CHAPTER XI

BANKING AND THE MONEY MARKET

I Banking Before Independence

The origin of money lending in India has been traced back to the Vedic period c. 2000 B.C. to 1400 B.C. More specific references have been found in the literature pertaining to the 5th century A.D. The financial organization was rudimentary and the operations consisted primarily of lending, without its modern counterpart, acceptance of deposits. The use of *hundi* as an instrument of credit made its appearance in the 12th century A.D. and laid the foundation of what later came to be called indigenous banking. By the time the British traders came to India in the 17th century, money lending and indigenous banking had been fairly well established. They formed the core of the financial market of those times.

Money lending was most often combined with other activities like trading, zamindari, etc. The methods of business varied widely. Normally loans were given on trust; sometimes they were secured against promissory notes, mortgage of land, houses, ornaments or cattle. In rural areas, loans were usually repayable at harvest time. The rate of interest was exorbitant. The indigenous bankers adopted more sophisticated business practices and were located mainly in towns and cities. The business was largely handled by *Shroffs, Chettiars, Multanis, Marwaris,* etc.

Modern banking business was initiated by British Agency houses set up in Calcutta and Bombay. Cooke has mentioned that the first bank called Bank of Hindustan was established in 1770. Later researchers have, however, doubted the validity of this statement. The development of banks was extremely slow and was confined largely to ports and important cities. The banks mainly financed trade and Government.

A major breakthrough in banking came with the establishment of the Presidency Banks in Calcutta, Bombay and Madras. The Bank of Calcutta was set up in 1806 principally to give support to Treasury Bills which were subject to acute seasonal fluctuations. Government held one-fifth of the share capital of the bank which was empowered (in 1823) to issue notes also. Subsequently (in 1840 and 1843) the Bank of Bombay and the Bank of Madras were established with minority Government participation. The Bank of Bombay went into liquidation in 1868: its place was taken by a new bank in the same

year with the same name. In 1862, the banks were deprived of the power to issue notes and in 1876 Government withdrew all its interest in banking business. The three banks were amalgamated into a single bank called the Imperial Bank of India. At the time of amalgamation in 1921, the banks had 59 branches and Rs. 7.2 crores of paid-up capital and reserves. The Imperial Bank was nominated banker to Government and it undertook some of the functions of a Central Bank. Currency management, however, remained with Government.

The development of joint stock banks was accelerated after Act VII of 1860 which introduced the principle of limited liability. However, banking was not a specialized business and most banks combined other interests as well. As such, nearly a half of the joint stock banks which came into being in 1833-60, failed. The business climate was vitiated by the cotton crisis; and in the subsequent five years, only one bank, *viz.*, the Allahabad Bank, was established. Not much headway was made in the last quarter of the 19th century. By 1900, there were only 20 commercial banks, including 8 exchange banks, with deposits of about Rs. 34 crores. The other savings institution which registered some progress was the Post-Office Saving Bank.

The pace of banking dramatically changed after 1906. In the next seven years, nine new large banks, with paid-up capital of over Rs. 5 lakhs each, were set up. These included the Bank of India, the Indian Bank, the Punjab and Sind Bank, the Central Bank of India, the Bank of Baroda and the Bank of Mysore. In 1912, the Indian Life Assurance Companies Act was passed. This introduced some rationale in insurance business but it was replaced by more comprehensive legislation in 1939.

Modern industry which had taken root in 1870 was beginning to assume definite shape after the Swadeshi movement. There were 5,189 joint stock companies in 1921-22 with a total paid-up capital of Rs. 231 crores. Jute, cotton, iron and steel, coal and tea were the major lines of activity. Industry was emerging as a potential client of the banking system. The growth of joint stock companies also necessitated a market for buying and selling shares. The first stock exchange was established in Bombay in 1887. This was followed by the setting up of stock exchanges in Ahmadabad, Calcutta and Madras.

The years 1913-24 were critical and about 161 banks with a paid-up capital of Rs. 6.75 crores went into liquidation. By 1925, there were 93 commercial banks, including 18 exchange banks, with deposits of about Rs. 212 crores. In the next five years, their number had increased to 107 and their deposits to Rs. 220 crores.

Banking business was limited in scope. Only 400 out of 2,500 towns, were served by joint stock banks and their branches. Indigenous banking and money lending still dominated the financial market. These survived even in places having banking facilities possibly because of their flexibility in business practices. To some extent, they also performed complementary functions which made them, in a limited way, a hand-maid to the banking system. Thus, the Report of the Indian Central Banking Inquiry Committee pointed out: "They performed the functions analogous to those of big brokers of the London Money Market". Available statistics indicate that there were about 100,000 money lenders and indigenous bankers in Bihar and Orissa and 20,000 in Bombay. In Bengal, the number of money lenders was 45,000 and in the Punjab 55,000.

Insurance was also making its way as a savings institution. The number of life insurance companies—Indian and foreign—went up from 72 in 1913 to 240 in 1930, with the business in force amounting to Rs. 88.66 crores.

The monetary and credit situation was not subject to unified control. As the Hilton Commission remarked in 1926: "The Government controls the currency; the credit situation is controlled as far as it is controlled at all, by the Imperial Bank. With divided control, there is likelihood of divided counsels and failure to co-ordinate . . . The only certain way to secure co-ordination is to concentrate controls in one hand. In other countries, the single controlling hand is that of a Central Bank". This recommendation was acted upon. In 1927, an attempt was made to create a Central bank called the Reserve Bank of India. The first attempt proved abortive. After considerable political debate, the Reserve Bank of India Act was passed in 1934. This was a major step in imparting a degree of cohesiveness to the monetary and credit situation, in imposing some financial discipline on scheduled banks and promoting better management of money and credit.

On the eve of the Second World War there were 679 commercial banks including 19 exchange banks. Their total deposits were Rs. 277 crores.

The war years gave a tremendous stimulus to the growth of banking. Excluding Burma, the deposits of commercial banks stepped up to Rs. 915 crores by 1944. By the time the country achieved independence in 1947, India had a fairly well developed and closely knit banking system with 648 banks having 4,819 branch offices. The deposits amounted to Rs. 1,164 crores, about 13 per cent of the national income. About 42 per cent of the deposits were invested in Government securities and 47 per cent used to give advances or

discount bills. Trade was the major client accounting for nearly a half of the total advances. Another one-third was taken up by industry.

The division of the monetary system into organized and unorganized sectors continued, although their shares had substantially altered. The organized sector comprising joint stock banks—scheduled and non-scheduled—with the Reserve Bank of India at the apex, had grown in size both absolutely and relatively. The unorganized sector was less important. It survived because first, banking was not widespread; secondly, there was some spill over of demand for funds; and thirdly, indigenous banking provided more personalized service. The co-operative sector had emerged as a source of finance in rural areas but hardly met even 3 per cent of the financial needs of agriculturists. Commercial banks had not entered the rural sector. For the bulk of their requirements the agriculturists depended on the traditional money lenders. The development of industry had given a spurt to trading in shares and organized stock exchanges had been put up in all industrial cities. There were 158 life insurance companies with Rs. 612 crores business in force. Thus the whole financial organization had, by the time the country became independent, developed sufficiently and provided the necessary infra-structure for the growth of the economy in the post-independence years.

II. History of Banking Legislation

Banking companies until 1936 were governed like other companies by the Indian Companies Act 1913. This Act, no doubt, made a distinction between banking companies and other companies but only in minor respects. For example, Section 4 of the Indian Companies Act 1913, prohibited a partnership from carrying on banking business unless it was registered as a company. Banks were required to submit returns every six months and were liable to inspection by the local Government. With the growth of the banking system and the periodical crisis to which it was exposed, it was realized that banking business was on a different footing and had to be regulated by a separate law.

It was also felt that the credit system, as in most other countries, should be brought under the control and supervision of a Central bank. The issue was examined by J. M. Keynes and Sir Earnest Cable in 1913. A specific proposal for setting up a Central bank called the Reserve Bank of India, was made by the Hilton Young Commission in 1926. After a protracted controversy and debate, the Reserve Bank of India Act was passed in 1934. The bank was set up as a share-

holders' bank with the object of "securing monetary stability in British-India and generally to operate the currency and credit system of the country to its advantage". Government control was limited to the appointment of the Governor and two Deputy Governors after considering the recommendations of the Central Board.

The specific functions of the Reserve Bank of India (R.B.I.) included issue of notes, providing banking facilities to Government and other banks, and maintaining the exchange ratio. The bank was given the exclusive right to issue bank notes. It had two Departments, *viz.*, the Issue Department and the Banking Department. Two-fifths of the assets of the Issue Department were to consist of gold coins, bullion and sterling securities. As banker to Government, the bank had to accept moneys or make payments on behalf of Government and to manage the Public Debt. Government in turn were obliged to deposit, free of interest, all their cash balances with the bank. An equally important role of the bank was to regulate the banking system in its capacity as banker's bank. Scheduled banks (and later State co-operative banks) were required to maintain with the Reserve Bank a cash balance equal to not less than 5 per cent of their demand liabilities and 2 per cent of their time liabilities in India. In return, the Reserve Bank was to provide accommodation to scheduled banks in the form of rediscounts and advances.

The relations of the Reserve Bank with the money market were to be mainly conducted through scheduled banks. The main instruments of control were the bank rate and open market operations. Since its inception, the Reserve Bank was also entrusted with three special obligations, viz.; to provide credit to agriculture, develop the bill market and to bring the unorganized sector within its ambit.

The Reserve Bank of India was a stabilizing and unifying force. But joint stock banks were not themselves subject to the type of regulation necessitated by the nature of business. The issue had been examined in 1929-31 by the Central Banking Inquiry Committee which found that the Indian Companies Act was inadequate and recommended separate banking legislation. In 1936, the Indian Companies Act was amended by the addition of a separate chapter containing provisions pertaining to banking companies. In terms of this amendment, a bank was defined as "a company which carries on its principal business the accepting of deposits of money on current account or otherwise subject to withdrawal by cheque, draft of order". This definition was soon found inadequate and had to be modified. Banks were prohibited from carrying on any other business, could not be managed by managing agents other than banking companies, and had to have a minimum capital of Rs. 50,000.

The 1936 Amendment to the Indian Companies Act was a stop-gap arrangement. A full-fledged banking law was on the anvil. The failure of the Travancore National and the Quilon Bank in 1938 hastened the pace of legislation and the Central Board of the Reserve Bank submitted proposals to Government in November 1939, in the form of a draft bill. Although consideration of the bill was postponed, some of its provisions were enacted in 1942 and 1944. After the Second World War, the bill was revised and finally enacted in the form of the Banking Companies Act in February 1949.

The Act defined the business to be carried on by banks, required banks to dispose of non-banking assets, prohibited employment of managing agents, specified minimum capital, debarred common directorships between banking companies, fixed cash reserves, restricted the nature of subsidiary companies, imposed limitations on loans to directors of firms or private companies in which directors were interested, empowered the Reserve Bank to control advances of banking companies in respect of purpose, margins or rate of interest, necessitated a system of licensing of banks, compelled banks to invest 20 per cent of their time and demand liabilities in liquid assets, made it obligatory on the part of the banks to submit information to the Reserve Bank, etc. The legislation was comprehensive and introduced considerable discipline in banking operations.

The principal object behind legislation since independence was to give a greater degree of protection to the public, exercise better control on the financial organization and management and ensure a socially desirable distribution of credit. The Rural Banking Inquiry Committee had drawn attention (in 1950) to the need for extending banking facilities to rural and semi-urban areas. On the recommendation of the All India Rural Credit Survey Committee, the Imperial Bank was nationalized in 1955 and renamed State Bank of India (S.B.I.) The State Bank was required to establish not less than 400 additional branches in 5 years. While it was to continue to undertake commercial banking functions, it was specifically desired to contribute to rural credit and provide financial assistance to small scale industries. Also, the Reserve Bank of India Act was modified to set up the National Agricultural Credit (Long-term Operations) Fund and the National Agricultural Credit (Stabilization) Fund. The object was to enable the Reserve Bank to strengthen the co-operative structure and provide larger funds for rural development. An equally important measure was the nationalization of life insurance companies and the setting up of the Life Insurance Corporation of India in 1956.

The Reserve Bank of India Act 1934 had imposed limitations on the asset pattern of its Issue Department. This 'relic of the past' was done away with by an amendment to the Act in 1956 and later in 1957. In terms of these amendments, the Issue Department was required to hold only a minimum amount of Rs. 200 crores of foreign exchange assets, Rs. 115 crores of which were to be in gold. Money supply thus became completely a matter of 'fiat'.

The Reserve Bank control on credit was further strengthened in 1956. The scheduled banks were required to keep with the Reserve Bank 5 per cent of their demand and 2 per cent of their time liabilities. These ratios were made variable between 5 per cent and 20 per cent in respect of demand and 2 per cent and 8 per cent in respect of time deposits. This measure added another dimension to the credit policy of the Reserve Bank. The Banking Companies Act of 1949 was also amended to give the Reserve Bank additional supervisory powers. Sections 12 and 16 were amended to prevent misuse of voting rights through concentration of shareholding and Sections 35 and 36 to enable the Reserve Bank to issue directives to banks in matters of policy, approve the appointment of managing directors, managers and chief executive officers, and appoint observers on the Board of Directors. Further amendment in 1959 necessitated Reserve Bank approval to appointment of Directors also.

The Reserve Bank of India was also emerging as a promotional and developmental agency. It had contributed to the share capital of the Industrial Finance Corporation of India (I.F.C.). It was providing finance to agriculture. In 1957, the Reserve Bank of India Act was amended to enable the bank to contribute to the share capital of any financial institution. This was done in anticipation of the bank's role in the Refinance Corporation for Industry which was set up in 1958. The State Bank of India Act was amended to enable it to give medium-term credit. In 1960, the Reserve Bank was enable to give credit facilities to State Finance Corporations. The Reserve Bank also subscribed to the capital of the Industrial Development Bank of India (I.D.B.I.) which was established in 1964. Similarly, the State Bank of India (Subsidiary Banks) Act 1959 permitted the State Bank to constitute 8 subsidiary banks.*

The failure of the Lakshmi Bank and the Palai Central Bank in 1960 revealed many weaknesses of small and medium banks and pressed the need for statutory powers to cope with the problem. Accordingly, the Reserve Bank was empowered compulsorily to amal-

*The Bank of Bikaner; The Bank of Indore; The Bank of Jaipur; The Bank of Mysore; The Bank of Patiala; The Bank of Travancore, The State Bank of Hyderabad and The State Bank of Saurashtra.

gamate weak banks with the strong, with the approval of the Government. The Reserve Bank was also allowed to declare a period of moratorium to facilitate such mergers and amalgamations. At the same time, to secure the interest of the public, particularly the small depositors, a Deposit Insurance Scheme was instituted. Additional measures were taken in 1962. The minimum capital of any new banking company was raised to Rs. 5 lakhs. The legal provisions in respect of liquidity of banks were altered in terms of which the minimum ratio of liquid assets to total deposits was raised from 20 to 28 per cent, comprising 3 per cent statutory reserves and 25 per cent other liquid reserves. Consequently, the Reserve Bank of India Act was also amended to require scheduled banks to maintain with the Reserve Bank an average daily balance of 3 per cent of total deposits as against 5 per cent of demand and 2 per cent of time deposits. The Reserve Bank was also empowered to vary the cash ratio from 3 per cent to 15 per cent. Thus, maximum liquidity ratio that could be statutorily imposed varied from 28 per cent to 40 per cent. The focus in credit policy gradually shifted from control of cash reserves to control of liquidity.

Supervision and control by the Reserve Bank were further strengthened in 1963 through the Banking Law (Miscellaneous Provisions) Act. The maximum voting rights of individual shareholders of banking companies were reduced from 5 per cent to 1 per cent of the total, the maximum term of office of persons managing the affairs of the bank was limited to 5 years, unsecured loans to any company in which the Chairman was interested were prohibited, the Reserve Bank was enabled to issue directions to banks regarding the maximum amount of advances or guarantees that could be given on behalf of any borrower, and was empowered to remove from office any person associated with the working of a bank, if considered desirable.

Thus, by 1963, the Reserve Bank had assumed substantial control over the working, operations and management of banking companies. But control on the credit system as such was only partial. A number of non-banking companies were also carrying on quasi-banking business. The Banking Law (Application to Co-operative Societies) Act, 1965 brought State co-operative banks within the ambit of the Reserve Bank's statutory control. The Reserve Bank also issued in 1965, and later in 1966, two directives under the Banking Laws (Miscellaneous Provisions) Act 1963 to non-banking financial companies and non-banking non-financial companies accepting deposits from the public. The directives prohibited companies from accepting deposits payable on demand and limited the period

of deposits to not less than 12 months in the case of non-financial companies and to 6 months in the case of hire-purchase companies. The latter were required to hold a certain percentage of liquid assets. The new directive issued in October 1966, restricted the amount of deposits accepted by non-banking non-financial companies, other than housing finance and hire-purchase finance companies, to 25 per cent of paid up capital and free reserves. The definition of deposits was widened in 1971 to include unsecured loans also.

The banking system had progressed fairly rapidly in the first two decades after independence. But there were some lacunae, mainly historical in nature, which failed to make the banking system conform to current social needs. There was considerable public debate which drew attention to the skewed pattern of distribution of bank credit in favour of industry, and that too, large houses. On the other hand, priority sectors like agriculture, small scale industries, exports, etc., were neglected. To overcome these deficiencies, Government adopted a scheme of social control over banks. This led to the setting up of a high level body called the National Credit Council in December 1967 and the enactment of the Banking Laws (Amendment) Act 1968. The short-lived Council was expected periodically to assess the demand for bank credit from various sectors, determine priorities for grant of loans and advances and co-ordinate lending and investment policies. The 1968 Amending Act provided for re-constitution of the Boards of Directors of banks so that more than a half of the members represented specialized fields like accountancy, agriculture, rural economy, small scale industries, co-operation, banking, economics, finance and law. At least two of the Directors were to represent agriculture, rural economy, co-operation and small scale industries. These directors were not to have substantial interest in any large or medium industrial or trading concern. A professional banker was required to be full-time Chairman and his appointment was subject to Reserve Bank's approval. Loans to directors were prohibited. Appointment of auditors needed the Reserve Bank's concurrence. The Reserve Bank was empowered to issue directions not only in the interest of depositors or proper management but also banking policy. Government was also enabled to acquire the business of any bank if it failed to comply with any directions.

The Banking Laws (Amendment) Act 1968 came into force from February 1, 1969 although banks with deposits of over Rs. 10 crores were persuaded to comply with the provisions of the bill even earlier. Simultaneously, Government set up a Banking Commission to examine the whole problem of banking organization.*

*The Commission submitted its Report in 1972.

The scheme of social control was on trial hardly for six months when Government announced the nationalization of 14 major Indian banks with effect from July 19, 1968.* The objectives of nationalization as stated in the preamble to the Banking Companies (Acquisition and Transfer of Undertaking) Act 1970 were "to control the heights of the economy and to meet progressively and serve the needs of development of the economy in conformity with national policy and objectives."

Banking legislation through the years unfolds a story of increasing Government control on banks ending ultimately in substantial ownership. The initial measures were aimed mainly at protecting the interest of the depositors. This was followed by measures specifically designed to control the efficacy of the credit system; the final act of nationalization accepts banking as essential public institution which can be best operated through public ownership.

III. The Reserve Bank of India

The Reserve Bank is the centre-piece of the money market. It issues notes, buys and sells Government securities, regulates the volume, direction and cost of credit, manages foreign exchange and supports institutions financing agriculture and industry. Within the immediate periphery of the Reserve Bank are the scheduled banks and State co-operative banks. Non-scheduled banks, which are a dying species, and the non-banking financial and non-banking non-financial companies accepting deposits from the public also fall within the ambit of the Reserve Bank's control although its extent and rigour is considerably less. The operations of the money lenders and indigenous bankers which are now relatively small are, however, largely outside the pale of the Reserve Bank policy.

The Reserve Bank has the monopoly of note issue. Small coins and one rupee notes which account for less than 9 per cent of the total currency in circulation, are, however, issued by Government. But the Reserve Bank undertakes their distribution as Government agent. Money supply in India is exposed to seasonal fluctuations, rising in the busy season, *i.e.* November-April and falling in the slack season *i.e.* May-October. At the end of April 1972, currency put into circulation by the Reserve Bank was Rs. 4,705 crores.

* These banks which had deposits of over Rs. 50 crores each include: The Central Bank of India Limited, The Bank of India Limited, The Punjab National Bank Limited, The Bank of Baroda Limited, The United Commercial Bank Limited, The Canara Bank Limited, The United Bank of India Limited, The Dena Bank Limited, The Syndicate Bank Limited, The Union Bank of India Limited, The Allahabad Bank Limited, The Indian Bank Limited, The Bank of Maharashtra Limited, and The Indian Overseas Bank Limited.

The assets and liabilities of the Issue Department at the end of April 1972 were as follows:

TABLE I

RESERVE BANK OF INDIA

Issue Department

(End April 1972)

Liabilities	*Rs. crores*	*Assets*	*Rs. crores*
Notes in circulation	4,749	Gold coin and bullion	183
		Foreign securities	222
Notes held in Banking Deptt.	54	Rupee coin	34
		Government of India rupee securities	4,364
	4,803		4,803

The Reserve Bank has offices of the Issue Department at Bangalore, Bombay, Calcutta, Hyderabad, Kanpur, Madras, Nagpur, New Delhi, Patna and Gauhati. Besides, the bank maintains currency chests with branches of the State Bank and its subsidiaries and with Government Treasuries. At the end of September 1969, these numbered 1,968.

Being banker to Government, the Reserve Bank receives and makes payment on behalf of Government, holds the cash balances of Government, manages the public debt and undertakes remittances. The Central Government usually floats securities of long maturity (over 15 years) and short maturity (less than 5 years), while the State Governments float medium-term securities (about 12 years). Before the loans are floated, which is normally in May-July, the Reserve Bank grooms the market to enable it to take up the largest amount of loans. Treasury bills are sold on tap throughout the years. The Reserve Bank holds about 37.5 per cent of the Central Government securities and 0.3 per cent of State Government securities (1969). This part of the loans of Government really amounts to deficit financing. The bank also gives ways and means advances to Government.

The monetary policy of the Reserve Bank has been described as one of 'controlled expansion' of credit. The object is to restrain prices while ensuring, at the same time, that legitimate credit requirements for production are not adversely affected. The instruments of control are the bank rate, variable reserve ratios, open market operations, selective credit control and moral suasion.

The bank rate is the rate at which scheduled banks are able to get refinance from the Reserve Bank. Currently the rate is 6 per cent. The Reserve Bank has also introduced a system of differential

interest rates which penalizes excess borrowing by scheduled banks. The impact of the bank rate changes on interest structure (interest on Government securities, debentures, preference shares or equities), has, almost on all occasions, been negligible.

The technique of variable reserve ratios was used in 1960 in the sharp rise in prices but had, according to the Reserve Bank itself, 'limited success'. Open market operations can make significant difference to the money market by:

(i) altering the ratio of securities to money in the pattern of financial assets, and

(ii) altering the maturity composition of securities.

The first factor is circumscribed by the fact that the Reserve Bank as an agent of Government, is primarily interested in selling securities and as such is not left with much freedom to buy. The second factor has helped Government to keep only a very thin margin between long rates and short rates of interest. Since 1951-52, the Reserve Bank undertook net open market purchases in six years and net open market sales in 14 years. On an average, there were net open sales to the extent of Rs. 23 crores per year.

Selective credit controls stipulate a margin, impose a ceiling or regulate the rate of interest in respect of advances against the security of any commodity or shares. These controls are imposed when the price of any commodity shows an unduly sharp rise. Selective credit controls have been imposed on a variety of commodities like foodgrains, oil-seeds, cotton and *kapas*, etc. The impact of selective credit control is limited to the extent that borrowers are able to get credit from the unorganized sector. Selective credit controls have also been imposed on advances against the security of shares with a view to checking speculation and cornering.

The Reserve Bank manages the Foreign Exchange Control. The object of the control is to bring a balance between supply of and demand for foreign exchange. The control has been in force since the outbreak of World War II. The control was put on a permanent basis with the enactment of the Foreign Exchange Regulation Act 1949. The Reserve Bank does not deal in foreign exchange directly but through authorized dealers. In addition, there are also licensed dealers who undertake limited business of buying and selling foreign currency, The Reserve Bank exercises co-ordination and supervision and also collects information for compiling the balance of payments.

The financial aspects of banking operations are reflected in the liabilities and assets of the Banking Department. At the end of April, 1972 these were as follows:

TABLE II

Banking Department

(End April 1972)

Liabilities	*Rs. crores*	*Assets*	*Rs. crores*
Capital and Reserves	155	Notes and Coins	54
National Agricultural Credit		Bills Receivable	11
(Long-term Operations) Fund,		Treasury Bills	52
National Agricultural Credit		Balances held abroad	200
(Stabilization) Fund, and		Investments	86
National Industrial Credit		Loans and Advances	
(Long-term Operations)		Government (State)	762
Fund	364	Scheduled Commercial	
Deposits:		Banks	23
(i) Government	218	State Co-operative Banks	273
(ii) Banks	266	Others	90
(iii) Others	107	Other assets	50
(iv) Other liabilities	491		

The advances of the Reserve Bank to agriculture and other rural activities through co-operative banks have substantially expanded. Outstanding short-term credit in the 20 years, 1950-51 through 1970-71, went up from Rs. 3.4 crores to Rs. 269 crores, loans under the National Agricultural Credit (Long-term Operation) Fund to State co-operative banks, State Governments and land mortgage banks from Rs. 28.6 crores in 1960-61 to Rs. 71.4 crores in 1970-71 and outstanding debentures of land mortgage banks from Rs. 0.2 crores in 1950-51 to Rs. 31.9 crores in 1970-71. The Reserve Bank has thus contributed in a significant measure to agricultural finance. But the needs are phenomenal and, consequently, additional demands have been made on the State Bank and other commercial banks.

As a developmental and promotional agency, the Reserve Bank has contributed to the share capital and bonds of the Industrial Finance Corporation of India, State Finance Corporation and the Industrial Development Bank of India.* These investments amounted to Rs. 64.6 crores at the end of March 1971. Apart from these, the Reserve Bank extends medium-term and short-term finance to I.F.C.I. and State Finance Corporations. The outstanding loans on this account were Rs. 4.1 crores (March 1971).

The Reserve Bank thus regulates money supply, controls and directs credit of the banking system, influences the structure of interest rates and provides finance on its own for agricultural and industrial development. The powers are wide and, excepting the money lenders and indigenous bankers, the whole credit system is under its control and influence.

* With effect from August 1, 1964 the shares of the I.F.C.I. held by R.B.I. stand transferred to I.D.B.I.

IV. The State Bank of India

The State Bank Group includes the State Bank of India and its subsidiaries. The bank has a Central Board of Directors and 7 local Boards at Calcutta, Bombay, Madras, New Delhi, Kanpur, Ahmadabad and Hyderabad.

The State Bank Group has close nexus with the Reserve Bank. The State Bank and its subsidiaries are agents for the Reserve Bank in places where R.B.I. does not have branches. With the nationalization of 14 major banks, the exclusive connection between Government and commercial banking through the State Bank has been superseded although these banks have not yet been authorized to transact Government business. The State Bank provides certain facilities to other scheduled banks which has earned it the title of 'lender of immediate resort'.

The State Bank Group had 3,781 branches, about 29 per cent of the total branches of commercial banks at the end of 1971. Most of these branches were in semi-urban and rural areas. The distribution by population was as follows:

TABLE III

	No. of branches	*Per cent to total*
Urban areas (Population more than 1 lakh)	725	19
Semi-urban areas (Population between 10,000 and 1 lakh)	1,541	41
Rural areas (Population below 10,000)	1,515	40

The deposits of the State Bank at the end of 1971 were Rs. 1,502 crores and of its subsidiaries Rs. 406 crores. The total deposits of the State Bank Group were about 28 per cent of the deposits of all scheduled commercial banks. Advances amounted to Rs. 1,431 crores and investment in Government securities to Rs. 504 crores.

The assets and liabilities of the State Bank Group at the end of December 1971 were as shown in Table IV.

The commercial nature of the State Bank is undoubtedly paramount. Of the total advances of Rs. 1,432 crores, loans to priority sectors were only of the order of Rs. 481.6 crores or 34 per cent. In 1968, this proportion was 18 per cent. The State Bank Group has, no doubt, more rapidly complied with social control on banking.

The major beneficiaries in the priority sector were small scale industries, exports and agriculture in that order. The State Bank has

TABLE IV

The State Bank Group

(Rs. crores)

Liabilities		*Assets*	
Capital funds	28	Cash and balances with banks	190
Deposits	2,201	Investments	681
Borrowings	98	Advances	1,457
Bills	105	Bills	105
Other liabilities	99	Premises and other assets	98

instituted a number of schemes to provide credit to small scale industries. It was responsible for 37.3 per cent of the total credit provided by all scheduled commercial banks to small scale industries. Similarly, the State Bank Group provided Rs. 122 crores for financing exports and its share in total export credit was 30.8 per cent at the end of September 1971. The State Bank Group has also made considerable headway in the field of agricultural finance. It was responsible for 35.4 per cent of credit given by scheduled commercial banks to agriculture.

V. Scheduled Commercial Banks

At the end of March 1971, there were 73 scheduled and 12 non-scheduled commercial banks. By June 1971, the number of non-scheduled banks had fallen to 7. Non-scheduled banks are either being merged with scheduled banks or are increasing their capital to pass into the scheduled category. Of the scheduled banks, apart from the State Bank, 14 major banks each with deposits of over Rs. 50 crores wesre nationalized in July 1969. Nationalized banks account for 82 per cent of the total branches and almost an equal percentage of deposits of all commercial banks. The banking system is thus substantially owned and wholly controlled by Government through the Reserve Bank.

The development of banking has not been even as between States. In Gujarat, Kerala, Karnataka, Punjab, Tamil Nadu and Maharashtra, the banking habit has been more widespread than in Assam, Bihar or Orissa. At the end of March 1972, population per branch office in Assam was 1.01 lakhs and in Bihar 1.07 lakhs, compared to the national average of 41,000. In the opening of new bank branches, considerable attention has been given to regional balance and, consequently, the disparities between States have been somewhat reduced. Similarly, with the inception of the State Bank,

and more particularly after the nationalization of 14 major banks in 1969, particular effort has been made to locate banks' branches in rural areas. As a result, the percentage of branches in rural areas rose from 22.4 per cent in 1969 to 35.6 per cent in 1971.

Branch expansion is pursued systematically under the Lead Bank Scheme introduced in December 1969. Under this scheme, banking development is governed by what has been called 'area approach'. The districts are allocated among different banks and each bank is expected to "survey the potential for banking development in the allocated districts to identify institutional and credit gaps and to take the initiative in endeavouring to fill them and thus intensively involve itself in the process of economic advancement of the district concerned". By March 1972, there were 13,309 bank branches compared to 8,284 in July 1969. This phenomenal branch expansion has brought down the average population served per bank office from 65,000 to 41,000. The distribution of branches among various categories of banks was as follows.

TABLE V

	Per cent to total branches of commercial banks
S.B.I. and subsidiaries	29
Nationalized banks	53
Other scheduled banks	16
Foreign banks	1
Non-scheduled banks	1
Total:	100

The total deposits of the scheduled commercial banks were Rs. 7,524 crores at the end of June 1972, about a fifth of the national income. In spite of the commendable progress made by banks in the 1960s, and more particularly in the past 3 years, there is considerable scope for further development. The comparative ratios of bank deposits to national income (in 1970) for some selected countries are shown in Table VI.

The rate of growth of bank deposits was about 19.4 per cent in 1970-71. If, as anticipated, national income increases at 6 per cent per year and the pace of deposit mobilization is kept up, the ratio of bank deposits to national inclome would be more than 34 per cent by 1975-76, about the same as in France and even higher than in the U.K.

The bulk of the deposits, *i.e.* about 57.3 per cent, is owned by individuals. Business, including industry, trading, financial orga-

TABLE VI

	Bank deposits as % of national income 1970
U.S.A.	49.8
U.K.	25.8
France	35.5*
Germany	60.4
Canada	43.3
Japan	87.0
India	18.0

*Relates to 1969.

nization, etc. account for only 23 per cent of the deposits. The banking system thus acts largely as an intermediary between households and business on the one hand, and households and Government on the other. The composition of deposits was as follows:

TABLE VII

	Percentage to total
Demand deposits	25.5
Savings deposits	24.6
Time deposits	49.9

Demand deposits do not earn any interest. Interest on savings deposits is 4 per cent and varies with the maturity period on fixed deposits. The rates for selected maturity periods are as follows:

TABLE VIII

	Rate of interest (per cent)
3 months	4.1/4
1 year	6
3 years	7
5 years	7.1/4

Banks have to maintain a certain proportion of their deposits in liquid assets like gold, cash, balances with the Reserve Bank and approved Government securities. The legal minimum is 28 per cent cash ratio and 25 per cent investment in gold, approved securities, etc. The Reserve Bank has also devised a system of differential interest rates in terms of which interest on borrowings from it are charged at a rate higher than the bank rate if liquidity ratio is below a certain level. Against the legal 31 per cent, the minimum liquidity ratio for purpose of borrowing from the Reserve Bank at the bank rate is 34 per cent.

Investment in Government securities is normally in short securities. This is so possibly because the potential capital loss in the case of short securities consequent on rise in the rate of interest is less. Besides, the liabilities of banks are mainly short-term and, consequently, banks would like to maintain short-term assets also. For example, of the fixed deposits, 59.3 per cent were for less than 1 year and 93.8 per cent for less than 5 years. Correspondingly of the total investments in Government securities, 56 per cent were short-term, maturing in less than 5 years.

The bulk of the deposits are used to give credit. This consists of advances, largely short-term and bills. Medium term advances are hardly about 10 per cent of the total. At the end of March 1972, the composition of credit of scheduled commercial banks was as follows:

TABLE IX

Type of Credit	*Rs. crores*	*Percentage to total*
Loans, cash credit and overdrafts	4,161	80
Bills:		
Inland	825	16
Foreign	222	4

Bills are not a popular instrument of credit. This is so possibly because of the absence of financial discipline and planning in business operations. In spite of repeated efforts made by the Reserve Bank, the Bill Market Scheme has not yielded any worthwhile results. As such, flexibility and control over the money market have been somewhat blunted. In November 1970, the Reserve Bank introduced a new Bills Discounting Scheme. The outstanding amount of bills held by the Reserve Bank had reached a peak of Rs. 45 crores on April 7, 1972.

The distribution of bank credit showed a great element of skewness. At the time when the banks were nationalized, nearly 66 per cent of the credit was taken up by industry and another 19 per cent by trade. Agriculture had a paltry share of 3 per cent. This inequity in the distribution of bank credit, though historically justified in terms of commercial banks' specialization, was possibly the main consideration in the nationalization of 14 major banks in 1969. The pattern of distribution of bank credit has since considerably changed in favour of priority sectors like agriculture, small scale industries, exports, retail trade, transport operators, professionals, self-employed and education. The total amount of credit to these

sectors rose from Rs. 438.5 crores in June 1969 to Rs. 961 crores at the end of December 1971.

Bank credit reveals a marked seasonal pattern, though lately the pitch of fluctuations has considerably reduced. In the busy season, November-April, there is a steep rise in bank credit followed by a decline, though of a lower magnitude in the slack season, May-October. This seasonal pattern reflects the predominant agricultural character of the economy. Thus advances against paddy and rice, wheat, sugar, *gur,* ground-nuts, jute, cotton, etc. rise in the busy season and fall in the slack season. No such seasonal pattern is however, discernible in respect of advances against industrial goods like textiles, iron and steel, chemicals and so on. Since the proportion of credit against industrial goods has increased in recent years, the seasonal character of advances has also been mitigated. Seasonal trends in credit induce counter variations in other assets. Thus in the busy season there is generally a reduction in Government securities and an increase in borrowings from the Reserve Bank.

Interest on bank advances has stepped up quite sizably in recent years. Currently, banks charge about 11 per cent interest on general purpose advances. But certain categories of advances, for example, exports, obtained finance at a concessional rate. There is no ceiling on interest on advances charged by commercial banks. In respect of advance against cotton which was object to price rise, the Reserve Bank stipulated 13 per cent interest. Recently a scheme of differential interest rates has also been introduced which consciously discriminates between different categories of borrowers. A concessional rate of interest at 4 per cent is stipulated to certain categories of weaker sections of the community.

VI. Foreign Banks

At the time when the Indian Central Banking Inquiry Committee reported in 1931, the financing of foreign trade was done almost exclusively by what were called exchange banks. The registered office of these banks were located outside India. Pre-emption of this business was not a matter of legal protection but a mere historical practice from the days of the East India Company. The exchange banks did not confine themselves merely to financing of foreign trade although this was their principal business. They also accepted deposits, purchased and discounted bills, etc. There were 18 exchange banks in 1928 with £ 53.3 million deposits in India.

With the progress of Indian banks and the establishment of branches abroad, the monopoly of foreign banks in the financing of foreign

trade was broken. What is more, the exchange control made it compulsory for all foreign exchange dealers to operate through the Reserve Bank. It has to be recognized, however, that foreign banks have a 'global affiliation' which facilitates collaboration between foreign and Indian businessmen and arrangement of loans in foreign currencies. It is in terms of this specilization that the Reserve Bank decides on the number and location of branches of foreign banks.

Mostly, the branch network of foreign banks is confined to port towns. The scope for branch expansion of foreign banks appears to be extremely limited. In the two years following nationalization of 14 major banks, the total number of branches of scheduled commercial banks increased by 3,716 but branches of foreign banks by only 1.

Banking laws do not make any differentiation between Indian banks and foreign banks. When banks were brought under social control informally in 1968, and through legislation in 1969, foreign banks, like Indian banks, were required to constitute advisory boards (consisting of Indians) with a majority of persons having special knowledge of or practical experience in accountancy, agriculture and rural economy, small scale industries, co-operation, banking, economics, finance and law. It was made incumbent on foreign banks informally to have as their 'own funds deployed in Indian business' an amount equivalent to 3.5 per cent of their deposits in India by creating reserves, granting loans in foreign currency to Indian parties or making deposits with the Reserve Bank in its foreign account. Foreign banks are required to maintain a credit deposit ratio of not more than 80 per cent subject to deduction in respect of export bills, etc.

There were 14 foreign banks in India accounting for about 9 per cent of the total deposits of scheduled commercial banks at the end of March 1972. Their principal assets and liabilities were as follows:

TABLE X

	Rs. crores
Liabilities	
Demand deposits	216
Time deposits	410
Assets	
Cash in hand, balance with R.B.I. and other banks, and money at call	48
Investment in Govt. securities	172
Bank credit	489

There are not many significant differences in the composition of assets and liabilities of foreign banks and Indian commercial banks except, in a small measure in respect of:

(a) the ratio of bank credit to bank deposits, and
(b) the ratio of bills to total bank credit.

The ratio of bank credit to bank deposits in the case of foreign banks was much higher than in the case of Indian banks. For example, at the end of March 1961 the ratio of bank credit to deposits was 107 per cent in the case of foreign banks compared to 71 per cent in the case of Indian scheduled commercial banks. Since then the credit deposit ratio in respect of foreign banks has been brought down to 78 per cent (March 1972), compared to 73 per cent in respect of Indian scheduled commercial banks.

The other marked difference is in the composition of bank credit. At the end of April 1972, this composition was as follows:

TABLE XI

	Foreign banks	*Indian scheduled commercial banks*
Percentage of loans to credit	75	80
Percentage of inland bills to total credit	12.5	16
Percentage of foreign bills to total credit	12.5	4

The differences in the pattern of assets reflect mainly the nature of specialization. Foreign banks allocate a large part of their business to financing of foreign trade, joint ventures, etc. Hence a larger percentage of credit is absorbed by purchase and discount of foreign bills. Foreign banks are more involved in the international economic aspects rather than in purely internal financial affairs.

VIII. Indigenous Banks

Money lenders and indigenous bankers comprised the core of the financial system until recently. In 1930, they accounted for nearly 90 per cent of the total credit. The growth of banking has since been at a relatively faster pace. As a result, indigenous bankers today hardly account for 10 per cent of the credit operations in the money market.

The number of money lenders and indigenous bankers was placed at 33,939 in the census of 1961. Of these, indigenous bankers are located primarily in urban areas and come largely from certain communities like *Multanis, Shroffs,* and *Marwaris* in the Western, Eastern and Northern India and *Sindhi Multanis, Nattukottai Chettiars* and Brahmins of Kallidaikurichy in South India. Indigenous bankers are concentrated in the industrial areas of Bombay, Ahmadabad, Madras, etc.

Indigenous bankers finance primarily those sectors which are not able to get credit from banks. These are traders, both retailers and wholesalers, small scale industries, etc. Some of the borrowers prefer indigenous bankers to commercial banks because the former provide informal and personalized services, are flexible in their approach and process proposals without delay. They mainly function on the basis of trust. The rates of interest are higher than those charged by commercial banks but lower than those charged by money lenders.

There are about 400 firms of *Multani Shroffs,* 253 of which operate in Bombay. The principal vehicle of credit used by *Multani Shroffs* is the *hundi.* The *Multanis* share risk when large loans are involved. Traders and small scale industries are the principal borrowers. The data collected by the Working Group of the Banking Commission indicate that the main sources of finance to *Multani Shroffs* are owned capital, bank borrowings and deposits. In respect of 319 firms, the components of capital employed were as under:

TABLE XII

Sources	*Rs. crores*
Bank borrowings	20.2
Owned capital	16.4
Deposits	3.7
	40.3

The *Multani Shroffs* have a close nexus with the banking system. Nearly a half of the capital employed is borrowed from commercial banks. The vast bulk of the other half is owned capital. Deposits are relatively insignificant. The *hundi* is the main instrument of credit and usually has a tenure of three months. As such, the total turnover of *Multani Shroffs* would be about Rs. 160 crores.

Unlike *Multani Shroffs,* the operations of the *Gujarati Shroffs* are akin to those of commercial banks. The bulk of the finance comes from current and fixed deopsits. Howevr, some of the *Shroffs* also combine commission agency business. The *hundi* is the principal instrument of credit and is used largely for marketing and movement of goods. In Ahmadabad, there are about 150 *Shroffs* who do exclusively financial business. In Bombay, most of the *Gujarati Shroffs* also combine other interests. The organization often takes the form of partnership, some with branches in rural areas. The financial structure of 350 *Gujarati Shroffs* (Ahmadabad and Bombay) in 1969 was as follows:

TABLE XIII

	Owned capital	*Deposits*	*Total resources*	*Advances*
150 Ahmadabad firms	5.10	11.0	16.10	14.0
200 Bombay firms	10.00	15.0	25.0	22.0
Total	15.10	26.0	41.10	36.0

The *Gujarati Shroffs* pay interest at the rate of 4 to 6 per cent on demand deposits; the commercial banks do not pay any. The *Gujarati Shroffs* also accept term deposits the interest on which goes upto 11 per cent or so. There is a call market for funds which redistributes, among the *Shroffs,* surplus funds for short periods.

The total *hundi* business of *Gujarati Shroffs* in Bombay and Ahmadabad is estimated at Rs. 600 and Rs. 300 crores respectively. Recently some of the *Gujarati Shroffs* formed themselves into groups of partnership firms and provide, in line with the business of *Marwari Shroffs,* short-term finance to retail trade, small scale industries, etc., against usnance *hundis.*

The *Chettiars* did banking business not only in South India abut also in Burma, Sri Lanka and Indo-China. Estimates about the working capital of the *Chettiars* varied from Rs. 36 crores to Rs. 105 crores. The bulk of these were owned funds. Similarly, reliable estimates about the capital resources of the *Kallidaikurichi* Brahmins are not available. But their operations were much smaller than those of the *Chettiars.* Both *Chettiars* and *Kallalidai-kurichi* Brahmins have shrunk in size and lost much of their business to *Multani Shroffs.* A few *hundi* firms have gone into banking business. Presently, there are less than 50 *Chettiar* firms doing *hundi* business.

The number of indigenous bankers known as *Marwari Kayas* in Assam is estimated at 400. They provide facilities mostly to tea gardens. They also combine other functions like retail trading, commission agency, etc.,

Indigenous banking is not an isolated sector of the money market. There is considerable inter flow of funds between indigenous bankers and commercial banks. The discounting of *hundis* by indigenous bankers enables the commercial banks to invest surplus funds for short periods. This opens a source of supplementary finanace to indigenous bankers, particularly *Multani Shroffs.* The rate of interest charged by indigenous bankers is higher,, because first, the interest rate is exposed more fully to market forces, and secondly, the element of lender's risk is greater. However, an effort has been made by some States to put a ceiling on interest rates through legislation. The Bombay Money Lenders Act puts the

ceiling at 17 per cent (since July 1971). The Mysore Money Lenders Act, similarly, imposes a ceiling of 18 per cent. With the ceiling rates and the rise in the cost of bank credit, the indigenous bankers' margins have been somewhat squeezed. The margin between commercial banks' discount rate of *hundis* and the lending rates of *Multanis* is even less than the differential between deposit rate and advance rate of commercial banks.

The indigenous bankers are largely outside the ambit of any credit policy. The Reserve Bank's attempts to establish direct links with indigenous bankers failed and all moves to integrate this unorganized sector with the rest of the financial system proved infructuous. The Banking Commission (1972) has recommended a closer link between indigenous bankers and scheduled commercial banks. The Reserve Bank control and supervision in that case will be indirect.

VIII. Insurance

The first step in regularizing insurance business was taken in 1912 when the Indian Life Insurance Companies Act was passed. The provisions of the Act soon proved inadequate and a comprehensive Insurance Act was promulgated in 1939. The Act was substantially amended in 1950. In 1956, life insurance companies numbering about 250 were nationalized. A single corporation called the Life Insurance Corporation of India was set up to take over the entire life insurance business. General insurance companies remained in the private sector. In 1968, a scheme of social control was introduced in the form of the Insurance Amendment Bill which was later passed by Parliament. These measures were considered insufficient and in 1971 Government took over management of general insurance companies through an ordinance. The companies were finally nationalized in 1972. Thus, the entire insurance business —life and general—is now in the public sector. While life insurance is handled by a single corporation, general insurance will be entrusted to four separate corporations to ensure competition.

The total business in force of the Life Insurance Corporation (L.I.C). at the end of March 1970 was Rs. 6,425 crores, nearly a fifth of the national income. The book value of the investment was Rs. 1,529 crores comprising stock exchange securities, loans, deposits and contribution to initial capital of the Unit Trust of India. The distribution of investments in India was as shown in Table XIV.

Life insurance is an important outlet for the savings of the households. In 1969-70, about 11 per cent of these savings (held in financial assets) were invested in life insurance policies. The L.I.C. has

TABLE XIV

Sectors	*Percentage to total*
Public sector	73.6
Co-operative sector	9.5
Joint sector	0.4
Private sector	16.5

become a crucial savings institution, and consequently, the pattern of its assets influences the overall distribution of funds in the economy.

The L.I.C. is a major customer for Government securities. In 1969, nearly 11 per cent of the Central Government securities and 23 per cent of the State Government securities were held by the L.I.C. What is important, the share of the L.I.C. in the public debt has been increasing over the years. The market for Government securities is now confined almost wholly to institutional investors including the L.I.C. provident funds and banks.

There were 67 Indian and 45 non-Indian insurance companies registered under the Insurance Act 1938 engaged in general insurance business. Their net premium income during the year 1969 was Rs. 106.5 crores and Rs. 16.7 crores respectively. For Indian insurers, excluding the L.I.C., the excess of income over expenditure was Rs. 13.09 crores, Rs. 5.81 of which represented an increase in reserves.

The composition of assets at the end of December 1969 was as follows:

TABLE XV

Type of Asset	*Indian Insurers*		*Non-Indian Insuruers*	
	Amount	*Percent to total*	*Amount*	*Percent to total*
Government securities	11.92	6.5	1.93	6.8
Debentures of Indian companies	14.01	7.5	1.39	4.9
Preference shares of Indian companies	13.35	7.1	0.74	2.6
Ordinary shares of Indian companies	42.06	22.4	3.22	11.4
Deposits, cash and stamps	43.37	23.1	9.99	35.3
Loans	4.71	2.4	1.25	2.6
Agents' balances outstanding	36.49	19.4	3.04	10.8
Property and other assets	18.77	19.0	6.77	2.03

There is considerable difference in the pattern of investment between the L.I.C. and general insurance. While the former invested the bulk of the resources in Government securities—Centre and States—the

latter used a larger part of the resources for investment in debentures, preference shares and ordinary shares of Indian companies. However, in absolute terms the resources at the disposal of the L.I.C. are larger. The L.I.C. holds over 9 per cent of the total number of shares quoted on stock exchanges.

The L.I.C. did not, until recently, exercise voting power in respect of shares held by it. The investment was purely financial. But with the promulgation of guidelines for conversion of loans into equities, it has been provided that the financial institutions should exercise their powers as shareholders more discreetly. This has put considerable voting power in the hands of the L.I.C.

The L.I.C. and the general insurance companies act as financial intermediaries for mobilizing capital for the private corporate sector. They underwrite capital issues. In 1970-71, of the Rs. 30.5 crores of capital underwritten, about 14.2 per cent was underwritten by the L.I.C. and 3.1 per cent by the general insurance companies. Of the total capital underwritten by them, 77 per cent was subscribed either as investors or as underwriters.

VI. Stock Exchanges

The first organized Stock Exchange was established in Bombay in 1887 and was styled as 'The Native Share and Stock Brokers' Association'. Even fifty years before the Exchange was established there were considerable dealings in securities. The number of brokers involved in this business numbered about 6 in 1850, and after the share mania induced by the American Civil War, increased to 200-250 in 1865. When the Stock Exchange was constituted in 1887 there were 318 members on the list.

The Stock Exchange in Bombay was followed by the Ahmadabad Share and Stock Brokers' Association in 1894, Calcutta Stock Exchange Association in 1908 and the Madras Stock Exchange Association (Pvt.) Ltd. in 1937. A number of other stock exchanges had sprung up during the First and the Second World Wars. But most of these were makeshift stock exchanges and collapsed soon after. When the Securities Contracts (Regulation) Act 1956 was passed, only 7 stock exchanges, *viz.*, Bombay, Ahmadabad, Calcutta, Madras, Delhi, Hyderabad and Indore, received recognition. The Bangalore Stock Exchange was registered in 1957 and recognized in 1963. There are thus 8 stock exchanges, only 5 of which were permitted to undertake forward dealing.

The Securities Contract (Regulation) Act 1956 is the major comprehensive legislation which regulates stock exchanges. The control

was operated earlier through the Bombay Securities Contract Control Act 1925 and the Defence of India Rule 94 C. The Securities Contract (Regulation) Act 1956 allows only recognized stock exchanges to carry on business.

Stock exchanges have to be approved by Government which has powers to amend any rule and frame new ones. Government can also institute enquiries into the affairs of stock exchanges. Excepting spot delivery, all other security contracts, to be legal, have to be effected through members of recognized stock exchanges. The Act empowers Government to prohibit any type of dealings on any stock exchange to prevent speculation. It is under these provisions that forward dealing in shares was banned with effect from June 27, 1969.

The Stock Exchange is not a source of finance to industry or Government. It is a market where securities like equity shares, preference shares, debentures, gilt-edged etc., are traded. By keeping the market active through spot and forward dealings, the Stock Exchange imparts liquidity to securities, promotes continuity of price, ensures free negotiability and thus makes them an attractive investment.

Securities quoted on stock exchanges can be classified into either cleared securities or non-cleared securities. Both types of securities can be dealt in for spot deliveries; but business for clearing can be done only in respect of the former. To get on the clearing list, securities must be fully paid up. Equity shares must have been admitted to dealings for at least three years to get on the clearing list. Besides, the company must be of public importance with paid-up capital of not less than Rs. 25 lakhs and the market value not less than Rs. 1 crore, at least 49 per cent of it being held by the public.

In 1969, there were 1,974 companies whose securities (equities, preference shares and debentures) were quoted on the 8 recognized stock exchanges. The paid-up capital of these securities was Rs. 2,560 crores and their market value Rs. 3,558 crores. The relative position of different stock exchanges is shown in Table XVI.

The industry-wise composition of securities has substantially changed in recent years. When the stock exchanges were set up, the vast bulk of the shares in Bombay and Ahmadabad were cotton textiles and in Calcutta, jute, tea and coal. With the industrialization of the country, a variety of new industries have emerged. The more prominent of these are engineering and chemicals. In 1969, engineering accounted for about 25 per cent of the market value of capital employed by way of equities, preference shares and debentures, and chemicals, another 10 per cent. The share of cotton textiles was 11 per cent and that of jute and coal even smaller.

TABLE XVI

	No. of listed companies	*No. of stock issued listed*	*Market value of capital Rs.* crores	*Paid up value of capital Rs.* crores
Bombay	570	1,042	1,485	1,014
Calcutta	641	1,066	897	655
Madras	361	673	405	348
Ahmadabad	127	272	307	196
Delhi	158	308	316	234
Hyderabad	38	66	57	49
Indore	14	19	34	17
Bangalore	65	108	57	47

The bulk of the shares are held by individuals either directly or through joint stock companies. The pattern of ownership was as follows:

TABLE XVII

Class of shareholders	*Percentage of shares held*
Individuals	45.58
Joint stock companies	32.76
Financial institutions	18.53
Life Insurance Corporation	9.02
Others	3.13

Share holding had attracted considerable public interest. This was particularly true of small investors. Between 1959 and 1965, for example, the total number of individual shareholders (accounts) in respect of 48 companies increased from 3,22,497 to 4,09,757. More than 93 per cent of the increase was in the small shareholder class holding shares of value less than Rs. 5,000. In terms of value, more than 64 per cent of the additional shares were held by this class. Unfortunately, however, this interest was short-lived.

The market for securities showed considerable actiivty in the mid-fifties and the early-sixties. Since 1962, however the market has been considerably subdued. The index number of variable dividend securities on base 1961-62=100 declined to 76 in 1965-66 and regained its level only in 1970-71. The index slumped again in 97.6 at the end of May 1972. In these 10 years, all other prices of commodities and assets had substantially increased, making industrial securities—equities, preference shares and debentures—an unattractive investment. This was possibly why companies were unable to raise adequate finance from the open market. The total capital raised by non-Government companies in 1971 was only about a half of that in

1961. Raising finance from the public has become a difficult task, and, as such, companies have been forced to depend, in a high measure, on financial institutions.*

Public interest in shares has been further weakened by factors which have impaired their liquidity. Banks are normally reluctant to advance against blocks of shares. For loans exceeding Rs. 50,000 secured by shares, the latter have to be transferred in the name of banks. This has made shares a poor security for bank advances and consequently diluted public interest in share-holding.

Since a large part of the finance for industry currently comes from financial institutions, it was suggested by the Dutt Committee that the financial institutions should have the option to convert a part of the loans into equities. These powers have now been given to the financial institutions and the conversion clause is usually inserted in all loan contracts exceeding Rs. 50 lakhs.

* The principlal institutions include I.D.B.I., I.F.C./S.F.C.s, and U.T.I. for long-term and medium-term funds and scheduled commercial banks for short-term funds.