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THE RATIONALE OF BANKING LEGISLATION

Banking is of high antiquity but our ancestors were familiar with banking credit; at least history credits them with that knowledge. Archæologists have discovered clay tablets of credit that were in use in Assyria. Students of Manu, the famous Indian lawgiver, are familiar with his well-known laws regulating the use of credit. The Athenian money-changers did business somewhat closely akin to modern banking business. Xenophon implanted the idea of a bank but he was too far ahead of his time. In the "argentarii" of Rome can be seen the nearest possible approximation of a modern banker. The barbarian invasions of Rome and the ensuing unsettled conditions of Europe during the Dark Ages must have prevented the early development of banking business. During the Middle Ages, the money-changers of Italy revived their business and the Jews, thanks to the persecutions of all continental countries, perfected the beautiful bill of exchange. The successful lead of the Italian merchants and their religious zeal to collect the papal dues while acting as the emissaries of the Pope in the continental countries led to a very extensive use of the bill of exchange. To Italy belongs the credit of having founded the first bank, *viz.*, the Bank of Venice, 1167; the Bank of Genoa, 1345. The Italian money-changer, the Jewish money-lender and the Lombard Street financier are the important connecting links in the banking chain. With the advance of centralisation in commerce and in national life the necessity for public banks arose. The development of manufactures and rapid growth of international trade led to large-scale banking and to-day, banking business is regarded as an honoured profession and it has received such a wide and varied form that it is hard to believe that our primitive ancestors were familiar even with the rudiments of banking credit.

If banking business is of such hoary antiquity and if state regulation of bankers and banking credit was well-known to our ancients as evidenced by the Athenian regulations, the Code of Manu and the Justinian Laws, the modern State need not feel ashamed at the perfunctory manner in which it attempts to control the modern banking business in the interests and well-being of the nation.

Besides this historical justification, there is another cardinal reason why the State should control banking business. The modern banks can make or mar the future of a nation. With the entire credit mechanism of the country controlled by it, with the whole floating capital of the nation deposited in its hands, with the nation's material future entrusted to it, and with the "fate of the nation lying on its lap," the modern banking system is indeed a vitalising force which if exerted in the right and proper channels is fraught with immense possibilities. With a judicious selection of their customers and with timely loans to them, they can build up the manufactures of a country and direct capital and labour to the most productive channels. By creating thriving industries, they can add to the national wealth of the people and bring contentment to the wage-earning labourers. They can accomplish all this and more.

But their power to do harm in case of misdirecting capital, encouraging speculation and wrongly investing is no less considerable. What the State aims at by wisely-directed banking legislation, is to maximise the advantages of sound banking and help the banks to better perform their task. Modern Banking is reckoned as a quasi-public service so that it must be watched and properly regulated. The anxiety of the State is to see that banking accommodation is extended to all the deserving persons on equal terms.

Again the failure of a bank creates a vicious circle and ruins several people. Though the State recognises the impossibility of legislating to prevent failures yet it attempts to

prohibit banks to do business of an unsafe character or alien to legitimate banking business.

The State while passing laws of a restrictive nature forbidding the banks to do as they like, is not altogether unmindful of the interests of the banks. It recognises the social services of the banks and gives them special facilities. The special laws about the negotiable instruments and other concessions shown to them, as the general lien of the banks, the Law of Estoppel and the Bankers Book Evidence Act are an evidence of this grateful recognition. While treating them very leniently, the State does not forget to restrain effectively their power to do harm to the public by their own indiscretion. General laws are passed, so as to attain uniformity and prevent favouritism.

Banking legislation extends from the Central Bank right up to the ordinary Joint-Stock Banks. The Central Bank is always made to work under special provisions incorporated in a separate charter. The Central Bank is the favoured child of the State. It performs valuable services to the State and obtains valuable concessions in return for them. The ordinary Joint-Stock Banks are incorporated under another law common to all of them.

Private banks escape vexatious government control in almost all countries. Their importance is, however, dwindling day by day. So long as they are under able financial guidance they earn the gratitude of their country. But the continuity of such able financial guidance is not assured in all cases and many ignominious failures have occurred in the past. Hence private banking is diminishing in importance. In England and America public opinion is decidedly against them and they are virtually forced to amalgamate themselves with other concerns by virile competition prevailing in the money market. Here, as elsewhere, the case of India forms a notable exception.

In India, the private bankers (indigenous bankers as they are styled) are going on as usual but the growth of the

co-operative credit societies is leading to the narrowing down of their clientele. The education of the masses, the general stability of the Joint-Stock Banks, a wide diffusion of sound banking facilities and the general apathy shown by the indigenous, that is, private bankers towards industrial development will certainly tell their own tale in the long run. These indigenous bankers, unless they become more progressive and adopt the best features of Joint-Stock Banking and adapt themselves to the changing needs of our society, are bound to disappear in our country also. But they are still a powerful element in our banking system to day.

The case of Joint-Stock Banks is different. They are under able financial guidance and influential directors can mould these institutions into such a shape as to bring about the greatest good of the greatest number of people in a given society. The necessity to earn profits must force these banks towards progress tempered with caution. Hence Joint-Stock Banks are on the increase everywhere and as the banking blue book indicates they are also increasing in numbers in our country as well.

The main reasons why the State is so solicitous to procure sound banking conditions have been set forth already. But something more must needs be stated to explain why Joint-Stock Companies conducting banking business are differentiated from other Joint-Stock Companies and treated separately. One law does not suit both of them because the banks are lending institutions while Joint-Stock trading concerns borrow money for their business. Secondly, banks create and protect credit; while other Joint-Stock Companies receive credit and exploit it. So banking companies have special safeguarding rules to protect and help them.

While usually one law is considered sufficient as regards the process of formation of trading as well as banking

companies the latter are subject to additional legislation of a very detailed character. Very careful prescriptions of law extending to every important item of banking business are laid down in order to bring about full trustworthiness of these banking companies. The amount of capital, the accumulation of Reserve, the character of loans and discount business, the nature of the Cash Reserve and its proportion as against the demand liabilities of the bank, and the very quality of the investments of these banking companeis are all subject to stringent regulations for the following reasons:

Capital:

The capital of a bank is the money subscribed by the shareholders. It stands virtually as a guarantee to the customers of the bank inspiring them with confidence. Banking business is purely a question of mutual confidence between the depositors of the bank, and the banker himself. Banking business consists in lending other's money and as Lord Overstone says "banking business is a business of the brain with other people's money." A paucity of capital will not enable the banking institution to execute its tremendous task of responsibility and trust efficiently, hence the legal regulations against inadequate banking capitalisation. In the case of new banks, there is always an impairment of capital for the first few years as expenses run in excess of interest collections and unless there is a large amount of capital actually paid up at the start, it is difficult to meet with success.

Accumulation of Reserve:

Coming to the Reserve, the State aims to compel the banks accumulating a decent Reserve in order to help the bank in its operations. The Reserve is virtually the shareholders' property and can be locked up [illegible]

greater the Reserve, the greater is the confidence inspired in the minds of the customers as regards the ability of the banks to discharge their liabilities.

Loans and Discount :

It is by loaning that a bank confers its greatest blessings on society and its business. The strength and safety of the bank depends on the character of the loans it grants. The bank has not only to select judiciously its customers but must not commit the fatal error of lending too much of its loanable money to any individual firm or undertaking. The object of the legislator is to see that the bank distributes its risks over several concerns or individuals of the most unimpeachable honesty, financial rectitude and business capability. Another object why loans by banks to its officers and directors are restricted, is to see that no greater line of credit is granted to them than they can obtain from any conservative banker. Even in the matter of discounting business, the anxiety of the legislator is to curtail the freedom of the banks from accepting anything except first class paper or tying up their money in transactions of a spurious character.

Cash Reserve:

The Cash Reserve of the bank is not only the foundation of any credit that can be created by it but is an insurance fund against risks. It enables the bank to meet any unusual and extraordinary demands made on it by the depositors. The object of regulating the Cash Reserve, fixing its dimensions and even prescribing its actual composition is to enable the bank to better perform its task and as the bank is always saddled with large and numerous "demand" deposits to be paid, there should be a guarantee that it can meet the depositors' call. That is why a generous Cash

Reserve is always stipulated for. The desire to earn profits is very natural and the tendency to reduce the Cash Reserve almost to the breaking point or "apprehension limit" as Bagehot puts it, has to be curbed by laws and there is nothing unwise about it.

But much has been written condemning all legislative interference in the matter of the Cash Reserve. It is said that a legal limit to the Cash Reserve tends to make it inelastic and any law prohibiting its free use in cases of rare emergencies is meaningless. As a recent writer says: "An iron ration which you must not touch even in the throes of starvation is something of a mockery."

It is indeed true that a sense of false security may be the result of any legal limitation of the Cash Reserve. By keeping the prescribed limit of the Cash Reserve, the bank may think it has done everything it has to do.

Although there is much truth in these remarks, the existence of laws which permit a free use of the Cash Reserve under certain conditions, certainly helps the amateur bankers and keeps under restraint "adventuresome banks" which wish to spread sail and provide for the storm only when it actually descends on them. Cast-iron laws do not bring about a better management of the Cash Reserve but the fact that the Cash Reserve is kept and that it enables the bankers to meet some portion of their liabilities, is a source of confidence. Again, it limits the field of disaster that may be brought about by injudicious or adventuresome banking. Instead of overwhelming and complete bankruptcy there is something which enables the banker to dole out to its creditors.

Successful banking is virtually dependent on a careful management of the Cash Reserve. While recognising that "the Cash Reserve is dead money and makes no contribution to dividend whatsoever," as Professor Foxwell puts it, the bank managers should possess a cool head, sound judgment and a

resourceful mind. By constantly adjusting their discount rate they should bring about satisfactory conditions always. Very few banks realise that it is better to erron the side of caution and provide a large Cash Reserve, thereby making a part of it idle, rather than be adventurous with a smaller Cash Reserve. The banks should not only rely on their ability and management "to muddle through somehow" as Lord Rosebery puts it. To avoid failure is far more important than to heap up high and precarious profits. As Bagehot says, "adventure is the life of commerce but caution if not timidity is the essence of banking."

Quality of Investments:

As regards investments, that is, the bank's holding of gilt-edged securities, the object of the legislator is to make the banks invest their funds in such a way as not only to yield profits but see that they are at the same time liquid. Only first class securities are to be held and these should possess absolute strength and safety and be easily marketable with the minimum trouble and risk of loss. As several of the ordinary industrial securities do not possess these coveted features, the banks are prohibited by law to invest their funds in them.

In addition to these laws hampering the freedom of the banks almost in every kind of their business, the State insists on the banks publishing their transactions periodically. Although some of the banks may resort to the pernicious practice of window-dressing at the time of publishing their balance sheets, much can be gained by publicity. The furnishing of a well informing balance-sheet which artfully unfolds the tale of progress and increase of business, is by itself the most successful method of attracting customers to the bank. The banks have realised the manifold advantages

of publicity and they are coming forward of their own accord to furnish all details of their business transactions.

This is the *raison d'être* of all banking legislation and there is ample justification for the State regulation of banking business. The State knows full well that the banks cannot be made safe and well managed automatically by its laws. It realises that no system of examinations can be a perfect one. It always grants considerable latitude in the matter of loans and knows clearly that to impose a dull uniformity without paying any due heed to the changing conditions of different localities, will be of no avail. Hence it is wise enough always not to descend to details. It is fully conscious of the fact that honesty, integrity and capacity cannot be obtained through the process of legislation. It cannot and does not aim to legislate so as to secure people from their own incompetence, their own lack of thrift and their own lack of business qualities. Such is the psychology of the bank-controlling mind.

It is indeed difficult to explain the absence of any banking legislation in our country. It cannot be attributed to any lack of knowledge in this particular sphere. Our embryo Central Bank and semi-state banking institution which has recently been created in our midst—the Imperial Bank of India—is controlled by the State. Its position does not cause any great anxiety for the State in the fullness of its banking wisdom has retained the old rules of the Presidency Banks' Charter Act of 1876. It is only the position of the newly started and small Joint-Stock Banks that is eminently unsatisfactory. The wonder is why the State has not thought it wise on its part to fetter the hands of these Joint-Stock Banks also by well-drafted regulations.

Another instance which goes to prove that our State has realised a high conception of its duty towards these banking concerns, occured quite recently during the days of the banking crisis of 1913-15. It volunteered help to all the sound

banks but the old Presidency Banks through whose medium and intervention the State wanted to help, did not rise equal to the situation and this forms one of the worst spots in the dark pages of their history. They have cast to the winds the expansive theory of banking which Central Banks ought to pursue during the period of a crisis.

Again, their policy of welcoming all foreign banks and extending an open door to them has resulted in much good to our country. These have not only popularised banking business in our country but are the standing monuments of a conservative policy always standing for slow, sure and steady progress in banking business.

But the *non-possumus* attitude of our State towards the smaller and newly arisen Joint-Stock Banks is hardly creditable to it. The existence of some kind of laws, good or mediocre, would have prevented several failures or at least would have mitigated the intensity and severity of our banking crisis and this subject will be treated at length on another occasion.

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