took place on 16 February 1976. With this development, the chairman of UTI was appointed by the government in consultation with the IDBI and the executive trustee was appointed by IDBI. The Bank appointed only one trustee under the amendment, in place of the four trustees it had appointed under the original UTI Act.

The delinking of UTI from the Reserve Bank took place during the Emergency. There was no internal noting in the Bank to show its views on the matter. There was also no record in the Bank to show whether it had been consulted before the Public Financial Institutions Laws (Amendment) Act was brought before the Parliament in 1973. V.G. Pendharkar, a former Executive Director of the Bank and one-time executive trustee of UTI, expressed his views on the delinking of UTI from RBI and placing it under the care of IDBI in his book, *Unit Trust of India: Retrospect and Prospect* (Mumbai, 2003), thus:

I think this transfer was a grave mistake. After all, the IDBI is a lending institution and, as such, a borrower-oriented institution. It is not a lender of last resort. Also it does not have the comprehensive knowledge of the economy and the kind of research capability which the Reserve Bank has and which is necessary to give guidance to an investor-oriented institution like UTI. Even more important, the Chairman of IDBI does not have the wide experience in administration and understanding of public interest, which Governor of Reserve Bank has. Nor he has their eminence and authority. By placing the UTI under IDBI the valuable personal link between the Chairman of UTI and the Governor of Reserve Bank was broken, much to the detriment of the UTI. Moreover, since IDBI was now under the direct control of the Finance Ministry, this transfer meant that Government could, if it chooses, influence UTI through IDBI. The original idea of the Trust being free from control of Government was whittled down somewhat with this transfer.

The central Bank being the agency to coordinate the activities of all financial institutions, and to ensure the availability and use of funds for developmental needs, an effective link would have been beneficial, till the market was around to play the allocative role. However, things were vastly
different from a political standpoint. K.S. Krishnaswamy, Deputy Governor, in an address on 19 October 1979, remarked:

Clearly, after nationalization, it has willy-nilly been subjected to political influences of various kinds and this is a situation that we have to accept because I do not think it is correct for anybody to imagine that in a modern society, he can live outside of politics; it would be wrong for us to argue or behave as if we can live outside of politics. So for better or for worse, banks will function in a political climate and their decision-making will be influenced by political considerations—some of which are legitimate and some not so legitimate.

THE BANK AND NON-BANKING FINANCIAL COMPANIES

India has always had a thriving money market. Until the development and growth of modern banking in the nineteenth century, the money market was mostly in what would be today described as the informal sector. Ordinarily, the importance of this sector should have gradually diminished with the expansion of modern banking. But that did not happen. To the extent that banking consists of taking deposits and giving loans, at the time of independence, there were a large number of what came to be called non-banking finance companies (NBFCs). Basically, these were banks that were not banks under the law. Although the size of each individual NBFC was small, together they controlled sizeable sums. It became necessary, therefore, to protect their depositors, most of whom were gullible persons attracted by the high rates of interest offered on deposits. The first step in this direction was taken in 1963, with the incorporation of Chapter IIIB in the RBI Act, 1934, and its effective operation from 1 February 1964. This enabled the Reserve Bank to control NBFCs. In March 1966, a Department of Non-Banking Companies (DNBC) was set up in the RBI. A few months later, a Directorate of Inspection and Investigation was set up in the Department of Company Affairs (DCA), for proper coordination.

In 1966, the Reserve Bank issued two directives, requiring all NBFCs to provide the Bank with audited balance sheets every year, as well as interim half-yearly accounts. The companies were also required to provide information on their management and finances in their advertisements soliciting deposits. The directions restricted the volume of deposits of financial companies other than those in the housing finance and hire purchase sectors (i.e. loan companies, investment companies, nidhis, mutual benefit funds, non-chit financial businesses of chit funds, and non-financial companies
that collected public deposits including those belonging to government) to 25 per cent of their paid-up capital and free reserves; for hire purchase and housing finance companies, they prescribed liquidity requirements (i.e. cash, current account balances in scheduled or notified banks, and central, state and trustee securities) of 10 per cent of their outstanding deposits. Any excess deposit was to be adjusted/liquidated over five years.

By 1967, the Reserve Bank’s responsibilities had grown manifold, both because the number of companies covered by it was large and because the business of these companies had grown substantially. The DNBC had a working arrangement with the Directorate of Inspection and Investigation, according to which inspection of financial companies was carried out by the Bank, while the inspection of non-financial companies was mainly carried out by the Directorate. It was not easy to get the exact details of the number of companies taking deposits or the number of financial companies that were actually working. Even so, an attempt was made to estimate the number of non-banking financial intermediaries that might be carrying on at least some business, and the turnover of their business.

It was estimated that about 2,700 companies (about 450 financial companies and about 2,250 non-financial companies) had received or might be receiving deposits from the public, and that about 1,750 financial companies might be transacting at least some nominal business. But their volume of deposits in the non-banking corporate sector as a whole and the volume of funds handled by all the NBFCs together was not such as to justify an elaborate system of regulations or an intensive system of inspection, scrutiny and control. So the Reserve Bank tried to frame policies within the framework of certain guiding principles, namely:

(i) To extend and modify the provisions relating to the acceptance of deposits in the non-banking corporate sector, so as to minimize the immediate difficulties, without prejudice, however, to the ultimate objective of reducing the extent of reliance by industrial and commercial companies on this mode of raising finance.

(ii) To divert the lending of non-banking financial companies into useful and productive purposes and to link them, if possible, with the commercial banking system, through a system of refinance and assistance.

The directives in regard to deposits of 1969 required an NBFC to disclose particulars regarding its management, business, profits, dividends, capital, reserves, deposits and other liabilities in its advertisements soliciting deposits from the public. The periods of deposits differed by type of non-banking company. Hire purchase finance companies were prevented
from accepting short-term deposits for periods of less than six months, whereas other companies could not accept deposits for less than one year. All companies were required to furnish proper receipts for deposits, maintain deposit registers, and include in their annual reports particulars regarding overdue deposits if the overdues were, in the aggregate, in excess of Rs 10 lakh.

Except in the case of hire-purchase and housing finance companies, which were free to accept deposits without any limit but were required to keep 10 per cent of the deposits invested in approved forms as a liquid reserve, NBFCs were required to limit the total volume of deposits to 25 per cent of their paid-up capital and free reserves. The development rebate reserve was counted as a free reserve for this purpose. This ceiling was imposed from 1 January 1967 and the excess deposits were to be adjusted by the end of December 1968. However, in the case of industrial companies, the time limit for adjustment of excess deposits was up to the end of 1971, subject to certain conditions.4

In 1966, the exempted unsecured loans and deposits of financial and non-financial companies grew by about Rs 75 crore. In 1967 they increased by Rs 100 crore. But the ceiling was not in force at that time. The Reserve Bank believed that the rate of growth since then had been moderated, mainly because of the easier availability of bank credit. Another factor retarding growth could have been the requirement to deduct tax at source in respect of any interest payment in excess of Rs 400. This would have had some deterrent effect on investment of unaccounted money. Moreover, many important companies in Bombay had also reduced rates of interest by one half of 1 per cent from March 1968, and some of the companies had stopped accepting deposits either because they had reached the ceiling or because they did not find it necessary.

The explanation of the rationale for the imposition of a ceiling on deposits was that unrestricted short-term borrowing in the form of deposits, merely because it was not covered by the definition of ‘debt’ for purposes of the Capital Issues (Exemption) Order, could not be permitted without causing detriment to the interests of the borrowing company. Certain exemptions in favour of unsecured loans, such as those obtained from shareholders, directors, managing agents or secretaries and treasurers, or

4 The companies had to have declared a minimum equity dividend of 6 per cent in the five years preceding 1 January 1967 or had to have unencumbered fixed assets of book value more than twice the volume of deposits as on 1 January 1967.
guaranteed by directors, managing agents or secretaries and treasurers, had been provided as a transitional measure.  

In relation to the total amount of bank loans to industry, the exempted loans were not seen to be large. The Reserve Bank hoped that it would be possible to withdraw the exemptions before the end of 1971, by when industrial and commercial companies would have had adequate time to make more permanent and satisfactory arrangements for meeting their financial commitments. It also hoped to refix the ceilings in terms of unsecured debt for short-term periods, to the extent that such debt was not covered by the definition of ‘debt’ in the Capital Issues (Exemption) Order, 1969.

There were two important concerns that drove both RBI and government policy at the time. One was the possibility that the deposit-taking company would not be able to repay its depositors; the other was the apprehension that the company would lend to its own directors, who could then vanish. The Bank tried to respond to the oft-repeated demand that it should be in a position to intervene more effectively in cases where deposits could not be repaid by non-banking companies belonging to any category, and that, in particular, provision should be made for the liquidation or winding up these companies and for prohibiting loans by private companies to their directors and their concerns so long as these companies accepted deposits from the public.

The RBI memorandum said that even though the government had the necessary powers, under Section 439(5) of the Companies Act, 1956, to apply for winding up of a company if it was unable to pay its debts, it was not realistic and might not be even in the interests of the depositors to use those provisions extensively. The reason was that liquidation proceedings tend to be protracted and very expensive. In the case of banking companies, the law provided for exclusive jurisdiction of the court that would be in charge of matters relating to winding up, determination of the rights of secured creditors within a reasonable period, and settlement of the list of debtors of the company and realization of the debts due. Such a simplified procedure was not available in the case of non-banking companies.

On the other hand, elaborate procedures, as laid down in the Companies (Court) Rules, 1959, would have to be followed, and various items of expenditure, including the cost of preparing a financial statement, audit fees, payment to the central government in accordance with the prescribed

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5 The total amount of exempted loans that were excluded from the definition of deposits was Rs 136 crore on 31 March 1967; this was perceived to be ‘a considerable figure’ and large in relation to deposits, placed at about Rs 250 crore.
rates and legal expenses, would have to be debited to the assets of the company.

The prohibition of loans by private companies in certain circumstances was seen to be administratively inconvenient and unworkable, besides dislocating the business of a large number of holding companies to the detriment of business and industry generally. A number of private companies were holding companies serving one or more subsidiaries, and arranging for funds or guarantees for companies within the group in the event of sudden or emergent needs.

The Reserve Bank was also concerned that the money garnered by the financial companies should be directed into more productive channels and linked to the organized business system. The memorandum stated that a beginning had been made in the case of hire-purchase finance companies, which were the most important among the financial intermediaries. These companies, apart from the liquidity requirement in respect of deposits, were required to collect their outstanding hire-purchase debts within a specified period. In 1967, commercial banks were asked to accord priority to the refinancing of hire-purchase transactions relating to commercial vehicles. The Bank indicated that unsecured loans granted for financing the purchase of commercial vehicles would not be taken into account for the purpose of the ceiling for unsecured advances and guarantees.6

The Study Group of the National Credit Council (NCC) anticipated a gap in the institutional framework for the provision of loans to individual road transport operators in the private sector. For filling this gap, the Group recommended that a dozen or so medium-sized hire-purchase finance companies should be formed; that the rate of interest to be charged by the hire-purchase finance companies should be restricted to a certain ceiling under certain conditions; and, finally, that the Credit Guarantee Scheme for small-scale industries should be extended to cover all loans granted under hire-purchase terms. The Bank proposed to examine these recommendations.

There were also the chit fund companies, which operated mainly in Madras, Kerala, Delhi and Greater Bombay. The total turnover and balance-sheet assets of 194 chit fund companies as on 30 June 1966 were about Rs 80 crore and Rs 10 crore, respectively. Their methods of working, however, were a cause for concern. The Reserve Bank forwarded to the

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6 IDBI announced a scheme for discounting of promissory notes relating to the purchase of commercial vehicles under hire-purchase contracts and, subsequently, granted limits amounting to Rs 3 crore under this scheme in favour of five banks. These limits, however, were not utilized and lapsed.
government a draft consisting of directions to be issued to all chit fund companies. The objective was to ensure, firstly, that their funds were invested in approved securities and, secondly, that these funds would not be diverted.

The government, while approving the proposals, favoured further stringent provisions and suggested that the commission payable to the foreman should be reduced and that the amount of security demanded from him should be increased. The Bank believed that as the new directions would be unpopular with many of the foreman companies, the cooperation of state governments would be necessary. It also felt that it would be desirable to have a model Chit Funds Act, incorporating the provisions regarding the investment of funds in liquid and approved forms and prohibiting diversion of these funds for financing the requirements of foremen (see Appendix 1). The Bank was also of the view that formulation of schemes for the development of other financial intermediaries, namely, loan, investment and housing finance companies, had been rendered difficult by the fact that the number of such institutions of a minimum size, say, Rs 25 lakh, which were either public companies or dealt mainly with the public, was quite limited.

In early 1970, the Finance Ministry was mulling over the desirability of amending Section 2(12) of the Companies Act to include fixed deposits in the definition of debenture. The idea was to introduce some amount of control over the deposit-raising activities of companies. But the Reserve Bank, both on legal and practical considerations, did not see merit in this proposal. It pointed out that in law there was a clear-cut distinction between deposits and loans, including debenture loans—a depositor was expected to seek the deposit-taker and to ask for repayment of the amount due to him, while a debtor was expected to seek the creditor and offer to repay the loan irrespective of any demand from the creditor.

This distinction was considered important in the context of the application of the rule of period of limitation for enforcement of the claims. In support of this reasoning, the Reserve Bank cited Section 26 of the Protection of Depositors’ Act, 1963, of the United Kingdom, which treated deposits and debentures as being mutually exclusive. On the principle of *ejusdem generis*, the Bank was in favour of interpreting Section 2(12) in such a manner as to include negotiable stocks or bonds and to exclude fixed deposits—which were not negotiable instruments. In another context, the Bank decided, on administrative grounds, that the word ‘securities’ as used in Section 11(2) of the Income Tax Act, 1961, could not be held to include fixed deposit receipts in accordance with the well-settled and well-
understood commercial practice, and on the basis of three other considerations.

First, the provisions of the Companies Act in regard to the prospectus would be suitable in relation to the raising of resources in bulk through the issue of shares and debentures at fairly long intervals but would not be suitable in relation to deposits that would be received throughout the year. In particular, the provisions relating to allotments, commissions and discounts and the return of amounts received in excess would not be applicable so far as deposits were concerned. Second, there were some companies, like the Madras Industrial Investment Corporation, which depended on public deposits to a very substantial extent. Third, there were \textit{nidhis} in Tamil Nadu and Andhra Pradesh which received deposits only from their own members and generally managed their business on sound and efficient lines, and chit fund companies which ran a number of chits or \textit{kuries} at the same time and received deposits attributable to each chit or \textit{kuri}. A general restriction of all deposits (as proposed in the amendment) would be either undesirable or unworkable in relation to these institutions.

The Reserve Bank felt that, even without the envisaged amendment, the restrictions imposed by its directives, on the one hand, would be adequate to ensure disclosure of all reasonable information to the public, and, on the other hand, the quantum of deposits would also be limited and would bear some reasonable relation to the paid-up capital and free reserves of the companies, given the provision for deduction of income tax at source (vide Section 194A of the Income Tax Act, 1961). In the circumstances, it said, inclusion of deposits in the definition in Section 2(12) would create some avoidable hardship to the companies concerned and it was therefore not in favour of the amendment.

In an effort to protect the unwary public and gullible depositors, the Department of Company Affairs proposed amendments to the Companies Act, 1956, such as a new Section 149A\footnote{149A (1) Where the memorandum of any company specifies the acceptance of deposit of money from the public repayable on demand or otherwise as one of its objects, the company shall not give effect to such object and shall not commence such business unless a prospectus in such form as may be prescribed has been issued, and a copy thereof filed with the Registrar, by such company. (2) If the company accepts any deposit of money from the public in contravention of the provisions of sub-section (1), every person who is responsible for the contravention shall, without prejudice to any other liability, be punishable with fine which may extend to five hundred rupees for every day during which the contravention continues.} and a new Section 58A. The latter was intended to prohibit any company to accept or invite deposits from the
public without a prospectus in the prescribed form. In addition, no company would be allowed to accept, without prior approval of the government, deposits which in the aggregate exceeded 50 per cent of the paid-up capital of the company.

The Reserve Bank’s response was prompt, comprehensive and full of reservations. Its basic objection was that what was being proposed would amount to parallel control. Deputy Governor S.S. Shiralkar reiterated the contents of the Bank’s letter of 4 April to Kelkar, adding that the provisions as worded would deem to apply to banking companies also, which would be ‘wholly inappropriate’. Secondly, he pointed out, the Bank’s current powers were adequate and the new powers would amount to parallel control. By virtue of the powers vested under Chapter IIIB of the RBI Act to regulate deposits with non-banking companies and partnership firms with paid-up capital exceeding Rs 1 lakh, the RBI had already issued directions to companies regarding the amount of deposits, the information to be given in any advertisement calling for deposits, the minimum period for which these deposits might be accepted, etc. These powers had recently been extended to unsecured loans taken from the public. Third, and most importantly, as a ceiling had been laid down in the Bank’s directions (i.e. deposits should not exceed a limit of 25 per cent of the company’s paid-up capital plus free reserves less accumulated losses shown in their balance sheets), and unsecured loans guaranteed by directors as well as loans taken from shareholders were also subject to a similar ceiling, the proposal in sub-clause (2) of the Section 58A would ‘conflict’ with this direction. Shiralkar who had had a long stint in the Finance Ministry, suggested that V.M. Bhide, Additional Secretary in the Department of Banking, also be consulted.

The press reported that the Law Ministry was in the process of finalizing the matter. At a meeting of the Consultative Committee of the Department of Company Affairs held on 17 May 1972, under the chairmanship of the K.V. Raghunath Reddy, a member pointed out that a number of companies accepted deposits far in excess of their capital reserves, which amounted to a ‘fraud’. The member asked for some legal protection to be afforded to these ‘trusting depositors’. The Minister responded that his Department was seized of the matter and that some suitable amendments to the relevant provisions of the Companies Act were under contemplation.

The Reserve Bank recognized that there were quite a few important and far-reaching implications in the administration of the proposals, namely,
the compulsory issue of a prospectus by a company before it invited or accepted deposits of money from public, and the restriction on the total amount of deposits taken from the public to 50 per cent of the paid-up capital of the company. Shiralkar therefore considered it necessary to have them examined internally. As a consequence, an eight-page note emerged, dated 22 May 1972, the burden of which was, don’t do anything without consulting us. The note was handed over to Bhide.

Events moved quickly thereafter. In June 1972, a sub-committee of the Cabinet took up for consideration the proposed draft Bill amending the Companies Act. The Finance Ministry sought the views of the Bank. Shiralkar pointed out that the Bank’s comments were indicated in the paper sent to Bhide but, nevertheless, repeated its gist.

In late August, Bhide informed Shiralkar that the Companies Amendment Bill, 1972, had been introduced in the Lok Sabha on 11 August and that the Bill had been referred to a Joint Select Committee. The ‘Statement of Objects and Reasons’ in the Bill stated that some practices prevalent in the corporate sector—one of which was invitation of deposits from the public by non-banking companies—in so far as they might prove injurious or undesirable, were sought to be checked. The Finance Ministry also forwarded to the Bank copies of the correspondence between the Department of Banking and the Department of Company Affairs, on clause 6 of the amendment Bill seeking to introduce the new Sections 58A and 58B to the Companies Act. It showed that there was a strong difference of opinion between the two Ministries on this issue and that the DCA was determined to implement the proposal.

The Bank sent a detailed rejoinder on 8 September, together with the study of the provisions of the draft Bill by its Legal Department. The letter covered two aspects—the policy angle concerning supervision and control, and various legal issues arising out of the proposed statutory amendment of the Companies Act. Shiralkar, who had been conducting the exchange throughout, drew the specific attention of the Ministry to the Bank’s firm conviction that it would not be desirable to have more than one authority to deal with deposits of non-banking institutions as this was likely to cause confusion. The government had two options: either the entire administration of non-banking companies’ deposits could be taken over by the DCA, or the DCA could deal with the deposits of the non-financial companies while the Bank continued to deal with the financial companies. ‘On the whole,’ wrote Shiralkar, ‘it seems better if the entire administration of control regarding deposits accepted by companies is taken
over by Government as the Department of Company Affairs would be better equipped to deal with companies because of their larger field organization.'

The Legal Department’s study showed that it was not desirable to have a provision that if a deposit had been accepted before the commencement of the Companies (Amendment) Act, 1972—that would not be deemed to have been accepted by the company in terms of rules made under subsection (1)—such a deposit would have to be refunded within thirty days or any further extension that may be given by the government. Shiralkar was not convinced of the practical utility of this provision and highlighted the adverse implications of the proposed stipulation.8

Another problem was the manner in which the refund was to be made to the depositors. This was because the directions did not specify that a refund should be made in similar circumstances but that the deposits should be brought down so as to conform to the requirements of the directions. This left the choice open to the company, which could include the possibility of converting some deposits into equity capital. By prescribing a straight direction that there should be refunds, the question might arise whether the refunds should be made in any particular order or on a pro-rata basis. The depositor would face the prospect (although this might be already implied) of having to accept the refund even if it might be premature in terms of the contract between him and the company.

In view of these drawbacks, Shiralkar considered it advisable to deal with these two types of cases separately, i.e. by ad hoc orders to be made as and when necessary in consultation with the Reserve Bank, thus making for flexibility as different types of cases might require different periods for adjustment.

The third point of divergence was the protection afforded by Section

8 ‘I wonder if it is desirable to have such a provision involving almost certainly innumerable individual extensions or even whether such a provision is defensible unless the period of adjustment is adequate (which the period contemplated is not). Although the law may not be susceptible to challenge, it would seem to be a bad law, since the company would be penalized for an action which was perfectly valid when it was taken and which it could not know would be illegal in terms of some rules to be made several years thereafter. The new rules are intended to promote the public interest and we have considered them solely from that point of view and not from the interests of any one class. On the one hand, it is considered necessary to protect the depositors by limiting the volume of unsecured loans that a company may take from the public but on the other hand, a reasonable period of adjustment would be very desirable so that the legitimate manufacturing and other business activity is not suddenly crippled for lack of time for adjustment to new regulations.’
616(d) of the Companies Act, 1956. The Bank was not sanguine whether such protection would indeed be available. The scheme of Section 616 was to exclude companies like banking companies as they were covered by a separate statute, whereas Chapter IIIB of the RBI Act dealt with only a particular activity of all sorts of companies (excluding banking companies) and not a particular type of company, and, as such, it might not be possible to hold that Chapter IIIB was a special statute governing special types of companies as in the case of other types of companies enumerated in Section 616. Even if it was assumed that Chapter IIIB was a special enactment for the purpose of Section 616(d) of the Companies Act, it was arguable whether protection was available only in respect of Acts of Parliament or directions and rules issued under such enactments also; furthermore, a fundamental question arose, namely, why was such an enactment necessary at all if it was to be rendered impotent whenever it was in conflict with the directions issued under Chapter IIIB of RBI Act?

The Legal Department also suggested minor changes in the wording of some of the sub-sections to make them less susceptible to challenge on the ground that the central government had been clothed with arbitrary powers without any guidelines, which were conveyed to the government. Shiralkar took the opportunity to remind the government of the Bank’s earlier suggestion about making it obligatory for statutory auditors of companies to furnish information regarding deposits taken by them. He reiterated that if the Bank was to continue to deal with financial companies, such a provision in the Act would be essential so that the Bank might get full information even in cases where the companies omitted to send a return to the Bank. In October, the Department of Banking conveyed the Bank’s strong opposition to the DCA, to the idea of regulation over the acceptance of deposits from the public or shareholders by companies being dealt with coextensively under the Companies Act and under the RBI Act. It also pointed out that if the provisions contained in clause 6 of the new amendment Bill incorporating Section 58A were allowed to stand, the Reserve Bank would ask for repelling Chapter IIIB of the RBI Act altogether. Thus a stalemate developed.

To sort it out, R. Prasad, Secretary, Department of Company Affairs, convened a meeting on 9 October with top officials of the Department of Banking (N.C. Sen Gupta, V.M. Bhide, D.N. Ghosh and M.K. Venkatachalam). The latter pointed out that Chapter IIIB of the RBI Act and the directions issued thereunder regulated the acceptance of deposits from the public by all financial and non-financial companies and clause 6 of the new amendment Bill covered the same ground; therefore, they were in effect
parallel provisions. The representatives of the Department of Company Affairs did not agree; it argued that these were complementary and that there were no inconsistencies. Nevertheless, in order to achieve the objectives underlying the new provisions, the meeting discussed the possibilities of harmonization of any conflicts that might arise out of the operation of the two sets of provisions. The Department of Banking felt that since, from the point of view of monetary and credit policy, financial companies had a large role to play and since the question of control over financial companies had been reviewed extensively by the Banking Commission, the proposed Section 58A might be amended to exempt these classes of companies and such other classes of companies as the government might, after consultation with the Bank, specify in this regard. This would mean that as a result of the amendment, non-banking non-financial companies alone would be left within the purview of the proposed Section 58A (see Appendix 2).

The Department also pointed out that if the deposits were to be refunded after thirty days, as provided for in the Section, there would be demand for additional funds from the banking system to preserve the liquidity of the corporate sector and banks might not find it possible to meet the demand. Therefore, after considering the pros and cons of the problem, it was agreed that sub-section (3) might be made applicable only to deposits accepted after the commencement of the Companies (Amendment) Act, 1972. Further, the time within which deposits were to be refunded was to be left to be governed by rules to be prescribed so that there would be sufficient flexibility and it would not operate as an onerous burden on the finances of companies in general.

The DCA then suggested that the objective of the Department of Banking could be served by amending sub-section (5) of the proposed Section 58A. This would enable NBFCs to be notified as a class exempt from the provisions of Section 58A in the same manner as banking companies, except in regard to the obligation of publishing advertisements, which they had to comply with. Regulations on non-banking non-financial companies would be made in consultation with the Reserve Bank. D.N. Ghosh forwarded the agreed minutes of the meeting to Shiralkar. Shiralkar, in his reply, desired to have the redraft in due course and suggested that a private company which accepted deposits from the public might be subjected to the same restrictions as applied to public companies as long as such deposits were outstanding. This stipulation should apply to financial as well as non-financial companies. Reference was made to the British Protection of Depositors Act, 1963, which had a similar Section. Shiralkar also suggested
that an obligation might be imposed on the statutory auditors of companies to report on the extent to which the rules regarding deposits were being complied with by the company concerned. Towards the last quarter of 1973, the Joint Select Committee of Parliament *inter alia* accepted the amendments as suggested above to the Companies (Amendment) Bill.

The Finance Ministry advised the Bank on 28 September 1973, that the DCA had suggested that RBI should start drafting the rules under the said clause of the Bill for consideration by them. The Department of Non-Banking Companies began drafting the new rules, which was generally on the lines of the existing directions issued by the Bank to non-banking non-financial companies. Meanwhile, the Bank continued to harbour reservations on certain provisions: on the definition of a deposit, repayment of deposits, and the time allowed for repayment of unauthorized deposits. These were conveyed to the government on 2 November 1973.

In the end the Bank lost the battle. The Companies (Acceptance of Deposits) Rules, 1975, made under Section 58A of the Companies Act, 1956,

9 (i) *Repayment of deposits.* In terms of the new rule every deposit accepted by a company before the commencement of the Companies (Amendment) Act, 1973, in accordance with the directions made by the Reserve Bank of India under Chapter IIIB of Reserve Bank of India Act, shall be repaid in accordance with the said directions. The Bank felt that the scope of this clause was ‘not very clear’, as the Bank’s directions merely laid down certain restrictions about acceptance of deposits, such as their nature and quantum, and did not provide any conditions subject to which the deposits should be accepted and repaid. The Bank’s conjecture was that the total quantum of deposits might be brought down to conform to the ceiling in instalments as laid down in the directions.

(ii) *Time allowed for repayment of unauthorized deposits.* Under the Bank’s existing notification, non-financial companies holding unsecured loans specified therein in excess of the prescribed ceiling or holding irregular deposits had to work off the excess in three annual instalments before 1 April 1975. In contrast, the proposed Section 58A provided for time till 1 April 1976 for repayment of any deposit accepted in contravention of the directions issued by the Reserve Bank. The Bank surmised: ‘The reasons which weighed with the Government for laying down a period longer than that specified in the directions is not known. Perhaps the intention is that reasonable time, after the commencement of the proposed provision, should be given for repaying such deposits. Presumably, this provision was considered necessary in the Act itself so as to enable the companies to repay the excess deposits within three years notwithstanding the fact that the relative individual contracts provide for longer periods of repayment. If so, we agree with the provision. Our directions, as you are aware, are with reference to the total quantum of deposits as a proportion of paid-up capital and free reserves rather than individual deposits. (This approach has its own disadvantages but was unavoidable as there is some doubt whether subordinate legislation can supervene pre-existing contractual obligations.)

(iii) *Definition of ‘deposit’.* The Bank suggested that the term ‘deposit’ in the Explanation to the proposed Section 58A might be defined more comprehensively.
came into force on 3 February 1975. As a result, control over the deposit acceptance activities of non-banking non-financial companies was transferred to the DCA. The Bank’s directions to such companies were withdrawn from 3 June. It retained only a nominal link in the form of consolidating the data relating to non-financial companies for the purpose of annual surveys carried out by it.

Henceforth, the primary responsibility of the Reserve Bank was to administer the scheme of control over financial companies. Here, too, since the Department of Non-Banking Companies was not involved in the registration of financial companies, the only method by which it could extend its control over all the functioning financial companies not already on its list or those that were incorporated subsequently, was through maintenance of close liaison with the DCAs and the various Registrars of Companies who actually administered the provisions of the Companies Act. By arrangements entered into with them, the Registrars were furnishing to the Department of Non-Banking Companies, periodical lists of companies newly incorporated. Based on a scrutiny of the lists received from time to time, the Department called for the necessary documents from the companies to classify them and thereafter bring them within the ambit of the directions. As the gap between the number of companies as appearing in the records of the DCA and the list maintained by the DNBC was sizeable, the Raj Study Group suggested that vigorous steps should be taken to bring all the functioning of financial companies within the purview of the scheme of control, through close liaison with the Company Law authorities.

SELECTED POLICY ISSUES EXAMINED BY THE BANK

COMPANY DEPOSITS versus BANK DEPOSITS

During this period, the Reserve Bank examined several new policy issues. One of these was the question of company deposits versus deposit mobilization by banks. The point for determination was whether acceptance of deposits from the public by the corporate sector to meet part of the project cost impacted on the deposit mobilization efforts of banks, in the context of a query raised by a chartered accountant, M.P. Chitale. What happened was as follows.

In November 1972, the IDBI took up for consideration a proposal of Gujarat State Fertilizers Company Ltd (GSFCL), to raise deposits from the public to the extent of Rs 1 crore, carrying interest at 8 per cent for one-year deposits and 8.75 per cent for two years and above. In December, Chitale wrote to V.V. Chari, Deputy Governor of RBI, that even though
the company’s proposal would provide depositors a more attractive alternative, it would hamper the development of institutional credit and attempts to integrate the unorganized capital market with the organized market. State financial corporations and nationalized banks, respectively, offered interest at rates of 6 per cent and 6.5 per cent on deposits for one to two years and two to three years. Further, in order to improve their average yield, commercial banks themselves would be ‘willing and happy’ to advance a crore to GSFC for two years or more at 8.5 per cent. Chitale argued that when banks were expected to provide assistance at cheaper rates to some sectors and they happened to be the only convenient outlet for investment for persons situated away from urban centres, it was desirable to adopt practices that would improve their earning yield. In short, he was arguing for increasing intermediation.

The points he raised of considerable importance, not least because if everyone started borrowing directly, it would mean great hardship for the banks, which were expected to perform a social role as well. There was also the question of the viability of other all-India term-lending institutions. So the matter was discussed at a joint meeting of these institutions in March 1973, where it was agreed that company deposits were a normal means of financing to a limited extent, but they had to be raised at reasonable rates of interest and should be for relatively small amounts as compared to the project cost. Moreover, the acceptance of deposits from the public was not viewed with disfavour in cases where the promoters’ contribution was low and where they were not in a position to bring in additional share capital. But a proviso was added, namely, that such deposits had to carry a ‘reasonable’ rate of interest, and were to be repaid only with the prior approval of the financial institutions. The meeting also decided that the institutions might continue to follow the existing policy of treating each case on merits and accept this source of finance if the quantum, as part of the financing scheme, was moderate.

The Reserve Bank decided to examine this issue in terms of its wider policy aspects. In June 1973, a note was submitted by the Department of Non-Banking Companies (DNBC), which pointed out that the Banking Commission had examined the issue and felt that company deposits did not compete with banks so far as short-term deposits were concerned but did compete in regard to fixed deposits. A comparative study of accretion of deposits with banks and NBFCs during 1969, 1970 and 1971 revealed that, in spite of the high rates of interest offered by the latter, growth with commercial banks was much faster, which meant that deposit growth with an institution did not necessarily depend only upon the level of rate of
interest offered by it, but also upon the confidence it commanded with the investing public. Moreover, advances by commercial banks were generally security-oriented or purpose-oriented and it was doubtful whether they would have been in a position to make available amounts raised as deposits on commercial considerations, given the pre-emptions for priority sector lending or the prescriptions relating to minimum lending rates laid down by the Reserve Bank. The note said that the existing ceilings for acceptance of deposits by companies *ipso facto* circumscribed their accepting deposits without limit.

The note also pointed out that control over deposits of non-banking companies had two main objectives, namely, as an adjunct to monetary policy and as protection of depositors’ funds. Another purpose that the RBI was suggested ‘modernization’ of the capital structure of the borrowing companies by indirectly inducing them to broaden their capital base and reduce their reliance on public deposits by prescribing a ceiling on borrowings.10 The note said, ‘thus our directions provide for a built-in mechanism whereby an excessive reliance by non-banking companies over deposits as a source of financing their operations is prevented’, but admitted that the directions did not stipulate the rates of interest payable on deposits, except in the case of premature repayment of deposits. On the whole, therefore, the Department was in favour of a ‘more reasonable approach’ to the question and ‘a pragmatic view’ of the matter. It did not think that acceptance of deposits by companies from the public would have a sizeable impact on the deposit mobilization efforts of commercial banks or that the earning capacity of the latter would be materially affected.

Shiralkar then spoke to Chitale, who reiterated that GSFC, instead of being allowed to raise deposits, should have been asked to approach banks who would extend loans at 8.5 per cent because they were flush with funds, and that depositors would tend to withdraw deposits from banks where they got only 6.5 per cent and put the money in GSFC. Shiralkar, in turn,

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10 Since 1967, the Reserve Bank had allowed companies to accept deposits only to the extent of 25 per cent of their paid-up capital and free reserves. By an amendment of the directions, from 1 January 1972, unsecured loans taken by companies (other than hire-purchase finance and housing companies) from their shareholders, and loans taken from any other person or party against guarantees issued by their directors, ex-managing agents, secretaries and treasurers, which were till then treated as exempted loans, were brought within the scope of the directions and subjected to the same sort of regulation as was applicable in respect of deposits since January 1967. A separate ceiling of 25 per cent of the net owned funds was prescribed in respect of these unsecured loans.
expressed his doubts as to whether banks, even though flush with funds, would lend at 8.5 per cent, which was the State Bank of India’s prime rate, and told Chitale that banks would in any case recoup their withdrawn deposits when the companies or their contractors redeposited the funds with them. Finally, with the minimum lending rate ruling at 10 per cent on 16 July 1973, the point had lost its validity. Chitale agreed and that was the end of the matter.

**Ceiling on Interest Rates**

Another issue examined by the Reserve Bank was prescription of a ceiling on interest rates. The credit policy for the slack season 1977 had reduced interest rates on fixed deposits for periods ranging between 91 days and five years. As a follow-up, the DNBC examined whether a similar type of ceiling could be prescribed on company deposits.

The key point to note here was that the interest rates had been reduced primarily to rationalize the cost structure of banks and were confined to certain categories of fixed deposits. The cuts did not reflect a basic change in the interest rate policy because the Bank rate remained unchanged at 9 per cent. Nor had any change been made in the rates offered for other competing instruments, such as postal savings certificates. This led to the view that any imposition of a ceiling on interest rates of company deposits might induce undue suspicion about the Bank’s interest rate policy. Since the interest rate offered by non-banking companies generally varied within the maximum interest rate on deposits paid by banks and the minimum lending rates charged by them, the Bank expected the rate of interest offered by non-banking companies to come down to some extent as a result of the recent changes.

Reference was also made to the Raj Study Group on Non-Banking Companies to show that the rate of interest paid by banks acted as a barometer for the rate offered by non-banking companies. Based on this logic, some of the bigger companies had already reduced their deposit rates from 0.5 to 2 per cent, and a few companies had announced that they would accept deposits only up to three years and not five years as in the past.

On the other hand, the Reserve Bank conceded that some of the medium-sized companies or those with a weak financial base might try to attract deposits by offering slightly higher rates of interest. To that extent, a shift in movement of deposits could take place from the banking to the non-banking segment, which, however, was subject to the limits prescribed by the RBI. But the shift would be insignificant.
Above all, it was considered extremely difficult to watch over the implementation of the ceilings since the machinery of the Reserve Bank and the Company Law authorities was not adequately geared for this purpose. As the Bank’s scheme of control over acceptance of deposits by non-banking companies stood at that time, it did not include a watch over their methods of operation, management, etc., as was the case with supervision of commercial banks. If a ceiling was imposed, the companies could circumvent it by offering incentives like bonus, gifts or even cash compensation. All things considered, the Bank decided not to regulate interest rates on deposits. Governor Narasimham conveyed this to Manmohan Singh, Secretary, Department of Economic Affairs, in November 1977.

Alteration of Terms and Conditions by Companies

Two other issues that the Bank took up were the unilateral alteration of the terms and conditions by companies and a proposal for setting up a committee to look into the causes for default in payment of interest or repayment of deposits.

In 1979, the Department of Company Affairs pointed out to the Reserve Bank that Mohta Alloys & Steels Ltd had armed itself with the power to alter any term and condition agreed to at the time of acceptance of deposits without notice to the depositors. It said that the Companies (Acceptance of Deposits) Rules, 1975, should be amended to provide that the terms and conditions of deposits cannot be changed by a company, especially in respect of the interest rate payable. After making the necessary enquiries, the Department of Non-Banking Companies found that the companies were not altering the terms. The RBI then told the government that *prima facie* it was not in favour of amending the Companies (Acceptance of Deposits) Rules. But the DCA remained unconvinced and persisted. The Bank was asked to reconsider its decision and agree to the proposed amendment. It did not resile from its stand but, with a view to put an end to the controversy, it concluded its letter saying, ‘government may take such decision as might be deemed necessary and appropriate’.

The Finance Ministry took up the matter with Deputy Governor Krishnaswamy in a strongly worded letter. A.K. Ghosh, the Special Secretary, wrote:

I must confess I am unable to appreciate why the Reserve Bank of India is reluctant to agree to the proposed amendment. It is also not clear why it is necessary for a company to arm itself
with a specific provision to alter the terms and conditions after it has obtained deposits.

Krishnaswamy, apparently in view of the government’s persistence, sent a guarded reply, leaving it to the government to go ahead with the proposal provided certain difficulties anticipated in its implementation, as pointed out by the Bank’s Legal Department, were taken care of. The Bank thus gave in.

**COMMITTEE TO LOOK INTO DEFAULT CASES**

The other proposal, for setting up a committee to look into causes default, came from the Reserve Bank itself. In July 1980, the chief officer of the DNBC suggested to the government that a committee be set up to probe defaults by non-banking companies. For some reason, never fully understood, this reasonable suggestion upset the Finance Ministry.

In a letter addressed to I.G. Patel dated 19 August 1980, A.K. Ghosh opposed the proposal tooth and nail. He cited a recommendation of the James Raj Study Group, which favoured a gradual reduction in the limits of deposits accepted by each company since the main cause for such defaults was their acceptance of deposits out of proportion to their capacity to repay them at maturity, and, in several cases, the deposits were found to have been used for purposes of fixed capital formation. The Companies (Acceptance of Deposits) Rules, 1975, had been amended in April 1978 to give effect to this recommendation but the enforcement of the reduced limit of 25 per cent was to become effective from 1 April 1981 instead of 1 April 1980. He also recalled that the government had implemented another recommendation of the James Raj Study Group, viz. disclosure of information about the management and financial position of companies in the advertisements issued by them inviting deposits. The objective was to assist the intending depositors to assess the risk attendant on their deposits and thus serve as another safeguard for the depositors. The Sachar Committee had pointed out in its report that public deposits with companies primarily established a relationship of creditor and debtor inter se and in case of default there existed provisions in general law for enforcing the right of a creditor, including the right of filing a petition in a court of law for winding up of the company. Despite the view of the Committee that it was not possible to give full protection to depositors, the government at that time was considering certain measures to extend more protection to them.
Therefore, Ghosh wrote:

There does not appear to be any need for setting up any Committee at this stage to probe into causes leading to defaults by companies in repaying deposits, or to suggest measures, legislative or otherwise, to prevent such defaults. The setting up of any such Committee will not serve any useful purpose. Indeed, other than arousing false expectations in the minds of the investing public—that the Reserve Bank and/or the Government are going to take steps for ensuring refund of their deposits, which is not actually possible under the law—no benefit is likely to emerge. The law does not empower Government to direct any company to refund deposits. Any probe into the causes leading to defaults in repayment of deposits would necessarily require detailed investigation into the affairs of the company concerned, and no Committee can undertake such an enquiry.

All this led to a minor panic in the Reserve Bank and when it enquired into the matter, it found that the chief officer may have exceeded his brief. Krishnaswamy and Patel were satisfied with this elucidation and the former replied to Ghosh that the Bank saw no need to set up a committee for the purpose, thus soothing the ruffled feathers.

The initiative towards conversion of certain types of NBFCs into commercial or cooperative banks subject to Reserve Bank’s conditions, case by case, could provide some motivation for desirable deposit acceptance activities and operational aspects relating to the working of financial companies.
Prize Chit and Money Circulation Schemes (Banning) Act, 1978

The Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973, issued on 23 August 1973, covered companies conducting conventional chits as also prize chit schemes. While the subscriptions received under conventional chits specified therein were exempt from the purview of the directions, those collected in respect of prize chits, mentioned therein, were treated as deposits for the purposes of the directions, and the restrictions regarding tenure, ceiling and advertisements were made applicable to them.

It came to the notice of the Reserve Bank that companies conducting prize chits—as distinguished from conventional chits—which are essentially in the nature of lotteries, were recording a mushroom growth, especially in big cities like Ahmedabad, Bombay, Calcutta and Delhi. (The company acts as the foreman or promoter and collects subscriptions, in one lump sum or by monthly instalments spread over a specified period from the subscribers, to the scheme. Periodically, the numbers allotted to members holding the tickets or units are put to a draw and the member holding the lucky ticket gets the prize either in cash or in the form of an article of utility such as a motor car, scooter, etc. Once a person gets the prize, he is very often not required to pay further instalments and his name is deleted from further draws. The schemes usually provide for the return of subscriptions paid by the members with or without an additional sum by way of bonus or premium at the end of the stipulated period, in case they do not get the prize.)

The Study Group on Non-Banking Companies, with a view to examine in depth the adequacy or otherwise of the provisions of Chapter IIIB of the Reserve Bank of India Act and the directions issued thereunder, looked into the various aspects of the working of such companies and recommended, inter alia, the banning of prize chits only. The Study Group observed that prize chits, as distinguished from conventional chits, were schemes essentially in the nature of lotteries, and they benefited primarily the promoters and did not serve any social purpose; in the circumstances, it recommended that the conduct of prize chits, by whatever name called, should be totally banned in the larger interests of the public and that suitable legislative measures should be taken for the purpose, if the provisions of the existing enactments were considered inadequate. The Reserve Bank accepted these recommendations and, in consultation with the government, the Prize Chits and Money Circulation Schemes (Banning) Act, 1978, was enacted, to prohibit the promotion and conduct of prize chits and money circulation schemes. The Act came into force on 12 December 1978, and applied to all types of organizations, viz. companies, firms, individuals, etc., throughout the country, except Jammu and Kashmir. Although the state governments and union territories were responsible for administering the Act, the Bank was assigned a certain advisory role in the administration of the Act, namely, tendering advice to them in framing Rules under the Act, in the disposal of winding up plans submitted by promoters of prize chits and money.
circulation business, and in granting exemption to charitable/educational institutions to conduct prize chits, etc.

Incidentally, thirty companies with registered offices in West Bengal filed writ petitions at the Calcutta High Court against the application of the Act to them, contending that the Act did not apply to the types of business being carried on by them. The petitioners included The Peerless General Finance and Investment Co. Ltd, Calcutta, and Favourite Small Investments Ltd, Calcutta, two leading companies. The Union of India, Government of West Bengal and Reserve Bank of India were the respondents. The cases were pending at the time of the third quarter of 1981, i.e. towards the close of our reference period of study.

**Chit Funds Act**
Chit funds are indigenous financial arrangements that facilitate the pooling of resources of a limited number of members with limited investible funds, for meeting, to the extent possible, the needs of the other members of the group who may be in need of funds, and thus constitute convenient instruments combining saving and borrowing. The mechanism of the conventional chit fund schemes involves the pooling of resources of a group of individuals, the loaning out of amounts thus collected, and the continuance of this process of collection and distribution till the completion of the stipulated period of the schemes.

The success of chit funds largely depends upon regularity in the payment of subscriptions by prized as well as non-prized subscribers, and the utilization of these monies only towards the chit business. However, several of the chit funds, whether conducted by individuals, partnerships or even joint stock companies, sooner or later were beset by various types of irregularities, resulting ultimately in delay or default in disbursement of the prize amounts. This could be on account of misutilization or diversion of funds by the foreman or on account of default in the payment of subscriptions by prized or non-prized subscribers. In order to save the business from disaster, the foreman was often tempted to start fresh chit fund schemes to enable him to roll over the funds. In cases where enrolment of the required number of members was not possible, the foreman himself subscribed to a number of tickets, sometimes in *benami* names. Quite often, the foreman also opened places of business for conducting the chit business. Manipulation of draws and commission of other types of malpractice to the detriment of the subscribers were also reported. The financial management or overtrading thus set in motion adversely affected the financial position of the foreman and ultimately put the interests of the subscribers in jeopardy.

On the question of the end-use of the funds, the Banking Commission had pointed out that the likelihood of the prize monies being put to productive uses was small. But the Raj Study Group on Non-Banking Companies, which went into the question, felt that whatever be the position, the savings mobilized and disbursed by chit funds by way of prize amounts satisfied the felt needs of a section of the community (even though the needs may be consumption needs dictated very often
by social customs, such as moneys required for celebrating marriages and observance of religious ceremonies.). The Group also pointed out that since chit funds had come to stay, ways and means should be found to regulate their working so as to ensure that they functioned on sound lines, and that the malpractices usually observed in their conduct were obviated to the extent possible. In order to prevent any abuse by the foreman who might resort to unfair methods for securing illegal gains, the Study Group expressed the view that there was a need for regulating the activities of such chit funds.

Legislative measures to regulate chit funds were introduced in the erstwhile state of Travancore as far back as 1918 and by the 1950s many other states, like Tamil Nadu, Andhra Pradesh, Maharashtra, Uttar Pradesh and the union territories of Goa, Daman and Diu, Delhi and Pondicherry, had enacted legislation to regulate chit funds in their respective territories. While reviewing the position of the chit business as prevalent in several states vis-à-vis the legislation in the concerned states, the Banking Commission had recommended, inter alia, that it was essential to have a uniform chit legislation applicable to the whole country and, as such, either an all-India Act may be enacted or a model law prepared for adoption by all the states. At the instance of the government, the Reserve Bank drafted a model Bill to regulate the conduct of chit funds, for adoption by state governments. The draft Bill was also referred to the Study Group on Non-Banking Companies for comments. It was unanimously of the view that the Bill should be enacted as a central legislation as such a step, besides ensuring uniformity in the provisions applicable to chit fund institutions throughout the country, would also prevent such institutions from either taking undue advantage of the absence of any law governing chit funds in any state or exploiting the benefits of any lacuna or relaxation in any state law by extending their activities to such states. The Reserve Bank also recognized the need for a uniform central legislation, mainly because of the growth in the number of chit institutions, which was of a mushroom character, and the tendency of foremen to expand their business quite out of proportion to their stake in the business by a proliferation of branches or otherwise.

Contrary to the view expressed by the Banking Commission that it would be desirable to provide in the legislation that only public limited companies might run chit funds, the Raj Study Group observed that there was no objection, in principle, to chits being conducted by private limited companies also, and, on a limited scale, even by unincorporated bodies such as individuals/sole proprietorships or partnership firms. The Bill was drafted taking into account the views expressed by the Raj Study Group, by the various state governments to whom it was circulated for comments and some of the points made in representations received by the government from time to time. While making provisions for regulating chit funds on the lines of the chit regulation in force in some states, certain new provisions, such as minimum capital requirements for companies conducting chit business, prohibiting chit fund companies from doing any other business, placing a ceiling on the aggregate chit amount or chits that might be conducted at any one time, pro-
viding a self-contained machinery for settlement of disputes between a foreman and a subscriber by means of arbitration, found a place in the Bill. Though the administration of the proposed Bill vested in the state governments, the Reserve Bank was given powers to inspect the chit books or records of any foreman and to forward a copy of the inspection report or extracts thereof to the foreman concerned for rectification of any undesirable features that might be observed in the working of the foreman or institution. The Reserve Bank was also empowered to forward a copy of the report to the state government concerned for such action as might be deemed necessary. These provisions were intended to enable the Reserve Bank, as the central banking authority of the country, to oversee the business of chits as obtaining in the various states, besides enabling it to fulfil its role of tendering appropriate advice to state governments on questions of policy. Thus, the enactment of the Bill would be conducive to the conduct of chit funds on sound and healthy lines, and would minimize the malpractices indulged in by foremen to a large extent and thereby protect the interests of subscribers to chits.

As regards the other activities which these companies were authorized to undertake under their memorandums of association, under the then existing state enactments regulating the conventional chit fund business, there was no restriction on carrying on other activities. However, once the model Bill came into force, companies conducting conventional chits would be prohibited from carrying on any other type of business except with the general or special permission of the state governments concerned. As regards companies conducting prize chit schemes which were also engaged in other activities, they would be required to eschew the business of prize chit under the new dispensation.

The Chit Funds Bill was drafted by the Reserve Bank in consultation with the central government. The Bill was introduced in the Parliament in February 1979, but lapsed on account of the dissolution of the Lok Sabha. After its reintroduction on 20 November 1980, the Bill was referred to a Select Committee constituted by the Lok Sabha for further examination and report. The Bill, as revised by the Select Committee, was again referred to a Select Committee of the Rajya Sabha for quick examination. In terms of the provisions of the proposed Bill, the state governments/union territories were required to make Rules in consultation with the Reserve Bank for effective administration of the Act. Further, the Bank may be called upon to perform certain other advisory roles. The Act also required the state governments/union territories consulted the Bank before granting exemption from any of the provisions of the Act. The Chit Funds Bill, 1982, having been passed by the Parliament, received the President’s assent on 19 August 1982, and became an Act.
6. After Section 58 of the principal Act, the following sections shall be inserted, namely:

58A. (1) The Central Government may, in consultation with the Reserve Bank of India, prescribe the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members.

(2) No company shall invite or allow any other person to invite or cause to be invited on its behalf any deposit unless—
   (a) such deposit is invited or is caused to be invited in accordance with the rules made under sub-section (1), and
   (b) an advertisement, including therein a statement showing the financial position of the company, has been issued by the company in such form and in such manner as may be prescribed.

(3) (a) Every deposit accepted by a company at any time before the commencement of the Companies (Amendment) Act, 1973, in accordance with the directions made by the Reserve Bank of India under Chapter IIIB of the Reserve Bank of India Act, 1934, shall, unless renewed in accordance with clause (b), be repaid in accordance with the said directions.

   (b) No deposit referred to in clause (a), shall be renewed by the company unless the deposit is such that it could have been accepted if the rules made under sub-section (1) were in force at the time of the acceptance of the deposit.

   (c) Where, before the commencement of the Companies (Amendment) Act, 1973, any deposit was received by a company in contravention of any direction given under Chapter IIIB of the Reserve Bank of India Act, 1934, repayment of such deposit shall be made, without prejudice to any action which may be taken, under the Reserve Bank of India Act, 1934, for the acceptance of such deposit in contravention of such direction, in the manner specified in clause (d).

   (d) Repayment of one-third of the deposit referred to in clause (c) shall be made, unless it is repayable earlier under the terms of the deposit, before the 1st day of April 1974; repayment of another one-third of the said deposit shall be made before the 1st of April 1975 and repayment of the balance of the said deposit shall be made before the 1st day of April 1976.

(4) Where any deposit is accepted by a company after the commencement of the Companies (Amendment) Act, 1973, in contravention of the rules made under sub-section (1), repayment of such deposit shall be made by the company within thirty days from the date of acceptance of such deposit or within such further time, not exceeding thirty days, as the Central Government may, or sufficient cause being shown by the company, allow.

(5) Where a company omits or fails to make repayment of a deposit in accordance
with the provisions of clause (c) of sub-section (3), or in the case of deposit referred to in sub-section (4), within the time specified in that sub-section,

(a) the company shall be punishable with fine which shall not be less than twice the amount in relation to which the repayment of the deposit has not been made, and out of the fine, if realized, an amount equal to the amount in relation to which the repayment of deposit has not been made, shall be paid by the court trying the offence to the person to whom repayment of the deposit was to be made and on such payment, the liability of the company to make repayment of the deposit shall, to the extent of the amount paid by the court stand discharged.

(b) every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to five years and shall also be liable to fine.

(6)(a) Nothing contained in this section shall apply to—

(i) a banking company, or

(ii) such other company as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.

(b) Except the provisions relating to advertisement contained in clause (b) of sub-section (2), nothing in this section shall apply to such clauses of financial companies as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.

Explanation: For the purpose of this section, ‘deposit’ means any deposit of money with, and includes any amount borrowed by, a company but shall not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India.

58B. The provisions of this Act relating to a prospectus shall, so far as may be, apply to an advertisement referred to in section 58A.