COMMERCIAL BANKS IN INDIA AFTER NATIONALISATION

B. N. ADARKAR

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OBJECTIVES

(i) Publication of one or more books is English, Hindi, and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more memorial lectures annually on subjects which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subjects to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce, Bombay.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them; and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper, it being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

INTRODUCTION

According to one of the objectives of The A. D. Shroff Memorial Trust, a public lecture on Banking was arranged on 30th March, 1971. The Trust was fortunate enough to get an eminent authority on banking, and a former Governor of the Reserve Bank of India, Mr. B. N. Adarkar, to deliver the lecture. The Trustees are grateful to him, and have pleasure in publishing the text of his lecture on "Commercial Banks in India after Nationalisation" for the benefit of the banking public and educational institutions.

Mr. Adarkar's lecture is very timely, in the context of the momentous changes which are taking place in the banking structure and practices of this country. The lecture is truly stimulating and thought-provoking. It makes various constructive suggestions and indicates very wise guide-lines for the operation of nationalised banks on such sound lines as may best subserve the public interest. Nothing would be more appropriate to honour the memory of the late A. D. Shroff, who was himself a distinguished banker, than to publish such an illuminating address on banking.

N. A. Palkhivala
Chairman
The A.D. Shroff Memorial Trust

Bombay, 26th May, 1971

A. D. SHROFF

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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COMMERCIAL BANKS IN INDIA AFTER NATIONALISATION

By

B. N. ADARKAR

I am grateful to the Trustees of the A. D. Shroff Memorial Trust for the honour they have done to me by inviting me to deliver the Shroff Memorial lecture of this year. This is my first occasion since I left the Reserve Bank to speak publicly on banking or monetary problems, but what I appreciate most is the opportunity I have today to pay a homage to a great man who in his time made an outstanding contribution to realistic thinking in economic affairs. Mr. Shroff was a crusader for free enterprise, but one does not have to be a member of his school of thought to have deep respect for the sincerity of his convictions and his ardent faith in the potentialities of a free market economy. I had occasion to work with him on the Expert Committee on Forward Trading and that was a big experience for me. During that brief association, I was greatly impressed by his deep insight into the working of

Mr. B. N. Adarkar, presently Custodian of Central Bank of India, was educated in Bombay and Cambridge. Starting his career with the Bank of India Ltd., subsequently he has held many important positions such as being a member of the Indian Tariff Commission, an Executive Director of the International Monetary Fund, and Joint Secretary of the Union Commerce & Industry Ministry. He was a Deputy Governor of the Reserve Bank of India from 1965 till 1970 when he became the Governor. His publications include "Indian Tariff Policy"; "Devaluation of the Rupee"; "The Gold Problem" and "History of the Indian Tariff".

the financial world and his bold and commonsense approach. The fact that he recommended a scheme of regulation for forward trading in commodities showed that he could take a pragmatic view of controls and believed that it was only in that way that controls could be kept under control.

2. The first lecture in this series which was delivered in December 1967 by Mr. H. V. R. Iengar related to banking. His subject was "The Role of Central Banking Authority and Commercial Banks in a Planned Economy". Since then, fourteen banks have been nationalised and some data have become available about their working. I shall try in this lecture to review these data and to evaluate the working of the nationalised banks in the light of some general principles. The views expressed by me are entirely my personal views and do not reflect the policies or views of the Government of India, the Reserve Bank of India or Central Bank of India.

II

3. Bank nationalisation was a historic event associated with a political crisis. The question of compensation which dominated the hearings at the Supreme Court was of interest to the public mainly as an issue of public policy. So far as the shareholders were concerned, their contribution to the total resources of the banking system was in any case of the order of 3 to 4 per cent. Vast masses of people, on the other hand, acclaimed the measure as heralding a programme of radical economic reform symbolising Government's determination to realise their avowed socialist goals. In particular,

the Prime Minister made an explicit commitment that bank credit would hereafter be made available on a much larger scale than hitherto to agriculture and small scale industry and for the first time to several other poor and neglected sections of the community which had suffered for centuries from exploitation by money lenders and middlemen. Nobody thought that bank nationalisation had ushered in a millenium, but what evoked widespread enthusiasm was the feeling that Government had at last realised the potentialities of banking as an instrument of social welfare and had wrested it from private hands. Social Control could not make the same impact on people, because it envisaged a pace of reform (inevitable under a system of private ownership) which was too slow to satisfy public opinion.

4. *Structurally the banking system in India has gained distinctly in strength and cohesion after nationalisation.* The policies and working of the major nationalised banks have now been brought into closer harmony and co-ordination with those of the State Bank of India and its subsidiaries which, prior to nationalisation, moved in a somewhat different orbit. A better environment has thus been created for the formulation and implementation of monetary and banking policies. Secondly, the deposits of the nationalised banks are now better protected than they were before nationalisation. Consequent on nationalisation, the shareholders' equity has been transferred to Government and along with it the ultimate liability to depositors. *While the security of deposits is thus better assured, a*

heavier responsibility is thrown on the Management of nationalised banks to so conduct their affairs that there is a steady accretion to the banks' capital funds to absorb any losses, past or present, and thus to avoid an erosion of deposits. Government, therefore, found it necessary to set up an agency of its own in the form of the Department of Banking in the Ministry of Finance to supervise the management of banks. Of course, the powers of supervision and control vested in the Reserve Bank of India under the Banking Regulation Act remain unchanged except to the extent they have been modified by the Bank Nationalisation Act. Apart from the supervision exercised by the Reserve Bank, the erstwhile shareholders had the primary responsibility to ensure sound management of their banks; with nationalisation, that responsibility has now devolved on Government and is exercised through the Department of Banking.

5. Banking is a difficult art, more so when it has to combine financial and monetary discipline with the maximum effort to serve a credit-starved and credit-hungry community. On the one hand, the nationalised banks have to carry out the community's mandate to provide credit to certain neglected sectors like agriculture, small-scale industry, small scale business, self-employed people, transport operators, etc. which, under the influence of tradition and vested interests, were hitherto denied adequate access to the banking system. This involves a tremendous expansion of the branch network and increase in the number of accounts, adding greatly to the cost and complexity of admini-

stration. Nationalisation is also expected to correct the former apathy of banks towards the financing of public utilities, the various development agencies in the public sector and other projects of public interest. In other words, nationalised banks have now to cope with substantial new demands on their resources and may find it difficult to resist them, partly because they spring from accepted social and political goals, and partly because of the banks' own anxiety to live down their earlier reputation of apathy towards the sectors concerned. On the other hand, nationalisation does not absolve the banks from their obligation to maintain proper financial and monetary discipline. Banks do not cease to be commercial concerns even after nationalisation; they remain trustees for the community's savings and in fact their obligations in this respect become more onerous after nationalisation because the latter makes them answerable to the community at large and not merely to a small body of shareholders. A good banker must always aim at so deploying the deposit resources entrusted to his care as to minimise losses and earn sufficient profits for allocation to reserves; nationalised banks must also be judged by the same standard. Some percentage of losses is unavoidable in banking business, but the security of deposits is ensured if the banker builds up sufficient reserves to absorb such losses; he can do so only by earning sufficient profits. If sufficient reserves are not available to cover bad and doubtful debts and losses arising from other reasons, the bank's paid-up capital, which in the case of a nationalised bank is part of the community's investment.

will have to be drawn upon to meet the liability to depositors. Similarly, the compensation paid to the shareholders of the nationalised banks constitutes the community's investment in these banks and the aim should be to earn a reasonable return on such investment after providing for bonus, taxation and a reasonable allocation to reserves. Opinions may differ as to what constitutes a reasonable return, but since interest has to be paid on the compensation bonds issued to shareholders at 5½%, the profits transferred by a nationalised bank to Government should work out to at least that percentage, if not in each year, at least over a period of years. Any shortfall in relation to this minimum will constitute a drain on the Exchequer. Thus, *even after nationalisation the return on investment will continue to be an important yardstick for measuring the performance of banks.* Sufficient data are not yet available to judge the profitability of nationalised banks on a full year's working. The results for 1969 included less than six months of the post-nationalisation period and the net profits were arrived at after various adjustments for the period prior to nationalisation. The balance sheets for 1970 are yet to be published.

6. My stress on the profit motive should not be misunderstood as implying that the nationalised banks should give precedence to profits over the social objectives for which they were nationalised. *It is wrong to think that banks cannot earn a reasonable return on capital if they carry on their operations with due regard to their social obligations. Not all rural banks need run at losses, nor need the risk*

of loss on small loans be necessarily greater than on large loans. There may be cases where particular operations undertaken in pursuance of some social objectives result in loss of profits, but such policy induced operations should be segregated wherever possible from the bank's normal operations and if it is decided to pursue the objectives in question, their impact on the bank's profitability should be estimated to the extent possible, so that a proper assessment could be made of the bank's performance in its normal operations. In the absence of such approach, a fall in profits which may really be due to inefficient management may be attributed to uneconomic operations undertaken on grounds of public policy and *vice versa.* *If social objectives are accepted as an excuse for a lower return on capital, banks will have no incentive to combine social objectives with a high standard of management. Under the guise of social objectives losses may be incurred which will really be due to inefficient management. It is, therefore, essential to devise a management and accounting system whereby uneconomic operations undertaken on grounds of public policy are separately accounted for and bank's performance is judged by the rate of return earned by them on their normal operations.* Segregation of uneconomic operations will have the incidental advantage of focussing attention on the circumstances which make them uneconomic and provoking an inquiry as to how they could be remedied. For example, if, instead of treating all rural branches as uneconomic and thus enabling banks opening a large number of rural branches to explain away their low profits on that ground alone, rural branches in particular undeveloped areas are alone regarded as eligible for special treatment, banks will be forced to pay greater attention to location, staffing pattern and the ways and means of developing local business so that the rural branches as such will not be a drag on their profits for a long period. Rural branches in particular undeveloped areas where losses are likely to be chronic could then become the subject of a special study to see whether the losses could be minimised by special devices like mobile offices, offices working on a few days in a week or by such other means. This is only an illustration. There may be many other transactions in respect of which nationalised banks have to depart from normal commercial principles on grounds of public policy; in the interests of financial discipline, such transactions should be earmarked for special treatment so that they do not blur the responsibility of the banks to observe commercial principles and earn a reasonable rate of return on their normal operations.

7. *While financial discipline is the essence of sound banking, monetary discipline is vital to the health of the economy as a whole.* When the available savings are insufficient to finance even the most essential projects, there is continual pressure on the monetary authorities to create money to let such projects go through. The created money may take the form of deficit financing by Government and/or extension of credit by commercial banks in excess of their deposit resources, i.e. out of funds borrowed

from the Reserve Bank. To the extent the authorities yield to such pressures, there is inflation, and the demand for credit increases further, both on account of rise in prices and increase in speculative activities. In such a situation, *the commercial banks have a two-fold duty to perform; to put forth their best endeavour to mobilise deposits, and secondly to check extension of credit so as to avoid excessive borrowing from the Reserve Bank.* If the Reserve Bank were to allow liberal refinance facilities at bank rate, commercial banks could borrow heavily from the Reserve Bank and still earn good profits. That would, however, mean a lowering of monetary discipline. Thus profitability, which implies good financial management, is not a sure index of monetary discipline. A good bank should try to secure the best of both worlds : to mobilise deposits to the maximum extent possible and deploy them wisely and profitably, but at the same time to take good care to see that its loan portfolio does not bulge so much it has to borrow heavily and persistently from the Reserve Bank to fulfil its loan commitments. However, any plan of credit restriction, if defined only in overall terms, hurts — and hurts not only speculative activities but genuine production too. *To ensure a steady growth of production and employment, it is necessary to exercise purposeful discrimination between one demand for credit and another. In other words, a scheme of credit priorities and of credit planning must be an integral part of any scheme of credit restriction. A credit-hungry economy which is also suffering from a chronic state of inflation has to accept credit restraint as a more* *or less normal feature of its monetary system and must, therefore, have proper arrangements for credit planning so that there is always a rational allocation of credit between different sectors of the economy. Thus, for a proper exercise of monetary discipline, all the three aspects, namely, deposit mobilisation, credit restraint and as its natural concomitant credit planning must be taken care of.*

8. While emphasising the need for credit restraint, I do not wish to subscribe to the extreme view that credit expansion by commercial banks should be rigidly restricted to what they can support out of their own deposit resources. There is often a time lag between the emergence of new credit needs and the growth of deposit resources and the Reserve Bank has to provide bridge finance to avoid the risk that otherwise such needs may have to be met only by diversion of resources from other sectors and this may cause dislocation in the economy. Some new needs are such that having regard to their magnitude and duration, they can be absorbed in accruing deposits over a short period. Much of the credit expansion which takes place during what is called the busy season is of this kind; the additional requirements are largely of short duration and any unabsorbed increase in credit remaining at the end of the busy season is absorbed by the deposit accretion in the slack season. Borrowings from the Reserve Bank to meet such short term increases in the demand for credit last for a short period and serve a legitimate function. Traditionally commercial banks are expected to pay off their busy season borrowings from the Reserve Bank not later than

30th June. In recent years, however, owing to the growing importance of the manufacturing industry among the borrowers from the banking system, the distinction between the busy season and the slack season is getting blurred and the proportion of busy season credit being returned to the system during the slack season is declining year by year. This increases the strain on the resources of commercial banks and increases their dependence on the Reserve Bank unless they exercise due restraint on their credit expansion during the busy season. There are, however, other demands for credit which are altogether of different priority, magnitude and duration; for example, the demands arising from food procurement or the financing of buffer stocks of foodgrains, sugar and other commodities. The banking system cannot possibly meet these demands out of the deposit resources accruing during a year or so without upsetting its entire pattern of lending. A good part of these demands has to be met out of funds provided by RBI, admittedly out of created money, and such assistance has to remain outstanding beyond the normal period of six or nine months. The Reserve Bank's scheme of refinance recognises the need for using created money to finance demands of this kind for a relatively long period, but this may encourage banks to depend on this source of finance for an indefinite period. The scheme aims at tapering off the assistance from year to year requiring banks either to pay off a growing proportion of it out of their own resources or else to pay a penal rate. The penal rate has the effect of restricting the banks' borrowings from the Reserve

Bank and consequently their credit expansion, unless, of course, the banks are permitted to pass on the penal rate to their customers. Under the Reserve Bank's refinance scheme, in computing a bank's excess borrowings from the RBI, on which a penal rate becomes leviable, the borrowings against its credit for specified priority purposes (e. g. food procurement) are excluded only partially, in some cases to the extent of the increase over a base period which is shifted from year to year, in other cases, only upto 50 percent of such increase, so that the bank has to finance the balance of such credit out of its own deposit resources or else to pay a penal rate on its excess borrowings from the Reserve Bank. Thus, while the Reserve Bank's refinance facilities provide a temporary respite to banks in respect of their credit to priority sectors, banks are not thereby absolved from the necessity to take over the burden of financing such credit in due course, either by mobilising additional deposits or by adjusting their loan portfolio. There is nothing objectionable in using created money to get over a hump in the demand for credit, provided such created money is allowed to remain outstanding only for a reasonably short period during which banks should be expected to carry out the necessary adjustments. This principle holds good even in respect of sectors like agriculture, small scale industries, retail trade, other small scale business, transport operators and professional and self-employed people, where the banks have been asked to go all-out to make additional credit available; banks must gear themselves to provide such credit out of their own deposit resources sooner or later.

Unrestricted extension of credit out of created money can generate inflationary pressures and eventually do serious harm to the economy, however laudable is the purpose for which such credit is provided in the first instance.

9. To some of you it may appear that I am merely stating some elementary text-book principles. Those who take this view may well be right. However, it is my personal belief confirmed by silent observation throughout my official career that most vital issues of public policy call for nothing more than an exercise of commonsense, and when wrong decisions are taken, it is often because considerations other than commonsense have prevailed. It often happens that when principles are agreed, practice is taken for granted, without realising that a constant effort is required to ensure consistency beween the two. It is not, therefore, an altogether fruitless exercise to remind ourselves of certain basic principles of sound banking which must be observed in order to make bank nationalisation a success.

III.

10. To my mind *the major achievements of nationalised banks are in the realm of branch expansion, deposit mobilisation and extension of credit to agriculture, small scale industry and certain other hitherto neglected sectors.* The facts about the banks' achievements in all these respects have now been so widely publicised that a brief reference here will suffice. In July 1969, i.e. at the

time of nationalisation, the public sector banks, which include the State Bank of India and its subsidiaries and the 14 nationalised banks, had 6633 branches; in September 1970 the number had increased to 8598, i.e. they had opened 1965 new branches in a period of 14 months. Of these 1651 were in rural or semi-urban areas and 314 in urban and metropolitan areas. There are vast areas in the country which are still untouched by commercial banking; even now there is only one bank office for a population of 52,000 in India, as against 14,500 in Japan, 6,000 in U.S.A. and 4,000 in U.K. We have a long way to go before each and every one of our more than 5,67,000 villages is brought within reach of a bank office. Moreover, thanks to the Green Revolution, the improvement in agricultural productivity and the rise in commodity prices, there is a rise in agricultural incomes, and therefore, in savings and these can be tapped and used for national development programmes only by extending the operations of commercial banks and other financial institutions to rural areas. A branch office provides a base of operations without which a bank cannot effiectively handle its new responsibilities in the matter of financing of agriculture or of other sectors of the rural economy. Branch expansion was, therefore, given the highest priority after nationalisation and the banks were urged to go full steam ahead in opening offices, particularly in rural and semi-urban areas and in underbanked States. *It must be said to the credit of public sector banks that they took up this challenge and executed their branch expansion programme at a speed* *which was altogether without parallel in the banking history of this country.* If one thinks of the time taken to select a location, to fix up premises, to select and train staff, to print stationery and to do a host of other things necessary for opening a branch, big or small, one cannot but be impressed by the current rate of branch expansion, which for the public sector banks is nearly 160 new offices per month, as against a monthly average of 38 offices during the three pre-nationalisation years ending December 1968.

11. *The current rate of branch expansion can be maintained without risk to the banking system only if adequate arrangements exist for training and orientation of branch managers, for proper choice of locations, for inspection of branches at suitably short intervals and for Head Office coordination and control.* The internal organisation of many of the nationalised banks has been deficient in all these respects and it is not easy to make good these deficiencies in a short time. *It is, therefore, incumbent on the authorities to see that branch expansion programmes are accompanied by concurrent action to strengthen the internal organisation of banks, wherever it is weak, in these respects, and to fix branch expansion targets only after a careful examination of the personnel and other resources available to individual banks to manage a vast network of branches.* Banking is a decentralised operation and involves large delegation of powers to branch managers. An over-rapid branch expansion entails the risk of untrained or otherwise unsuitable individuals being appointed as branch managers.

Targets have their value as a means of pulling a system out of a rut and giving it a push, but thereafter performance should be judged more by quality than speed.

12. In the matter of branch expansion, the accent of policy has been largely on correcting the earlier tendency of commercial banks to open branches in metropolitan and urban areas. While the desirability of extending banking services to rural and semi-urban areas is beyond question, where rural and semi-urban offices result in losses, due regard must be paid to the capacity of each bank to sustain such losses without unduly impairing its overall profitability on which its viability as a financial institution depends. This calls for a careful appraisal of the economics of branch expansion, taking into account not only the direct earnings and expenses of a new office, but its contribution to the over-all earnings and expenses of the bank as a whole. It will be a good exercise to make a projection for each bank, and for the system as a whole, as to the quantum of losses sustained on new offices (i.e. offices opened after a base period) year by year and the stages at which the gains will balance and exceed the losses.

12.A. Consequent on the phenomenal growth and dispersion of the branch network, the training of branch agents and accountants has assumed special importance. Many banks do not have a large enough programme for training branch agents and accountants, their training courses being mostly designed to train fresh recruits or to train middle level employees in certain specialised fields like foreign exchange or financing of agriculture or small scale industry. It is essential that bankers should try to make good this deficiency as a matter of top priority. Secondly, in many banks the arrangements for Head Office control and coordination have become inadequate in strength and quality to cope with the rapid increase in the number and dispersion of branches. Inter-branch reconciliations are often in arrears. There is need for stricter appraisal of the potentialities of each location where a new bank office is to be opened and a more continuous assessment of the impact of branch operation on the resources and profits of the bank as a whole. Thirdly, as a system grows in size, communication, inspection and follow-up become less and less effective, because of the sheer weight of paper required to be handled, unless new methods are devised to deal with these aspects. There has to be appropriate delegation of powers to lower levels, and such delegation has to be matched with suitable inspection and follow-up procedures. While each bank is fully seized of the importance of these matters and changes are being made in internal organisation, progress in these matters is rather slow in relation to the pace at which branch expansion is taking place.

13. *In the matter of deposit mobilisation, commercial banks can be reasonably proud of their record over the last few years.* The new offices have helped to spread the banking habit in the rural areas and to bring within the banking system and for productive use resources which would have otherwise been used for wasteful consumption or

hoarding of gold and silver. The annual rate of deposit accretion has increased from 11 to 12 per cent to over 16 per cent during the last three years as may be seen from the figures given below:

ANNUAL INCREASE OF DEPOSITS OF ALL COMMERCIAL BANKS.

		Amount (Rs. in crores)	Percentage
1968	...	459	12.1
1969	...	656	15.4
1970	...	797	16.2

To some extent commercial banks acquire more deposit resources as overall monetary resources expand as a result of Government's deficit financing or other factors. While banks cannot claim much credit for increase in deposits resulting from this source, a good part of the increase is in fact due to the bank's own efforts to promote savings and to popularise the banking habit in areas where new incomes are being generated.

14. Despite the increase in deposits, most commercial banks are unable to satisfy the demand for credit, even for genuine productive purposes, and have to borrow heavily from the Reserve Bank, which means that *the economy needs a much higher rate of deposit accretion. However, the rate of deposit growth is partly a reflection of the rate of saving and beyond a certain limit bank credit cannot fill the gap between genuine savings on the one hand and the investment needs on the other. A shortage of bank credit is unavoidable in an economy suffering from a shortage of savings.* Second-

ly, rise in prices and increase in bank credit often form a vicious circle, one feeding the other, and the monetary authorities are forced to resort to credit squeeze as an anti-inflationary measure. It is no use denying the fact that such credit squeeze has its adverse effects on production, and when these effects begin to be felt, the Reserve Bank and the banks generally are criticised for following policies which are harmful to production. The Reserve Bank, however, has to keep an eye on the total amount of created money going into the system in any period, having regard to a realistic estimate of the growth of output. Credit needs of even genuine production have to be fitted within the limits set by this consideration — the consideration of not allowing the total amount of created money to grow *ad lib* — so that it is inevitable that the needs of some production sectors are met in full and those of others are only partially met. While all production and trade may be deemed entitled to the services of the banking system, the over-all shortage of resources makes it unavoidable to give priority to those sectors where an increase in production could be expected to be of substantial help in improving the overall price situation. Theoretically a credit plan could be evolved which satisfies the credit needs of all priority sectors and yet keeps the quantum of credit creation, whether by way of banks' borrowings from the Reserve Bank or by way of deficit financing by Government to the minimum, but life is not perfect and in putting through a plan of credit restraint various adjustments have to be made on account of the practical difficulties in revoking prior commitments or in recalling outstanding loans. *If the fact that owing to an overall shortage of real resources, a cut in credit facilities is unavoidable even for genuine production purposes in some sectors were more widely appreciated, there would be less criticism and more willing acceptance of the credit policies and operations of the Reserve Bank and commercial banks.*

15. The loanable funds at the disposal of banks in any period depend partly on the repayments of loans disbursed earlier. The normal pattern of bank credit in India is expansion from November to April followed by contraction in the following six months. It has been observed, however, that latterly the distinction between the busy season and the slack season is getting blurred inasmuch as the return flow of funds during the slack season is diminishing year by year, with the result that the banks' borrowings from the Reserve Bank are increasing in each successive busy season. Part of the explanation may lie in the fact that non-seasonal credit (e.g. credit for the engineering industries) now constitute a much higher proportion of outstanding credit. In one seasonal industry, namely, sugar, overproduction has led to funds being locked up in carry-over stocks. Apart from these factors, an additional factor which is difficult to assess quantitatively is the tendency of producers to accommodate traders and *vice versa.* In a period of credit shortage, such mutual credit extension between different parts of the economy increases;

mostly credit against book debts goes up and book debts are allowed to remain outstanding for a longer duration and bills are drawn for a longer period. The latest move of the Reserve Bank to reform the Bill Market system under which a good part of the credit to banks is going to be made available by refinancing their portfolio of genuine trade bills instead of their cash credits and overdrafts is likely to be an antidote to this tendency. *The new Bill Market Scheme will bring about quicker turnover of funds between banks and their borrowers and greater mobility of funds between banks and within the money markets generally.* The buyers will have to get the bills drawn on them accepted by their banks so as to bind them to pay their dues by definite dates. However, the buyers of raw materials are also sellers of finished goods and whatever inconvenience they suffer as buyers as a result of having to make regular payments will be amply compensated by their receiving regular payments as sellers of goods. Banks have already reduced their discount rates for bills backed by bank acceptances and since such bills are eligible for rediscounting with the Reserve Bank on very favourable terms, banks may be prepared to grant somewhat higher bill limits in lieu of the existing limits for book debts and for discounting ordinary DA or DD bills. *To get the maximum benefit for the economy from the limited credit resources, it is essential that commercial and industrial borrowers should practise utmost economy of credit and accept a measure of discipline in regard to the payment of their current dues. I would, therefore, take this opportunity* *to appeal to the commercial community to make the Reserve Bank's new Bill Market Scheme a success.*

16. The current shortage of credit is aggravated by two important factors : one is the burden now placed on nationalised banks to finance food procurement and distribution which was previously the responsibility of the State Bank alone, and the second is the growing demand for credit from agriculture and small scale industries. Both these factors have come to stay and there is no denying the fact that banks will have to adjust their credit portfolios suitably to accommodate them. Such adjustment can be carried out without a sharp reduction in credit to other sectors if the banks' deposit resources expand sufficiently to accommodate the new demands; however, there is a limit to the increase in deposit resources one may reasonably expect in a short period, and banks, therefore, need special refinance facilities from the Reserve Bank during the transitional period. The refinance scheme of the Reserve Bank provides for special facilities in respect of banks' credit to the priority sectors as well as to the food procurement agencies but the overall quantum has been found to be far too inadequate when the current increase in demand for credit from the two sources is compared with the current growth of deposits. *I feel that there is scope for liberalising the present refinance facilities of the Reserve Bank to take care of the increased demand for credit for food procurement and priority sectors, where such demand is high in relation to the optimum growth of deposits which the RBI may expect*

individual banks to attain. Judging from some of their recent measures, the monetary authorities seem to be well aware of the need for such controlled liberalisation.

17. Credit restraint and credit planning must go hand in hand in order that the limited credit facilities may be rationally allocated among the different sectors of the economy. *Prior to nationalisation, the National Credit Council was charged with the task of evolving a credit plan. It is high time a new credit council was set up to perform this function. The Council should be composed of individuals selected for their knowledge and expertise and not on the ground that they represent particular sections of credit users, as otherwise the Council may become only a forum for ventilating grievances or settling conflicting claims.*

18. *The expansion of credit to agriculture and small-scale industries was a trend started after the introduction of social control over banks but which gained momentum after nationalisation. Public sector banks, particularly their executives deserve praise for the alacrity with which they took the new task upon themselves and reoriented their policies and procedures to cope with it.* Prior to the introduction of social control, agriculture and small-scale industries absorbed only about one percent and six percent respectively of the total outstanding credit of public sector banks. These percentages increased to five percent for agriculture and eight percent for small-scale industries on the eve of nationalisation; one year after nationalisation, the

corresponding percentages were approximately nine percent and eleven percent respectively. In the case of agricultural credit, the number of accounts has increased from about 48,000 (June 1968) to 1,76,600 in June 1969, and to 7,30,700 in September 1970. In the case of credit to small-scale industry, the corresponding figures are 45,000, 62,200 and 1,27,400. Thus public sector *commercial banks have made good progress towards what was one of the main objectives of nationalisation, namely, to give the small borrower an access to bank credit.* However, there are two aspects which call for attention. First relates to the shortage of manpower resources: lending to a small man calls for the same degree of care and specialisation as lending to a large borrower and it takes time to build up a specialised cadre. Secondly, in view of the large number of accounts involved in loans to agriculture and small-scale industry, elaborate arrangements have to be made for pre-advance inspection, follow-up and recovery; the pace of lending will depend on the bank's ability to make such arrangements. Thirdly, in areas where a bank is trying to extend agricultural credit for the first time, some preliminary studies have to be made to identify the purposes for which such credit can be of maximum benefit to agriculture under local conditions. Most banks have only a limited staff at their disposal for carrying out such studies. Shortly after nationalisation, commercial banks allocated among themselves the 335 districts of the Indian Union in order that each of them may function as a Lead Bank in the districts allotted to it, and in collaboration with other banks, including cooperative banks, bring about a spread of banking services and extension of credit for productive purposes. Under the Lead Bank Scheme, some surveys have been carried out and new offices have been or are being opened at localities selected during the course of such surveys, but the main objective of bringing about a purposeful extension of credit so as to generate productive activity and employment in less developed areas is still far from being achieved. *Branch expansion is only the first step towards extension of banking services to rural and backward areas. The performance of lead banks should be judged not only by the number of branches opened by them but also by the number of projects for improving productivity or creating new employment opportunities which they are able to sponsor or finance in rural and backward areas. Many lead banks have a long way to go in building up the necessary organisation for this type of activity. Care has to be taken to see that excessive preoccupation with branch expansion does not divert attention from the basic and more difficult task of generating production and employment opportunities in rural and backward areas.*

IV

19. Now a few words about the management of the nationalised banks. These banks are at present managed by the First Board of Directors, but in a short while the scheme of management which was recently placed before Parliament will come into force. The scheme is well conceived and provides for due flexibility to enable Government to vary the

pattern of management from one bank to another according to circumstances. It follows the provisions of the law in regard to the representation of the depositors and the employees of the bank and the general body of farmers, workers and artisans on the Boards of Directors. It also provides for official representation on these bodies and for the setting up of various consultative organs to ensure that bank managements are duly apprised of national policies and of the credit needs and the deposit potential of the different areas and sectors of the economy. *Indeed some measure of official guidance is necessary and unavoidable in any scheme of public management, but it is important to ensure that despite such guidance, the Boards of Directors remain fully accountable for the final results, in terms of both profit and loss and service to the community. Official guidance should never go so far as to prejudice the accountability of the Boards of Directors. Equally, the principle of accountability should not be stretched so far as to leave the Boards free to adopt policies of their choice subject only to their being judged by the results at the end of the year.* While it is beyond question that the viability of a bank, whether nationalised or not, will ultimately depend on its profits and reserves, even where it is feared that particular policies which Government may wish a nationalised bank to follow may adversely affect profits, the Boards of Directors should not be deemed free to decide whether to follow such policies or not, but should on the contrary be held bound to comply with them. In such a situation, Government alone will be responsible for whatever adverse effect the particular policies have on profits and reserves. *But to allocate responsibility is one thing, to divide accountability is another. Efficient management of public enterprises requires that the Boards of Directors alone remain accountable for the final results.* To illustrate, where a bank shows lower profits, this may be due to faulty management or to circumstances beyond the bank's control, including certain policies which it had to follow, or certain operations it had to undertake, under official guidance. Thus the bank's Board is not fully responsible for the final results, but this does not mean that it alone should not be accountable; the Board may well account for the final results in terms of factors within its control and those beyond its control. *To ensure that the Boards alone remain truly accountable for the final results, official guidance should be provided in such form and manner that the Board is able to account for the results, and Parliament and the public are able to assess them, in terms of factors within the Board's control and those outside its control.* When a bank's working ends up in poor results, for which both faulty management and official guidance may be responsible, the management and control system must be such as to enable the impact of these two factors to be distinguished in some measure so that faulty management does not escape criticism under the alibi of official guidance or *vice versa. An attempt is worth making to specify matters considered suitable for official guidance,* so that the Boards will attach special weight to the views expressed by official representatives on such matters. On other matters the duties and responsibilities of official representatives should be on par with those of other directors. *Just as the official directors should not be regarded as having a representational role in all matters regardless of whether they call for official guidance or not, it needs to be clarified that the duties and responsibilities of other directors drawn from specified sector like depositors, employees, workers, farmers and artisans are not limited to their respective special interests, but include in their scope the wider interests of the institution and the community. Indeed, the institution will remain viable and prosper only in the measure official policies as well as policies aimed at promoting sectional interests, are framed with due regard to the capacity of the institution to bear the financial burden involved. This calls for a high sense of responsibility on the part of all directors and an ability to reconcile their representational role with their equally important duty to safeguard the viability of the institution.*

V

20. To sum up, commercial banks in India have made rapid strides towards the goals set before them at the time of nationalisation, though they have still a long way to go. Banking services have been extended, geographically and functionally. Almost all the districts in the Union have been covered by bank offices, although there are still thousands of villages which are devoid of banking facilities. The small borrower now enjoys much better access to banking facilities than he did before nationalisation. All leading public sector banks have reoriented their

lending policies in favour of agriculture and small-scale industries which accounted for about 9 percent and 11 percent respectively of their outstanding credit as at the end of September 1970. In trying to achieve these results in a short period, the banks' administrative machinery has come under a severe strain and profits have also declined.

21. It is essential at this stage that commercial banks take good care to consolidate the gains already achieved by strengthening their internal information and control systems and also by maintaining a proper balance between remunerative activities and those where losses are unavoidable for some time, so that their current profits are not unduly reduced.

22. On the whole commercial banks have readily responded to the challenge of nationalisation and have absorbed the new stresses and strains without dislocation. The Banking Commission headed by Shri R. G. Saraiya is currently examining the long term aspects of banking development and will no doubt recommend important reforms in the organisation, methods and policies of commercial banks.

23. An important reform which is long overdue is the revival with suitable changes in composition and functions, of the National Credit Council to formulate plans for allocation of credit among the different sectors of the economy in the light of the resources becoming available from time to time and to promote a better understanding on the part of the public of the need for credit restraint and credit discipline.

24. The task before the commercial banks is enormous and beset with difficulties arising *inter alia* from staff relations and the time-consuming process of training up the personnel required for some of the new functions assigned to them.

25. Since nationalisation, Parliament and the public are watching the performance of commercial banks with keen interest and considerable importance is now attached to their role in national economic development. There is need for sympathetic understanding of their difficulties so that there will be more patience about the pace at which they are able to move towards their new goals.

26. With professional management, the risk of interference by vested interests has now been greatly minimised. There is no reason why under the new set-up commercial banks should not come up to the nation's expectations. The difficulties in achieving quick results are not peculiar to the banking system; they are inherent in an economy of our size struggling with limited resources to cope with the rising expectations of a poverty ridden people.