UNIT 25 GROWTH OF MODERN BANKING SYSTEM, NATIONALISATION OF BANKING AND INDUSTRIES*

Structure

25.1 INTRODUCTION

In **Units 5** and **6**, you have studied the dominance of Indian merchant-financiers, particularly the Chettiars, Marwaris and Shikarpuris combining banking and brokerage and the role of *sarrafs* in issuing *hundis* for commercial transactions. The present Unit is a saga of survival, collaboration, fall and finally almost exit of the Indian merchant-financiers. You would find the transition of these caste-based merchant-financiers, particularly the Chettiars, into joint-stock banking, even though they could succeed to a limited extent in establishing their own joint-stock banks. The Unit further focuses on the processes of the introduction of modern banking in colonial India and its aftermath and finally, the banking reforms in the post-colonial period.

25.2 BANKING IN COLONIAL INDIA

The introduction of 'modern' banking in Colonial India, as Amiya Bagchi puts it, was 'basically to find cheaper money for the government in times of war'. The establishment of The Bank of Bengal should be seen in terms of Wellesley's financial drain during the Anglo-Mysore wars.

The earliest banks in colonial India were the banks established by Agency Houses.[1] In Bengal the first bank, The Bank of Hindustan was established in 1770s by the Agency House Alexander & Company. In 1819 Commercial Bank and in 1824, Calcutta Bank were also floated by the Agency Houses. The next joint-stock bank, Union Banks, established in 1829, was promoted by Mackintosh & Company. In eastern and Upper India, with the exception of Union Bank and Dacca Bank, other early banks so established had exclusively European promoters.

* Prof. Tirthankar Roy, London School of Economics and Political Science, London, UK

[1] Agency Houses were the establishments of private English merchants. They were financed by the capital of the East India Company's servants. Apart from banking, they were involved in shipping and trading in indigo, sugar, cotton, silk and opium. Some of the major agency Houses were: Alexander & Co.; Palmer & Co.; Fergusson & Co.; Mackintosh & Co.; and Cruttenden & Co.; Indian partners were Carr, Tagore & Co.

In Madras, by the end of the eighteenth century, three private banks ? The Carnatic Bank, The Madras Bank, and The Asiatic Bank (1804) – were in operation, and largely thrived on the Ramp of Arcot and by funding the Mysore wars. The major Agency Houses associated with them were: Harrington & Co., Lautour & Co., De Fries & Co. However, following the famine of 1805-1806 in Madras Presidency, a number of Agency Houses collapsed: Chase & Co.; Tulloh & Co. In 1812, the biggest Agency House in Madras, Harrington & Co. also collapsed. In 1806, the Government Bank was established by Lord William Bentinck. The Bank of Madras was the first government-sponsored joint-stock bank established in 1843.

In Bombay, the Company's government heavily depended upon Agency Houses particularly during the second Maratha War. In 1836, John Skinner proposed the establishment of The Bank of Bombay on the lines of the Bank of Bengal, initially vehemently opposed by the prominent merchant-financiers Forbes & Co., Schotten & Co, and Jamsetjee Jejeebhoy & Sons, which could finally be established in 1840.

Thus, by 1843, all three Presidencies had government-backed Presidency Banks, with the difference that The Bank of Bombay was more of a joint venture between British and Indian business houses.

Following The Bank of Bombay, The Bank of Western India was establishedand promoted by both Indian and European merchants. However, later it received a charter[2] and named Oriental Bank of Commerce with its head-office in London, thus turned exclusively a European firm. Followed by Commercial Bank of India and Mercantile Bank of India, in which the leading part was played by Cowasjee Nanabhoy Davar. After acquiring a charter it became The Chartered Mercantile Bank.

The interesting trend of these banks was that even with Indian promoters, there was a tendency to move towards port and finally to London, thus becoming exclusively European institution. These banks were largely financing external and international trade.

The Bank of Bengal not only assisted the Government of Bengal in stabilizing public credits, but at the same time, it helped European merchants in Calcutta provide a large liquidity base. This had transformed joint-stock Indo-British finance into British-dominated finance; this got hastened, particularly after the 'Agency House Crisis'[3] of 1826-1834, which resulted in the complete dominance of the Europeans in external trade finance. The first bank to collapse was Alexander & Co. and its Bank of Hindustan. Presidency Bank and Union Bank, though they survived, suffered heavy losses. Another crisis struck in the 1860s with the American Civil War. In 1860, there was a cotton boom. However, an abrupt end to the civil war in 1865 resulted in the bankruptcy of Bombay's leading merchants (including the Director of the Bank of Bombay, Premchand Roychand), leading to the collapse of the Bank of Bombay.

Nonetheless, there was active participation of the Indians in the Bank of Bengal, particularly for deciphering *hundi*; there was a *Nagari munshi*. *Khazanchee* also served as an essential link between Indian merchants and bankers. However, in terms of their salaries, they were heavily discriminated against compared to their European counterparts. *Banias* also served as financial anchors for Bengal Agency Houses. Some served partnership firms for two to three generations; the family of Ganganarayan Das served Palmer & Co., while the family of Ramdulal Dey and his son-in-law, Radhakrishna Mitter, served Fairlie Fergusson & Co. Sadly, with the major collapse of Agency Houses (1830-1834), not the principals (bankers) but their creditors and the *banias* were ruined, particularly the families of Kamalakanta Das and the banias of Alexander & Co., the barals, while many landed in jails. Those Indian merchant-financiers escaped the ruin caused by the crisis of Union Bank's fall in 1848. Dwarakanath Tagore, the main force behind Union Banks, suffered heavy losses.

[2] In 1860, Companies Act and later in 1876 Presidency Banks Act were passed. Prior to that, banks had to obtain a special charter from the British Crown.

[3] From 1826 on, there was a sharp fall in indigo prices, which was then a highly speculative commodity. Calcutta's Agency Houses invested heavily in indigo plantations. This sudden fall in demand resulted in heavy losses.

In the 1860s, Presidency Banks were kept outside foreign exchange banking, thus 'institutionally sanctifying' the foreign exchange banking exclusively by London-based banks, thus keeping Indian merchants completely away from external trade (though in Bombay Indian merchants had a substantial share in foreign trade, this completely sealed their fate as well). In Bank of Bengal, there was the least representation of Indians (after Raja Sukhomoy Roy, the grandson of one of the financiers of Clive, no Indian was appointed as Director); in contrast, Bank of Bombay was comparatively cosmopolitan in constitution. In the directorate, apart from three European directors, there were one Hindu, one Parsi, and one Gujarati Muslim director.

The Bank of Bombay was again restructured in 1868 as the New Bank of Bombay. There was a boom in joint-stock banks during 1906-1913. Many joint-stock banks (The People's Bank of India Ltd., The Bank of India, The Central Bank of India, Indian Bank Ltd., Bank of Baroda) were formed. However, they short-lived until the crisis of 1913-1917 completely overthrew them. In 1921, all three Presidency banks were merged to form the Imperial Bank of India, which, after independence, was renamed the State Bank of India in 1955. At the time of its establishment, it had 72 branches. Imperial Bank had branches spread out in Karachi, Lahore, Peshawar, Dacca, Chittagong, Burma (in Mandalay, Tenasserim, Akyab, and Rangoon), and Sri Lanka (Candy and Colombo). In 1934, the Reserve Bank of India Act was passed, establishing the Reserve Bank of India as the central bank with the right to issue notes. Though initially it was a shareholder's bank, by the passing of the Reserve Bank of India Act 1948, it was nationalized.

25.3 BANKING AS OF 1947

Responding to a vast increase in demand for trade credit in moving agricultural goods, banking of all types expanded in colonial India (1858-1947). Banking laws regulated some firms, but most were not regulated. The ones that were not were often called indigenous bankers. It was a diverse set. Several large family firms carried considerable market reputations at one end of the set. The corporate banks accepted the bills they issued, which made for overlap between their operations. On the other end, local lenders operated with no legally recognized instrument and only based on their knowledge of the clients, who were farmers or urban groups of small means.

When India gained independence, the country had four large stock exchanges, Calcutta or Kolkata, Bombay or Mumbai, Ahmedabad, and Madras or Chennai, in the order in which these were established. There were several hundred corporate banks. Besides these institutions governed by corporate law, there were many private bankers and moneylenders. Some houses among them were substantial, larger than the average corporate bank, and with many branches. Others were small and local. The 1920s Banking Enquiry Committee and contemporary sources had interviewed some of the largest non-corporate banking houses in Mathura, Benares, Ahmedabad, Patna, Jubbulpore or Jaunpur. These towns had substantial agricultural commodity trading. Most banks, corporate or otherwise, funded such trades.

While banking and commodity trade were well-integrated sectors, industries often found it difficult and costly to raise fixed capital. Technically the stock market could supply capital. But raising money from the stock market became easier if the company had prior reputation. And dependence on the stock market exposed companies to takeover risk, which was unpalatable to most promoters who wanted their families to retain control. Long-term capital, therefore, remained costly and scarce.

A country like India that wanted not only to industrialize rapidly, but build capital-intensive industries, had a problem at hand, to build a financial system that would be up to the job. For at least forty years after 1947, the government took a leadership role in financial markets to solve this problem. The first half of the Unit will discuss some of the most critical steps taken in that direction – bank *nationalization*, interest rate regulation, and establishment of state industrial finance institutions, among others. Most of these steps took shape from the 1960s, whereas in the years before that the financial system inherited from the colonial times persisted, even though the mainstay of that system, agricultural trade financing, declined because the government regulated the trade.

25.4 FROM MARKET-LED TO STATE-OWNED FINANCIAL SYSTEM: 1947-1969

After independence (1947), with the further growth of private corporate banks, the cost of short-term secured borrowing fell to 4-5 per cent (1950s). But long-term capital remained scarce. Except for a small number of top industrial firms, others faced serious problems procuring long-term credit cheaply from the unorganized market. Corporate banking remained private and had a healthy growth between 1947 and the mid-1960s. The largest of the banks were owned by big industrial conglomerates like Tata (Central Bank), Birla (United Commercial Bank), Dalmia (Bharat Bank), and Thapar (Oriental Bank of Commerce).

As for indigenous or non-corporate banking, this sector was under pressure because the government imposed many regulations on agricultural commodity trade. Besides that, the government (more accurately the Reserve Bank of India) came down quite heavily on the indigenous bankers. Provincial governments in colonial India sometimes worried over the high interest rates charged by these banks to their clients. The call to regulate indigenous banking was an old one, because of the usurious nature of local lending. In 1918, the Usurious Loans Act empowered the courts to reduce interest rates. The law followed an English precedence. Few cases, however, came to court. Individual provinces like Bombay and Punjab had passed laws restricting land transfers in the event of a failure to repay mortgaged loans. Other provinces preferred alternative institutions like the credit cooperative.

After independence, the anxiety about high interest rates returned. Government regulation practically outlawed the entire series of indigenous banking, big or small, regional or local, in all states. The move killed the more visible top order, the family firms that commanded market reputation. At the local level, where the clients are poor but still creditworthy (with some assets and a viable trade), the credit business went underground.

Whereas banks supplied working capital to industry, investment finance was raised from internal resources as well as the **stock market**. The stock market route was used cautiously and sparingly. Indian family firms suffered from the anxiety that any expansion of **shareholding** could amount to losing control and preferred to borrow or channel retained earnings into investment. Stock market raids suffered by the Indo-British firms of Calcutta may have made all companies, including the foreign ones, wary about dilution of shareholding. In any case, the reliance on debt than **equity** made investment costlier than it should be, and limited investment capacity. The anxiety was alleviated somewhat by the government financial institutions empowered to buy company **shares**, but these bodies appeared much later.

In political circles, there was considerable anxiety over two things that were seen as critical weaknesses of the financial system – the fact that most large business groups had their own banks, which might mean that they circulated money raised from public deposits within affiliated companies strengthening monopolies, and the high rates of interest in informal and rural credit. Calls to regulate the banking business to serve the poorer borrowers, and start new types of institutions to meet the long-term capital deficit, therefore, were raised from time to time.

Between 1966 and 1969, governmen followed a policy called 'social control' of banks, in response to public criticism that the banks preferred to lend to big businesses at the expense of small ones and the socially weaker sections. It is not clear what social control meant in terms of practical regulation during these years.

25.5 BANK NATIONALIZATION AND DEVELOPMENT FINANCE INSTITUTIONS

The leftist lobby within the ruling Congress Party decided, after a general election in 1967, to become more assertive than before, and adopted a ten-point programme, of which one concerned banking. They noted that the banking sector concentrated wealth and diverted public deposits to industries (like cotton mills) which according to the government did not meet priority requirements. In 1965, 49 per cent of the shares of the leading banks were held by three per cent of the shareholders. The proportion of credit disbursed to agriculture (as a percentage of total credit) was low and had fallen from four per cent in 1953 to 0.2 per cent in 1965.

The Banking Laws (Amendment) Bill was approved and brought into effect on 1st February 1969. Fourteen major banks were nationalized (a further smaller set of nationalizations happened in 1980), except the small number of foreign banks. Only one foreign bank, Allahabad Bank, was nationalized by mistake. A new organization called the National Credit Council, headed by the finance minister, oversaw credit policy, allocating more bank credit to agriculture, small-scale industry, and priority industrial enterprises, and opening bank branches in unbanked areas. During discussions that led to bank nationalization, and later justifying the step, the Council's views were often quite influential. For example, a Study Group led by V.T. Dehejia observed that bank credit disbursement to industry in the 1960s had risen much faster than inventories and stocks with the borrowing companies, suggesting that industry utilized short-term borrowing facility more than they needed to. They used their special relationship with the banks, and perhaps used the loans for purposes like trading or buying shares. The Council was also influential in monitoring the branch expansion activity before and after nationalization.

The purpose of the move was explicitly to direct capital away from the larger businesses to make loans available for peasants and craftspeople. Eventually, social control took a more concrete shape in the policy of 'priority sector' lending, that is, the corporate banks were forced to lend to farmers and small business.

That move, therefore, did not alleviate the problem that industries faced in raising long-term capital. To address that issue, a string of financial institutions had been set up between 1955 and 1965, including the Industrial Credit and Investment Corporation (1955, joint venture with the World Bank and domestic companies, and parent of the ICICI Bank today), the Industrial Development Bank of India (1964, parent of IDBI Bank now), and the Industrial Finance Corporation of India (1956). IDBI was initially a subsidiary of the central bank and nationalized in 1976. IFCI was initially meant to fund government projects and could finance private investment from 1972. A fourth big player was Small Industries Development Bank of India or SIDBI, established in 1990. The Life Insurance Corporation (LIC) also supplied industrial finance. And on a smaller scale, so did financial corporation set up in several states. These institutions did not finance a large enough share of the fixed investment in private corporate sector until the 1980s, when their role enlarged considerably.

Development banks had already been in operation in several countries when these institutions rapidly expanded in India in the 1980s. Such banks were especially prominent in Latin America, except Argentina. Their defining feature was to offer long-term capital investment loans, whereas banks usually offer only short-term working capital, to prioritize applications for loans according to national developmental priorities and offer favourable terms to borrowers. The underlying logic was that the capital market in developing economies tended to be imperfect, undeveloped, and unsuited for 'lumpy' or large-scale investment projects in the private sector. In other words, the development bank was an alternative to public sector investment in big industrial projects or utilities. An alternative model was to engage the private sector in these fields but offer them easy long-term and short-term credit.

25.6 CRISIS AND RECOVERY: 1970-1990

Most assessments of the bank nationalization policy suggest that it had a mixed effect on development of credit market, savings, and investment. It encouraged bank branch expansion programme and led to a significant reduction in the population-branch ratio. This spread also encouraged financial savings. However, the directed credit policy associated with it had a negative effect on investment rates, because priority sectors generated little profits. During much of the 1970s and the 1980s, the nationalized banks were subjected to directed credit policy as well as administered interest rates, which were set at below market rates, though how much below the market rate cannot be ascertained. Bank profitability suffered because of the policy, eventually affecting investment and raising concerns over the sustainability of the policy. Most assessments of bank profitability before and after the financial sector reforms of the late-1990s show that the public sector banks earned a small and near-zero profit after tax as a proportion of their investments. The percentage was slightly smaller than that in the private banks, and considerably smaller compared with international banks. Incidentally, the performance benchmarks of all banks improved after deregulation of the financial system, especially since 2000, and the most impressive improvement occurred among public sector banks.

The economic and industrial stagnation of the 1970s, and partial withdrawal of the government from industrial investment, increased pressure on these institutions to lend to finance more private investment. Until then, evidence suggests that most large business conglomerates in cement, shipping, paper, machinery, financed investment capital from internal accruals and loans. Indian companies, if they went to the share market at all, preferred fixed-interest instruments that would attract investors and yet avoid takeover threats. The strategy raised the **debt-equity ratio** above the international standards, and made investments either more expensive or more risky or both than it should be. It discouraged investments, relatively speaking. In the 1960s and the 1970s, the proportion of corporate sector investment funded by bank loans increased substantially. Since 1980, however, the stock market became more important, but less as a source of equity capital and more as a source of debt securities like **debentures**. Equity is the cheapest source of money, and if this was used to a moderate extent, the practice should suggest that investment carried higher cost than in a fully functional stock market system.

The government financial institutions changed the rules of the game in the 1980s. Their involvement in the private corporate sector sharply increased in the 1980s. These semi-government financial institutions bought company shares. The development finance institutions continued to expand for part of the 1990s. After that, their business contracted in real terms. At their peak, mid-1990s, the five main development financial institutions (IFCI, ICICI, IDBI, SIDBI and LIC) provided the major part of capital funding to private corporate manufacturing companies.

At the same time, revival of private investment as the government liberalized licensing rules somewhat meant that the trading volume in the stock markets rose too in the 1980s. More Indian companies resorted to the stock exchange. With or without government participation, the resort to equity finance made Indian firms more vulnerable to losing control. A few well-publicized episodes of the 1980s reveals the risk, and the unpredictable role the government institutions could play in struggles for control. Government institutions were critical to the success of takeover bids in Shaw Wallace (Chhabria), CESC (R.P. Goenka), Best and Crompton (Vijay Mallya), and India Cements (N. Srinivasan and N. Sankar), and critical to the failure of the bid in Larsen and Toubro, Gammon India, Escorts, and DCM.

The unsuccessful attempt by the British businessman Swraj Paul to take over DCM and Escorts in 1982 was one of the first such episodes. A Dubai-based trader, Manohar Chhabria raided Shaw Wallace, Mather and Platt, and Dunlop in quick succession in the 1980s. His bid for a fourth company, Gammon India, failed. Without tacit support of the financial institutions which held chunks of shares in these firms, the moves would not usually work. In Shaw Wallace, after a protracted battle with the incumbent management, Chhabria got that support. In Gammon, he did not.

Manu Chhabria succeeded in inducing a bunch of top managers to leave their employers and join these companies, and then failed to persuade them to stay on. Within three to four years of the takeover, the companies were in trouble. Insiders attributed the syndrome to Chhabria's 'feudal' style of management. At the very least, he was said to constantly interfere with and overturn executive decisions. By 1994, the companies were experiencing a 'run' on executives. Whether Chhabria could have turned them around is an academic question, for he died in 2002, and the companies were either sold or went bankrupt.

Predatory takeover was not the only symptom of a revival of the stock market route to raising industrial finance. The use of that route also involved strikingly successful innovations.

The name of Dhirubhai Ambani, who began career as a textile trader to create a large synthetic fibre conglomerate, is associated with the most famous set of innovations. Instead of generating resources from retained profits, which would limit growth, or raising money mainly from banks, which would make investments unsustainably expensive, his firm Reliance raised money from the market by means of a variety of hybrids between debt and equity, such as convertible debentures and preference shares. These instruments were expensive too, but less so than bank debt. The method of financing diversified the investor base, which included shareholders, holders of debentures of various types, and holders of cash certificates and deposits. Financiers included a large body of ordinary investors, employees and former employees, and banks and financial institutions. This diversity of instruments and investor bases insulated the company from stock market speculation and allowed it to spread risks.

Ambani used the money in continuous growth and modernization. After 1977, Reliance shareholders got such exceptionally good value year after year that the conversion of debentures into equity occurred easily and raising more money by fresh debentures became easier too. This combined strategy – continuous modernization, innovative financing in a high-cost capital market, and advertising – made Reliance a safe bet for the financial institutions. In turn, its goodwill with the banks enabled the Company to raise foreign currency loans via Indian banks, which were used to finance machines purchased abroad.

In July and August 1988, Larsen and Toubro shares rose sharply, when first Manu Chhabria and then Dhirubhai Ambani started buying up large quantities of the shares of the firm, while maintaining in public that they did not plan a takeover. Early in the contest, Ambanis went ahead of Chhabria and were invited to join the board. For Reliance, the acquisition would achieve synergy between the engineering firm and petrochemical projects under construction. The transfers involved large scale transactions between the government owned financial institutions, in particular, Life Insurance Corporation, a finance company set up by the Bank of Baroda, and Ambani's friend the Unit Trust of India. Hints of corruption and collusion were present. At the very least, the institutions appeared arbitrary in the way they intervened in the boards.

Mahindra and Mahindra was another company in which the family stake was small, and the majority shareholders were the institutions. Since the Swraj Paul episode, the press speculated frequently about imminent takeover moves on the company.

In the 1990s, after India's economic reforms had enabled Indian firms to access foreign capital markets, the last major expansion plan in Dhuribhai Ambani's lifetime took place. Foreign institutional investment was still modest in India. But it was possible to raise shareholding abroad via the bank-mediated route of Global Depository Receipts[4] (GDR). The bank was the depository, which issued receipts to investors carrying an entitlement to share ownership. An Indian company raising equity capital abroad was an unusual event. To Reliance's advantage, its plant was world scale in capacity and technological capability. In 1992, expansion in the petrochemicals plant was expected to be financed by the GDR route. The attempt did not meet expectations, though a convertible bond issue next year was more successful. In 1994, the UTI scandal soured relations between Morgan Stanley, the bank that mediated Reliance's entry in global capital market, and the company. In the second half of the 1990s, the company shifted to Euro and 'Yankee' bonds, a move that was eased by relatively low and steady interest rates.

25.7 REINVENTION OF THE FINANCIAL SYSTEM IN THE 1990S

In the 1980s, the Reserve Bank of India had permitted some flexibility to the nationalized banks in setting interest rates. Together with the opportunity to finance export-oriented

[4] Depository receipts are certificates issued by a bank to represent a foreign company's traded shares. The shares are held by the bank. Instead of the shares, the depository receipts trade in the market.

businesses that grew in the wake of exchange rate reforms, banks found new profitable ways to create assets. In the early-1990s, a deeper reform of the banking sector began, initiated by the landmark Narasimham Committee-I report. The committee recommended deregulation of interest rates, and reduction of the statutory liquidity ratio (mandated percentage of deposits held in liquid form) and cash reserve ratio (mandated percentage of deposits held with the central bank) and dilute the norms of priority sector lending. A close interdependence emerged between economic growth, total investment rates, and credit disbursed by nationalized banks. In a second round of reforms, the government permitted freer entry and expansion of foreign and private banks as well.

Soon after the reforms began, the development financial institutions reinvented themselves as banks, and the cushion of joint ventures was no more available either. This trend was present not just in India, but throughout the world where development banks had once been a popular model. There were two reasons behind the global decline of the idea. The first one was the allegation of political influence on their operation, given that nearly all were directly or indirectly government controlled. Second, a third model yet was growing in popularity, to allow private sector banking to grow and play a fuller role in the financial market. The development banks represented an old anxiety about the private operator in the financial market. Once that ideology began to be less influential, these institutions lost their rationale.

Stock markets would play a bigger role than before. Market capitalization data before 1990 are hard to obtain. In 1990, market capitalization of listed companies in the Indian stock markets was less than half a per cent of the world, from that level there was a large but unsteady increase in the share in the next 25 years.

From the 1990s Indian companies demanded more options in methods of raising capital, and the demand was granted quite simply by aligning India with global practice. One area of reform was the increase in options about the types of equity. Indian companies could earlier raise preference and common shares. In 2000 more combinations of voting and returns were allowed. Buybacks and stock options were introduced. In 2000 again, depository receipts were allowed, and cross-border listing norms were liberalized. The scope of such instruments was expanded to include global depository and American depositary receipts. Since economic liberalization began, companies started raising more money from the stock market, and market capitalization levels increased. From 2003 especially, foreign institutional investment in India's equity joined this process. The licensing norms for issuing such instruments were liberalized in 2014. Restrictions (and sometimes ambiguity), however, persisted in matters of taxation, convertibility into equity, eligibility of a company to issue depository receipts, and disclosure and governance norms.

Although global depository receipts became hugely popular, since 2017 concerns have been raised that they are sometimes used for money laundering and stock market manipulation. One case emerged in the 2010s, when a fund owner purchased GDRs issued by Indian companies, with loans taken from a bank controlled by the same group. When the loan was not paid back, the shares were sold in India. Subscribers to these shares observed the GDR issue and the rise in market activity and were misled into thinking the company had a bright future. Initially, the legal authority of the SEBI in dealing with cases like these was not quite clear, because GDRs were issued abroad. A Supreme Court case clarified that these were legally securities in India, and subject to SEBI regulation. The investigation into the case took several years. The legal liability was still not clearcut. Eventually in 2022, an arrest was made in the case.

These changes raised the importance of the stock markets in India's economic transformation. Was the institution ready for the challenge? The oldest stock exchange in the country, the Bombay Stock Exchange, or BSE, was owned by individuals who had trading rights in the exchange, a situation that was widely seen as detrimental to its governance. By contrast, the National Stock Exchange, or NSE, is owned by financial institutions and is more professionally managed. From its start in 1992, the Securities and Exchange Board of India, or SEBI, worked to separate ownership and trading rights in the BSE and other regional exchanges where the problem existed.

If these steps addressed conflicts of interest, they did not stop insider trading. Government-owned banks were especially vulnerable to being abused in this process. In two successive frauds in ten years, bankers' trust came into question. Commercial banks were required to maintain a statutory holding of government securities, which offered low rates of interest. Money tied to such transactions was diverted to the stock market through the operational departments. The procedure involved an instrument called the bankers' receipt (BR), which was issued by a bank selling securities to another bank. Banks also made payment by banker's cheque for purchase of securities. The BR was issued in anticipation of an actual transfer of securities but involved a transfer of the money. Many transactions took place through broker's. The money was deposited in a broker's account and could be immediately invested in the stock market. If all went well, the money was returned before the transfer of securities took place.

In 1992, in what became known as the Harshad Mehta scam, the National Housing Bank issued a cheque to the stockbroker Mehta for securities. It was subsequently discovered that the bank had no record of receiving these securities. In turn, Mehta instructed his bank to make a payment to another party against this cheque, and the money ended up in the stock market. Mehta already had a reputation for bullish bets. His biggest bet, however, was funded by staggeringly large amounts of money diverted in this way. A string of brokerage firms affiliated with him would sell the shares at inflated prices. In 2001, the Ketan Parikh scandal involved an almost identical tool but a different set of government banks.

Fixing responsibility was never an easy matter in these cases. No law had been broken. Individuals followed the banks' procedures. The bankers had failed to perform their "fiduciary duty". No one knew whether this was a criminal liability or that *mens rea* (criminal intent) was implicated. Still, the transfer of the funds was a failure of the internal management audits of the banks and technically also a failure of the Reserve Bank of India, for securities transactions needed to be reported to and approved by its Public Debt Office. However, BR issues did not get reported to the central bank. The RBI was also implicated because it was the regulator of the banks, including the government banks.

The substantial response to the 1992 scam was the new regulator of stock markets, SEBI, which had been created in 1988 and became an independent regulator by a parliamentary act in 1992. One of its key preventive interventions was the introduction of the so-called Clause-49 norms, which set out requirements on disclosure, independence of the board and audit, and accounting standards. This was introduced in 2002, ten years after SEBI started as a regulator and soon after the passing of the Sarbanes-Oxley compliance rules in the United States. A few years earlier, in 1994, the RBI set up the Board for Financial Supervision, an office to supervise governance norms in banks. Initially these norms addressed capital adequacy and liquidity; in the 2000s these were expanded to include disclosure, accounting, and composition of the boards.

25.8 REFORMS IN 2000S

The decade of 2000 is marked by radical reforms in the banking sector.

25.8.1 Reforms and Private Banks

In the 2000s, the government and the Reserve Bank of India actively encouraged entry of private banks and conversion of the old state-owned financial institutions into banks. The move succeeded to the extent that the share of private banks in total deposits increased from less than 10 to more than 25 per cent between 1997 and 2007. Some of these, like ICICI Bank and Kotak Mahindra Bank, were new private banks. Other were old private banks like the Oriental Bank of Commerce, and a few were foreign banks. The growth occurred mainly in the new banks. At the same time, there were huge changes in technology, retail banking, assets, liabilities, and corporate governance mechanism. But change was slow to come in reforming the still dominant government-owned bank's, which continue to be burdened by 'non-performing assets'. The problem varied from bank to bank. The source of bad assets ranged from policy-directed lending to weak borrowers, to politically influenced lending to powerful corporates, to heavy exposure to clusters of bankrupt firms as in Eastern

India. At a deeper level, the syndrome reflects the banks' inability to emerge as independent and responsible players in the financial market under state ownership.

25.8.2 Nationalized Banks in the Post-Reform Era

After the global financial crisis of 2008-9, a significant divergence appeared in the credit portfolios of private and public sector banks. The latter played a much larger role in disbursing credit to relatively low return and high gestation projects, especially infrastructure. Normally such long-term projects carry higher risk, especially for a bank whose capital comes from deposits of short duration, and the interest rate and loan terms should reflect that. In this case, the connection between risk and return was weak. In the 2010s, public sector banks also gave more credit to stressed companies. Thus, even as formally directed credit was withdrawn, the suspicion that bank credit disbursal continued to be subjected to informal political pressure, was present. Finance from public sector banks sustained investments in the infrastructure sector, which sustained economic growth, but led to an accumulation of bad debt, or non-performing asset.

Government banks had specific problems to deal with. Industrial sickness hit many of them hard and left them with a load of bad debts for, among others, the reason that the government regulators often arm-twisted them into joining consortium loan schemes in favor of doubtful debtors. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, provided for a definition of bad loans (non-performing assets) in financial companies, created mechanisms to differentiate the quality of loans and to securitize loans, and made recovery and reconstruction of assets easier.

One of the means, tried elsewhere with mixed experience, is an asset reconstruction company that securitizes loans and sells them to financial companies. Reconstruction companies began to be created around 2010, but they had little chance of making a difference to the health of the banks. Security receipts formed less than a quarter of the size of bad loans because half of the bad loans had been given to small firms and peasants under an administrative fiat known as priority sector lending, and these could not be easily securitized. Asset valuation and getting lenders together were also complicated issues. Perhaps when the banks are government owned, the best chance of a successful deal involves political intervention of some kind, which had created the problem of bad loans to begin with.

25.8.3 Non-Bank Financial Companies

In part a legacy of indigenous banking, the non-bank financial companies made money by lending to businesses that banks would not ordinarily lend to, such as personal loans and trade credit. Because interest rates were often high in these transactions, they could also offer depositors a more attractive rate than the banks. These businesses, however, carried high risk of default. And to protect their credit, the NBFCs sometimes built political connections and exposed themselves to pressures to lend to politicians.

This was one area where corporate governance failed repeatedly. With the banks doing the government's bidding, the financial regime allowed for large excess demand to develop in such important but overlooked businesses as commodity trading, hire purchase, leasing, and housing finance. All except the regulators knew that exceptionally high rates of interest were to be had in some of these markets if money was carefully invested. The NBFCs emerged to collect public deposits on promise of higher-than-official rate of interest and to invest the money in the high-return markets such as trading and stock market speculation. Not all NBFCs entered high-return, high-risk markets, but many did. Their business not only carried risks, it was also occasionally exposed to political interference. Given the extremely cumbersome system of land law in most states, political influence helped to conduct the real estate business but exposed the deposits to demands from the benefactors.

In practice some of these firms have often willingly or unwillingly ended up as Ponzi schemes. There is no evidence that the people who promoted the most disastrous such schemes necessarily started with wrongful intent. The big gap between government-regulated low interest on bank deposits and market rate of interest in unregulated commercial loans was enough incentive to draw both honest operators and wise depositors into the game. However, short-term investments could carry high risk.

The RBI is the regulator of such businesses. A Prize Chits and Money Circulation Schemes (Banning) Act, 1978, had been in place, and an investigative agency, the Serious Fraud Investigation Office, had existed since 2003. Still, preventive checks have never been very robust in this sphere. The regulatory laws consisted of a set of specific directions that the RBI introduced. These directions introduced restrictions on raising finance and penalties for default to depositors but did little to reduce either the attraction of these unserved markets or the risks that these entailed. Within an individual NBFC, the passage from sound to unsound business practice occurs so silently that the regulator is routinely caught unprepared. In the early 1980s West Bengal saw several companies collapse; the most famous ones were Sanchayita, Sanchayani, Favourite, and Overland. In the 2010s, again, the collapse of Sarada and Rose Valley underlined the failure of law to act as a preventive check.

25.9 FOREIGN INVESTMENT

After 2003, foreign investment surged in India. Investment came both as institutional investment by foreign funds in Indian companies, and as direct investment by multinational companies. The surge changed the complexion of the business world, popular views about foreign investment, and academic scholarship in important ways. For example, corporate governance returned as a big theme, a reminder of the managing agency discussion from 80 years ago.

One of the changes was a renewed interest in the distinction between closely-held and owner-manged family firms and publicly held professionally managed firms. Analysts asked, did foreign institutional investors discriminate between the two? The answer is that they did, they preferred to invest more money in professionally managed firm. What was once only a difference became a divergence between two broad types of firms, one traditional and the other relatively modern. But how sharp was the distinction between these types anyway? In many small or mid-sized IT firms, the owner was also a professional. And IT firms received more institutional investment than any other type.

The issue of investor-selection linked to the larger theme of corporate governance. In India, corporate governance norms were formally coded and enforced by the regulator, the Securities and Exchange Board of India (SEBI), from 2000-01. Although most companies complied with the formal norms, the move had more symbolic than substantive effects on management cultures. Scholars who have done pioneering research on the subject discuss these issues, which include investor selection, ownership structure, and preferences and policies of institutional investors.

At the same time, greater openness to investment sometimes compromised corporate governance. Foreign investors selected the better-governed firms, they also tried to shape or influence governance practices as a matter of strategy. The global influence on corporate management raises the prospect of a homogenization of practices and laws across borders. There is some sign that foreign investment can change the behaviour of firms, especially family-run businesses that have an opaque style of governance, that is, many crucial decisions are invisible to the public or may serve the family better than the shareholding public. Family versus professional management matter too to the growth of firms. Family businesses sometimes raise more money from bank capital, and especially public sector banks. They had poorer access to foreign funds, as we have seen. They tended to rely more on institutional investors and played politics more than professionally managed firms needed to do.

Foreign investment changed the game in other ways too. Between the first half of the 1990s and the second half, mergers and acquisitions activity speeded up, led by the re-entry and consolidation of multinational companies. Analytical research on mergers and acquisitions asked if we could better predict target firms and measure effects of the moves. This scholarship need not concern us here. But one of its findings is significant. A predictive benchmark is leverage, and it was found that low leveraged firms in India were more likely to be targets of acquisitions. The finding suggests why companies may prefer dealing with the politically connected banks rather than the market in raising finance.

Along with foreign inward investment, there was a larger-than-before outflow as well.

25.10 OUTWARD FOREIGN INVESTMENT

As we have seen in the previous Unit, Indian companies expanded the scale of asset holdings abroad between 1948 and 1982, though a precise division of these assets into private industrial and other types is unavailable. In any case, the scale of the recent increase dwarfs the older outflow. The recent outflow was industrial and reflected a globalization of Indian corporate capital. How large was the tendency? And what does it mean? Despite the rising scale of overseas investment from India, at least until 2008 when the flow began to drop, the relative scale of Indian investment was not really large enough to be excited about, not nearly so in comparison with the counterpart investment flow from China or South Korea.

It is harder to answer the second question because outflows were still influenced by factors specific to industries and individual firms. In the software industry, acquisition of foreign branches and partnerships occurred systematically. In a pattern reminiscent of the managing agencies, the leading firms in software established partnership with local firms, or established fully owned companies in countries where the clients were. But these were not the most discussed instances. Overseas collaborations and acquisitions by three automotive firms (Tata, Mahindra, and Bajaj) received much more attention, but what lessons these cases have for overseas investment in general it is not clear.

Nevertheless, the existence and visibility of Indian multinational has spawned a scholarship. It overturns common prediction that foreign investment should flow from capital-rich to capital-scarce regions. In one interpretation, favoured by the leftist economists in India especially, the overseas expansion represents the success of import-substitution, when India learnt to industrialize, and the state nurtured some firms to become strong and capable. But as we see from the preceding paragraph, very few private sector firms of the import substitution era appear in the list. Other scholars refer to special dimensions of state aid. For example, some make use of the 'varieties of capitalism' literature to suggest that globalizing firms in India shared certain inherited and distinctly Indian advantages, including help from the state in the form of a special patent regime, for example. Large firms in emerging markets tend to be state-dependent, as another article on Indian MNCs shows, illustrating the point with investment by state-owned financial institutions in large corporates. Public sector banks have indeed opened more services abroad, responding to more relaxed rules about non-resident Indian investment in India. Quantitatively speaking, this is a small outflow since Indian banks were minnows in the global financial market.

None of these explanations suit the global software firms particularly well. Overall, it remains difficult to explain overseas investment as a single process.

25.11 SUMMARY

In the long run, the Indian financial system made a transition from a mainly private sector banking system in the 1950s to a public sector financial system (banks for short-term credit and other state-owned institutions for long-term capital) in the 1980s to a mixed economic model in the 2000s. The problems of the public sector persisted despite many new profitable opportunities. The private sector does not consist anymore of just banks but also channels that direct a much larger inflow of foreign capital into portfolio and business investment in India. Law and regulation have tried to adapt to this financial globalization of the recent past.

25.12 GLOSSARY

Debt-Equity Ratio	Debt-Equity Ratio comapares company's total liabilities with its shareholder equity. It also suggests companies' reliance on debt. Higher debt-equity ratio suggests more risks; equally lower debt-equity ratio suggests that company is not doing well.
Debentures	Debenture is an act of companies to borrow money. It is a legal certificate in the form of a long term security issued by a company at a fixed rate of interest against its assets.
Equity	Equity is an asset (of an owner/company) calculated after subtracting liabilities from assets.
Euro Bond	Euro Bond is issued by a government or a company offshore in a currency other than that of the currency of the issuer's country.
Nationalization	Nationalization of any company relates to an act of taking over of any private sector company by the government by way of purchase of majority shares (more than 50%) of a particular company.
Stock-Market	Stock-market refers to several exchange where publicly held company's shares are bought and sold.
Shares	Share is a Unit of equity ownership in a company.
Shareholding	Shareholding is an allocation of shares of a company.
Yankee Bond	Yankee Bond is a debt obligation issued publicly in US by a foreign government or company and denominated in US dollars.

25.13 EXERCISES

1) What were the early difficulties faced by banking sector in the post-independent India?
2) What led to nationalisation of banks in India? What were its long-term consequences?
3) What impact did bank nationalization had on the development of credit market, savings and investments?
4) Discuss the reinvention of the financial system with reference to deeper reforms of the banking sectors in the 1990s.
5) Discuss the radical reforms introduced in 2000s in the banking sector. What were its impacts?
6) Discuss post-2003 foreign investments surges in India. In what ways did it impact the Indian companies?

25.14 SUGGESTED READINGS

Azad, Rohit, Prasenjit Bose, Zico Dasgupta, " 'Riskless Capitalism' in India: Bank Credit and Economic Activity", *Economic and Political Weekly*, 52(31), 2017, 85-98.

Bagchi, Amiya Kumar, *The Evolution of the State Bank of India: The early years,* *1806-1860,* New York: Oxford University Press, 1987.

Bagchi, Amiya Kumar, "Transition from Indian to British Indian Systems of Money and Banking 1800-1850", *Modern Asian Studies*, vol. 19, no. 3, 1984, pp. 501-519.

Chaudhuri, Saumitra, "Some Issues of Growth and Profitability in Indian Public Sector Banks'' *Economic and Political Weekly*, 37(22), 2002, 2155-2162.

Ketkar, Kusum W., Suhas L. Ketkar, "Bank Nationalization, Financial Savings, and Economic Development: A Case Study of India", *Journal of Developing Areas*, 27(1), 1992, 69- 84.

Mukherjee, Anirban, "Transition of Credit Organizations", *Social Science History*, vol. 41, no. 2, Summer, 2017.

Nagaraj, R. "India's Capital Market Growth: Trends, Explanations and Evidence'' *Economic and Political Weekly*, 31(35-37), 2553-63.

Schwecke, Sebastian, *Debt, Trust, and Reputation: Extra-legal Finance in Northern India,* Cambridge: Cambridge University Press, 2022.

Sen, Kunal, Rajendra R. Vaidya, *The Process of Financial Liberalization in India*, Delhi: Oxford University Press, 1997.

ignou
THE PEOPLE'S
UNIVERSITY