HISTORICAL EVOLUTION OF BANKING IN INDIA

Najmi Shabbir*

ABSTRACT

This paper mainly analyses the early phase of Banking in India upto 1947. The phase leading up to independence laid the foundation of the Indian banking system. The initial phase (up to 1947) was a difficult period for the banking sector. In Pre-independence period most banks were small and had private shareholding, they were largely localised and many of them failed. They came under the purview of the Reserve Bank that was established as a central bank for the country in 1935. In this phase, many banks failed which was marked by the two World Wars and the Great Depression. By the end of this phase, the country's financial requirements were still catered to, in a large measure, by the unorganised sector. The focus of the banking sector was on urban areas and the requirements of agriculture and the rural sector were neglected. Although the co-operative credit movement had a very encouraging beginning, it did not spread as expected despite Government patronage.

Key Words: *Unorganised Sector, World Wars, Government Patronage, Reserve Bank, Great Depression.*

***Lecturer, Shia P.G. College, Lucknow**

Introduction

The financial Sector of a country is very critical for the development of the economy, and Banks are the most important institutions of the financial sector. Banks act as intermediaries between savers and investors. On the one hand, they collect funds from those who have surplus money and on the other they provide these funds to the investors that are the entrepreneur, firms and the companies.

A developed banking sector discharges this function efficiently and effectively. It can be seen in the modern world that only those countries have developed fast that had an efficient financial sector in general and banking Sector in particular. This is true not only of today but in the past also. The development of the economy and its various sectors depends primarily upon the flow of credit from the Banks. It has been experienced that those Sectors which have an easy access to the bank credit, develop faster as compared to those which do not have such an access. Since Banks are commercial ventures they have a natural tendency to make their credit available to those parties which are financially viable. In the process it often happens that many of the important sectors are left out which are important from a social and economic point, but might not be financially so rewarding. To address this issue the government either directly or through the central Bank of the country directs the banking sector to make their credit available to particular Sectors of the economy. Such sectors may be called the Priority Sectors. The focus of the present study is on analysing the Priority sector lending by the Banks in India. However, before coming to this specific issue, an introduction to the evolution of banking in India and its present status is necessary which is being done in the following paragraphs.

Although Banks had existed in ancient period also, their evolution can be traced back to the development of different economies and the modern pattern of banking can be traced to the fifteenth century, in Banca Monte dei Paschi di Siena in Italy (1472), Riks bank in Sweden (1668) and the Bank of England (1694). Thereafter the development of banks spread across the entire Europe, the U.S. and other colonies of the European countries.

In India, although the moneylenders etc. had existed in an ancient period also but the development of modern form of Banks is attributed to the establishment of British rule. From these early days of banking in India to the present times, Indian banking system has reached International standard with different types of Banks. There are approximately 18,000 Bank branches in the country having all modern means of bank management. For analysing the changing banking scenario historically, the time period has been divided in four phases.

I. The Early Phase of Banking in India- up to 1947
II. Banking in the Early years of Independent India- 1947 to 1967
III. After Nationalisation - 1969 to 1991
IV. Post Reforms – 1991 onwards.

1. The Early Phase of Banking In India –up to 1947

The foundations of the Indian banking system were laid down during this period. The western variety of joint stock banking was brought to India by the English Agency houses of Calcutta and Bombay (now Kolkata and Mumbai). Bank of Bombay was the first bank of a joint stock variety which was established in 1720 in Bombay[1]. This was followed by Bank of Hindustan in Calcutta, which was established in 1770 by an agency house[2]. This agency house, and hence the bank was closed down in 1832. The General Bank of Bengal and Bihar, which came into existence in 1773, after a proposal by Governor (later Governor General) Warren Hastings, proved to be a short lived experiment[3.] The first 'Presidency bank' was the Bank of Bengal established in Calcutta on June 2, 1806 with a capital of Rs.50 lakh. The Government subscribed to 20 per cent of its share capital and shared the privilege of appointing directors with voting rights. The bank had the task of discounting the Treasury Bills to provide accommodation to the Government. The bank was given powers to issue notes in

1823. The Bank of Bombay was the second Presidency bank set up in 1840 with a capital of Rs.52 lakh, and the Bank of Madras the third Presidency bank established in July 1843 with a capital of Rs.30 lakh. These banks were known as Presidency banks as they were set up in the three Presidencies that were the units of administrative jurisdiction in the country for the East India Company. The Presidency banks were governed by Royal Charters. The Presidency banks issued currency notes until the enactment of the Paper Currency Act, 1861, when this right to issue currency notes by the Presidency banks was abolished and that function was entrusted to the Government. The first formal regulation for banks was perhaps the enactment of the Companies Act in 1850. This Act is based on a similar Act of 1844 in Great Britain. With the collapse of the Bank of Bombay, the New Bank of Bombay was established in January 1868. The three Presidency banks came under the Presidency Bank Act, (1876) and it imposed some restrictions on their business. It prohibited them from dealing with risky business of foreign bills and borrowing from abroad. In terms of Act XI of 1876, the Government of India decided for the periodic inspection of the books of these banks. Until the enactment of the Paper Currency Act, 1861, the Presidency banks had the right to issue currency notes. The right to issue currency notes by presidency banks was abolished and that function was entrusted to the Government.

The first Indian owned bank was the Allahabad Bank which was set up in Allahabad in 1865, followed by Punjab National Bank in 1895 in Lahore, and Bank of India in 1906 in Mumbai. All these banks were established under private ownership. The Swadeshi Movement of 1906 gave a great impetus to joint stock banks of Indian ownership and many Indian commercial banks such as Central Bank of India, Bank of

Baroda, Canara Bank, Indian Bank, and Bank of Mysore were established between 1906 and 1913. By the end of December 1913, the total number of reporting commercial banks in the country reached 56 comprising 3 Presidency banks, 18 Class 'A' banks (with capital of greater than Rs.5 lakh), 23 Class 'B' banks (with capital between Rs.1 lakh to 5 lakh) and 12 exchange banks. Exchange banks were foreign owned banks that engaged mainly in foreign exchange business in terms of foreign bills of exchange and foreign remittances for travel and trade. Class A and B were joint stock banks. The banking sector during this period, however, was dominated by the Presidency banks. Three presidency banks were amalgamated into a single bank i.e. Imperial Bank of India in 1921 (table 1)

1.1 Setting up of the Reserve Bank and its Role

On account of Bank failures the setting up of a central bank of the country was recommended by various committees. To take care of bank failures many central banks were established all over the World[4].The US Federal Reserve was established in 1913 due to recurrent banking crises. The Reserve Bank of India Act 1934 was enacted for the setting up of the Reserve Bank of India. The reason of bank failures and the need for catering to the requirements of agriculture were the two prime reasons for the establishment of the Reserve Bank. The banking sector came under the purview of the Reserve Bank in 1935. At the time of setting up of the Reserve Bank, the joint stock banks constituted the largest share of the deposits held by the banking sector, followed by the Imperial Bank of India and exchange bank (table 2)

Table 1 : Number of Banks, Capital and Deposits (Amount in Rs Lakhs)

No of Reporting Commercial Banks						Paid up Capital and Reserves				Deposits				
End Dec	Presidency Imperial Bank	Class A'	Exchange Bank	Class B''	Total	Presidency Imperial Bank	Class A'	Class B''	Total	Presidency Imperial Bank	Class A'	Exchange Bank	Class B''	Total
1870	3	2	3	-	8	362	12	_	374	1197	14	52		1263
1880	3	3	4	-	10	405	21	_	426	1140	63	340		1543
1890	3	5	5	-	13	448	51	_	499	1836	271	754		2861
1900	3	9	8	-	20	560	128	_	688	1569	808	1050		3427
1910	3	16	11	-	30	691	376	_	1067	3654	2566	2479		8699
1913	3	18	12	23	56	748	364	#	1112	4236	2259	3104	151	9750
1920	3	25	15	33	76	753	1093	81	1927	8629	7115	7481	233	23458
1930	1	31	18	57	107	1,115	1190	141	2,446	8397	6326	6811	439	21973
1934	1	36	17	69	123	1,128	1267	149	2,544	8100	7677	7140	511	23428

Note:
': Banks with capital and reserves of Rs 5 lakh and over
'': Banks with capital and reserves over Rs 1 lakh and up to Rs 5 lakh
#: Negligible.
Source: Statistical Tables Relating to Banks in India, Various Issues

Table 2: Number of Commercial Banks in India and their Deposits

End December	Imperial Bank of India		Exchange Banks		Joint Stock Banks		Total All Banks	
	Number	Deposits (Rs crore)	Number	Deposits (Rs crore)	Number	Deposits (Rs crore)	Number	Deposits (Rs crore)
1	2	3	4	5	6	7	8	9
1926	1	80 (37.4)	18	72 (33.3)	76	63 (29.4)	95	215 (100)
1929	1	79 (37.3)	18	67 (31.4)	79	66 (31.2)	98	212 (100)
1932	1	75 (33.6)	18	73 (32.5)	87	76 (33.9)	106	225 (100)
1935	1	79 (32.3)	17	76 (31.1)	106	90 (36.7)	124	245 (100)

Note: Figures in brackets are percentage share in total
Source: Statistical Abstract Relating to Banks in India, 1935

The Reserve Bank of India Act, 1934 gave various powers to the Reserve Bank, which include the power to issue the currency notes, the custody of the commercial banks' cash reserves and the discretion of granting them accommodation. To secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage, it keeps the Reserves of the Banks. The main functions of the Reserve Bank could be classified into the following broad categories (a) to act as a banker to the Government; (b) to issue notes; (c) to act as a banker to other banks; and (d) to maintain the exchange rate. In 1935, banks were required to maintain cash reserves of 5 per cent of their demand liabilities and 2 per cent of their time liabilities on a daily basis. The task of managing the currency that was assigned to the Controller of Currency came to the Reserve Bank in March 1935 under Section 3 of the RBI Act, 1934. The provisions of the RBI Act also required the Reserve Bank to act as a banker's bank. In accordance with the general central banking practice, the operations of the Reserve Bank with the money market were to be largely conducted through the medium of member banks, *viz.,* the 'scheduled' banks and the provincial co-operative banks. The 'scheduled' banks were banks which were included in the Second Schedule to the RBI Act and those banks in British India that subsequently became eligible for inclusion in this Schedule by virtue of their paid-up capital and reserves being more than Rs.5 lakh in the aggregate. The power to include or exclude banks in or from the Schedule was vested with the Governor General in Council. Agricultural credit was a special responsibility of the Reserve Bank in terms of the RBI Act. The Reserve Bank had commenced two studies in 1936 and 1937 in this area. Almost the entire finance required by agriculture at that time was supplied by moneylenders; cooperatives and other agencies played a negligible part. During the period from 1935 to 1950, the Reserve Bank continued to focus on agricultural credit by fostering the co-operative credit movement through the provision of financial accommodation to co-operatives. A well-differentiated structure of credit institutions for providing credit to agriculture and allied activities was emerged, due to concerted efforts and policies of the Reserve Bank. Within the short-term structure, primary agricultural credit societies at the village level formed the base level, while district central co-operative banks were placed at the intermediate level, and the State co-operative banks at the apex level. The long-term structure of rural co-operatives comprised State co-operative agriculture and rural development banks at the State level, and primary co-operative agriculture and rural development banks at the decentralised district or block level. These institutions focused on providing typically medium to long-term loans for making investments in agriculture and rural industries.

The central bank, if it is a supervisory authority must have sufficient powers to carry out its functions, such as audit and inspection and restrain unsound practices and suggest corrective measures like revoking or denying licenses. However, the Reserve Bank in the earlier years did not have adequate powers of control or regulation. Commercial banks were governed by the Company Law applicable to ordinary non-banking companies, and the permission of the Reserve Bank was not required even for setting up of a new bank. The period after setting up of the Reserve Bank saw increase in the number of reporting banks. The classification of banks was expanded to include the banks with smaller capital and reserve base. Class ‘A’ banks were divided into A1 and A2. Further, two new categories of banks, viz,. ‘C’ and ‘D’ were added to include the smaller banks. Banks with capital and reserves of greater than Rs.5 lakh and included in the second schedule to the RBI Act 1934 were classified as Class A1, while the remaining non-scheduled banks with capital and reserves of greater than Rs.5 lakh were classified as Class A2. The rest of the non-scheduled banks were classified according to their size; those with capital and reserves of greater than Rs.1 lakh and lower than Rs.5 lakh were classified as Class B; banks with capital and reserves of greater than Rs.50, 000 and up to Rs.1 lakh were classified as Class C; and those With capital and reserves of less than Rs.50, 000 were classified as Class D. In 1940, the number of Reporting banks was 654.

1.2 The World War II and its Impact on Indian Banking

The effects of the Second World War (1939 to 1944) on Indian banking were far-reaching. As India increasingly became a supply base for the Allied armies in the Middle East and South-East Asia, Government expenditure on defence and supplies to the Allies led to a rapid expansion of currency. As a result, the total money income of some sections of the community rose. This combined with a diversity of causes such as the difficulty in obtaining imports, the diversion of internal supplies to war needs, the control of the channels of investment and the distortion in the pattern of income distribution, among others, led to a rapid increase in the ‘unspent margin’ in the higher income groups, which, in turn, brought about a large pool of bank deposits. Such a situation encouraged the development of banking enterprises, apart from exchange banks, whose performance was driven mainly by external factors. The number of branches increased sharply between 1940 and 1945 and most of this branch expansion was accounted for by scheduled commercial banks (other than Imperial Bank of India and exchange banks) and non-scheduled banks. (table 3)

Table 3: Number of Bank Branches: 1940-45

End Dec.	Imperial Bank of India	Exchange Banks	other Scheduled Banks	Total Scheduled Banks	Non Scheduled Banks	All Banks
1	**2**	**3**	**4**	**5**	**6**	**7**
1940	383	87	844	1314	650	1964
1941	393	84	937	1414	882	2296
1942	392	84	971	1447	1132	2579
1943	399	84	1395	1878	1396	3274
1945	428	77	2451	2956	2245	5201

Source: GOI, Reserve Bank (History) volume I

Several of the banks that expanded had very low capital. For instance, one bank with a capital of less than Rs.2 lakh opened more than 75 branches.

Conclusion

The phase leading up to independence laid the foundation of the Indian banking system. The initial phase (up to 1947) was a difficult period for the banking sector. In Pre- independence period most banks were small and had private shareholding, they were largely localised and many of them failed. They came under the purview of the Reserve Bank that was established as a central bank for the country in 1935. The *Swadeshi* Movement during this phase saw the establishment of many Indian banks, most of which continue to operate even now. In this phase, which was marked by the two World Wars and the Great Depression, many banks failed. Most of the small banks were local in character and had low capital base. As a result, they were not resilient enough. Apart from the global factors, one of the major reasons for failures of small banks was fraudulent manipulation by directors and managers and inter-connected lending. Also, several banks that failed had combined trading functions with banking functions. Partly, in order to address the problem of bank failure, the Reserve Bank was set up in 1935. In fact, central banks in several other countries, including the US, were also set up to address the problem of bank failure. However, the Reserve Bank had a limited control over banks and lack of an appropriate regulatory framework posed a problem of effective regulation of small banks. By the end of this phase, the country's financial requirements were still catered to, in a large measure, by the unorganised sector. The focus of the banking sector was on urban areas and the requirements of agriculture and the rural sector were neglected. Although the co-operative credit movement had a very encouraging beginning, it did not spread as expected despite Government patronage.

Notes and References

1. Reserve Bank of India (2006)
2. Indian Central Banking Enquiry Committee (1931)
3. Reserve Bank of India (History), Volume 1, page 6
4. *op.cit.(*1931)