REPORT
OF THE
STUDY GROUP ON NON-BANKING FINANCIAL INTERMEDIARIES

BANKING COMMISSION
(Government of India)
BOMBAY
1971

BANKING COMMISSION
(Government of India)
''White House''
Walkeshwar Road,
Bombay-6.

Date August 10, 1971.

The Chairman,
Banking Commission,
(Government of India
Bombay.

Dear Sir,

Report of the Study Group on
Non-Banking Financial Intermediaries

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I have pleasure in submitting to you four copies of the Report of the Study Group on Non-Banking Financial Intermediaries appointed by the Banking Commission in June 1970.

Yours faithfully,

Bhabatosh Datta
Chairman,
Study Group on Non-Banking
Financial Intermediaries.

PART I

PREAMBLE, SCOPE AND METHOD OF STUDY AND APPROACH OF THE STUDY GROUP

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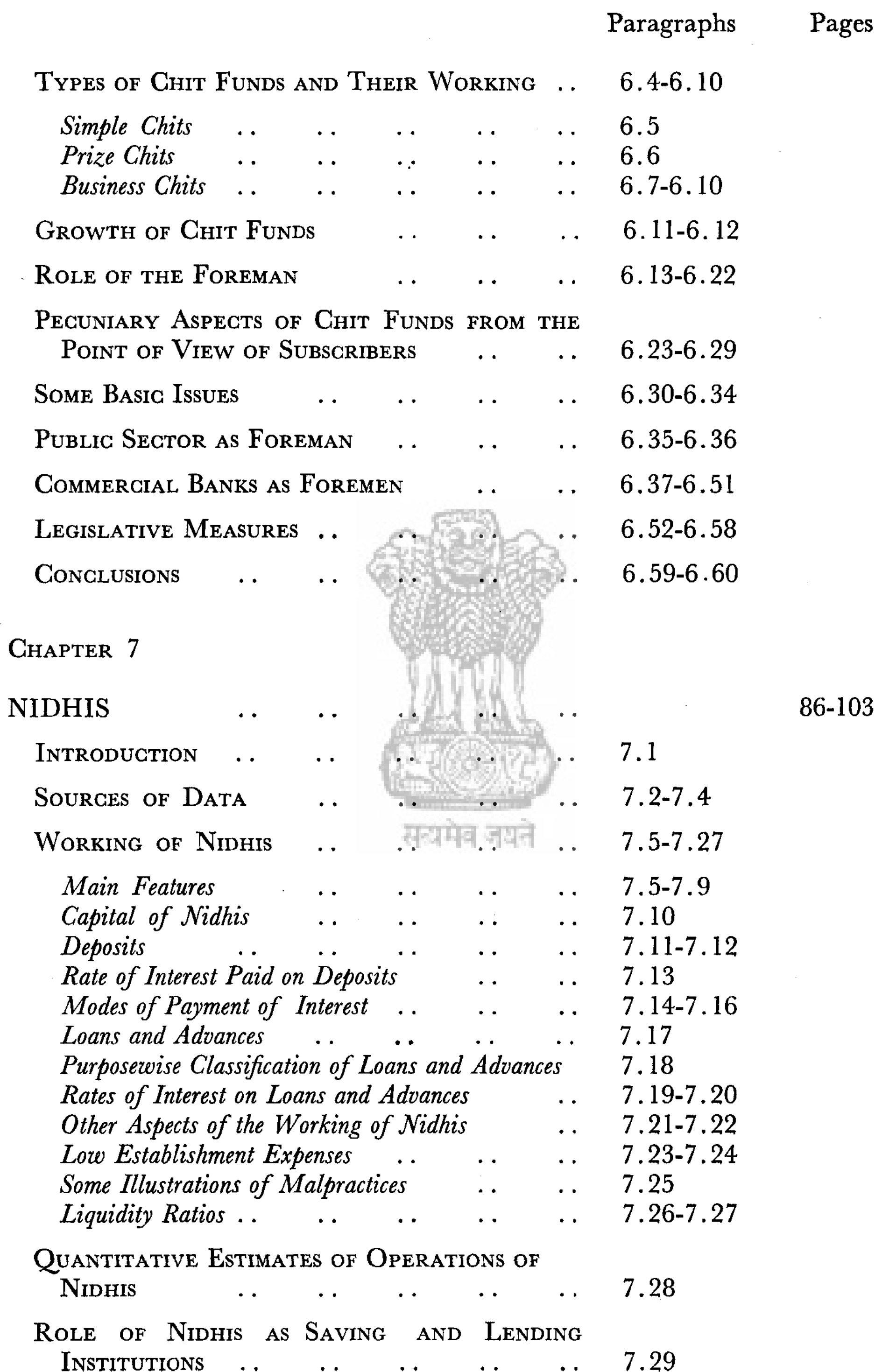

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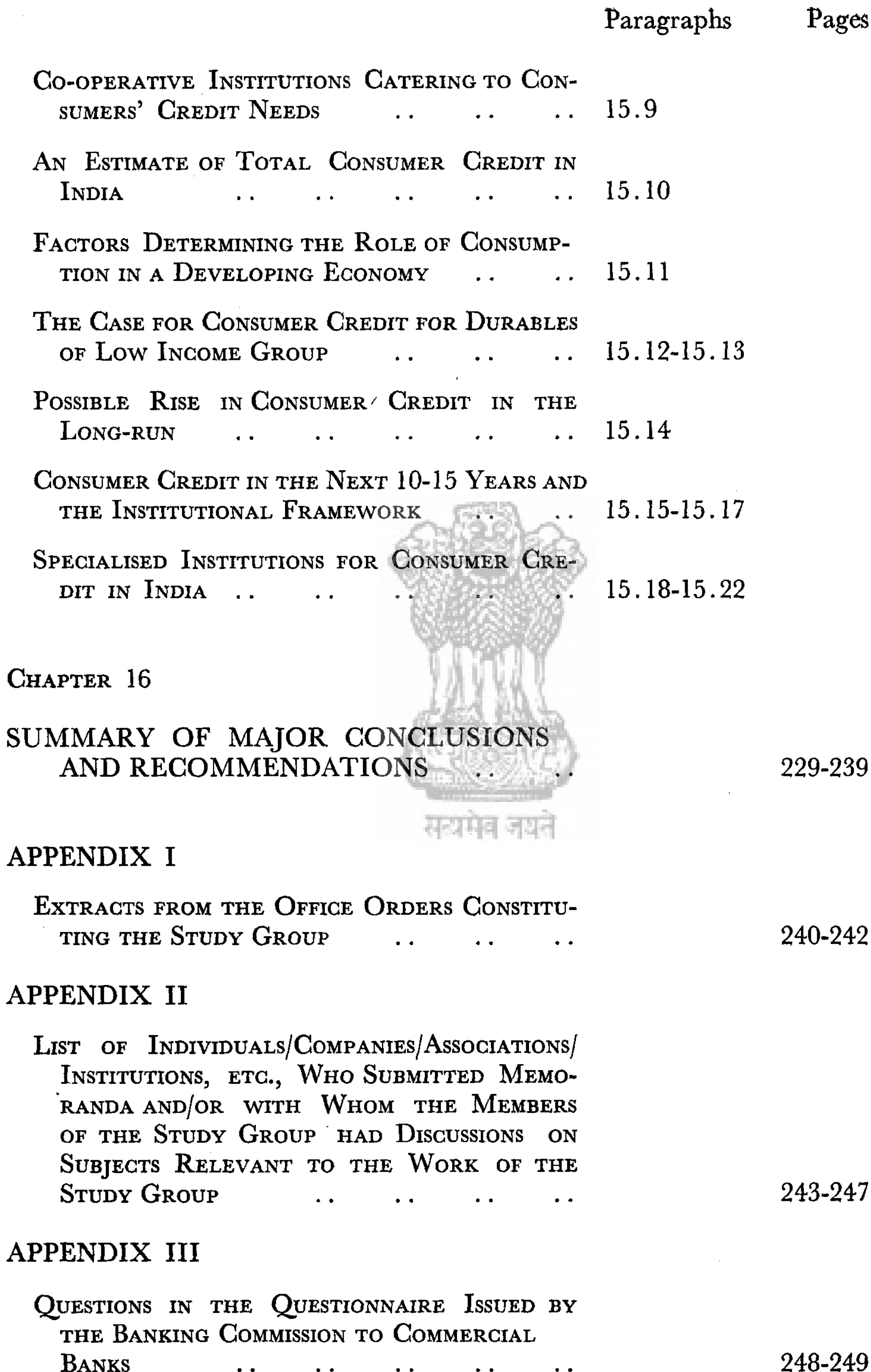

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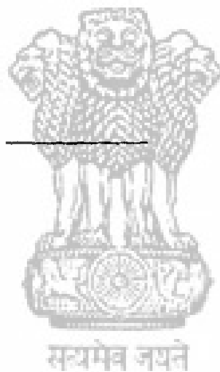

CHAPTER 1

PREAMBLE

GENESIS OF THE STUDY GROUP

The Banking Commission which started functioning in March 1969, was appointed by the Government of India to examine the banking system of the country and make recommendations for improving its structure and extending its geographical and functional coverage. According to one of its terms of reference, the Commission was also asked "to review the role of various classes of non-banking financial intermediaries, to enquire into their structure and methods of operations and recommend measures for their orderly growth". In order to make a detailed study of the existing non-banking financial intermediaries and to examine the question whether specialised financial institutions were required by the economy, the Banking Commission constituted the present Study Group on 4th June, 1970.

TERMS OF REFERENCE

1.2 The terms of reference of the Study Group were :—

(*i*) To review the role of various classes of non-banking financial intermediaries at present existing in the country such as Unit and Investment Trusts, Chit Funds, Nidhis and loan companies, and other finance companies ;

(*ii*) To enquire into the structure and methods of operations of these non-banking financial intermediaries and to recommend measures for their orderly growth (Insurance companies and Development banks such as the I.D.B.I., I.C.I.C.I., S.F.C.s, would be excluded from the purview of the Group);

(*iii*) To consider what other types of non-banking financial intermediaries such as specialised savings banks, building societies, consumer finance companies, Export-Import Bank, Small Scale Industries Bank, etc., are needed for the proper development of the economy ;

(*iv*) To recommend appropriate measures therefor ; and

(*v*) To make any recommendations on any other related subject matter as the Study Group may consider germane to the subject of enquiry or any related matter which may specifically be referred to the Group by the Commission.

Composition of the Study Group

1.3 The following was the composition of the Study Group :—

1. Dr. Bhabatosh Datta,
   Member,
   Banking Commission,
   Bombay. — *Chairman*
2. Shri D. A. Ambekar,
   Manager,
   Maharashtra Co-operative Housing Finance Society Ltd.,
   Bombay. — *Member*
3. Shri R. S. Bhatt,
   Chairman,
   Unit Trust of India,
   Bombay. — *Member*
4. Shri A. B. Bilimoria,
   Managing Director,
   Investment Corporation of India Ltd.,
   Bombay. — *Member*
5. Shri D. N. Kaveeshwar,
   Deputy Superintendent of Police,
   Bureau of Police Research & Development,
   Ministry of Home Affairs,
   Government of India,
   New Delhi. — *Member*
6. Shri M. Narasimham,
   Secretary,
   Reserve Bank of India,
   Bombay. — *Member*
7. Shri S. D. Pardiwalla,
   Deputy General Manager,
   Union Bank of India,
   Calcutta. — *Member*
8. Shri T. S. Santhanam,
   Chairman,
   Sundaram Finance Ltd.,
   Madras. — *Member*
9. Shri A. Hasib,
   Director of Research,
   Special Cell in the Reserve Bank of India to assist the Banking Commission,
   Bombay. — *Convener*

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1.4 Shri Ambekar expressed his inability to serve on the Study Group and Shri Jawaharlal A. Darda, Chairman, Maharashtra Co-operative Housing Finance Society Ltd., was appointed a member in his place. However, Shri Ambekar attended some of the meetings. Shri K. J. Natarajan, Officer on Special Duty, State Bank of India and Shri R. Krishnan, Assistant Legal Adviser, Reserve Bank of India were permanent invitees to the meetings of the Group.

Work of the Group

1.5 The Chairman of the Banking Commission, Shri R. G. Saraiya, inaugurated the first meeting of the Study Group. In all 8 meetings were held at Bombay on the following dates :

1st meeting on 17th June 1970

2nd meeting on 20th July 1970

3rd meeting on 24th August 1970

4th meeting on 6th November 1970

5th meeting on 17th December 1970

6th meeting on 4th February 1971

7th meeting on 21st and 22nd June 1971

8th meeting on 9th August 1971

1.6 Some members of the Study Group also undertook tours to Bangalore, Madras and Calcutta to make on-the-spot studies on some subjects relevant to the work of the Study Group and to have discussions with representatives of different bodies.

Acknowledgement

1.7 The work of the Study Group which covered a wide range of subjects could not have been finished within a short period of a little over one year if the Study Group had not received the co-operation of a number of persons and institutions. Shri R. G. Saraiya, Chairman of the Banking Commission, Shri N. Ramanand Rao, Member and Shri V. G. Pendharkar, Member-Secretary, attended some meetings of the Group and made valuable suggestions. The Group is particularly grateful to Shri Pendharkar for the keen interest that he took in its work and for the valuable contribution that he made to its deliberations. The Reserve Bank of India supplied useful material. Shri R. K. Seshadri, Executive Director of the Reserve Bank of India, in particular, gave valuable assistance and suggestions to the Group.

The Government of India, some State Governments and the Industrial Development Bank of India also helped the Group by sending material in response to its request. A number of banks, associations and individuals also submitted memoranda and some of them had discussions with the Group. All this material was useful for the discussions of the Study Group and the preparation of its Report. It may be added that none of the institutions or persons who assisted the Group is responsible for the views expressed in the Report.

1.8 The Study Group is also thankful to Sarvashri K. J. Natarajan and R. Krishnan who attended almost all the meetings of the Group and took active part in its deliberations. Sarvashri A. Vasudevan, M. Saravane and K. N. Kotwal, Officers of the Special Cell in the Reserve Bank of India to assist the Banking Commission prepared useful papers for the Group. Shri R. Rajamani, Deputy Secretary of the Banking Commission was good enough to go through the draft of the Report and make useful suggestions. Shri S. P. Kothari rendered valuable assistance by collecting material, making statistical calculations and generally attending to the work of the Group. The Study Group would like to place on record its appreciation of the valuable services rendered by them in promoting the work of the Group.

1.9 The members of the Study Group would like to place on record their sincere appreciation of the excellent work done by the Convener, Shri A. Hasib. The Group had to go into a field which was largely uncharted and it was necessary to bring together, within a short time, a wide variety of scattered information from many different sources. Shri Hasib did the work with great thoroughness and he rendered invaluable help to the Group in processing and analysing the data and in preparing the Report.

CHAPTER 2

SCOPE AND METHOD OF STUDY

INTRODUCTION

2.1 In chalking out the scope of its study, the Group was confronted at the outset with the problem of defining a non-banking financial intermediary (NBFI). It was recognised that defining a NBFI would mainly amount to clarifying what this institution is or is not in relation to a bank. Accordingly, an attempt was made to find out whether there could exist, when viewed from the economic angle, any meaningful way of drawing the line between a NBFI and a bank.

INADEQUACIES OF ECONOMIC CRITERIA FOR DISTINGUISHING BANKS FROM NBFIs

2.2 There are three factors of economic significance which suggest themselves in the first instance as factors or qualities for the purpose of classifying financial institutions into banks and NBFIs. These factors are (*i*) the nature of liabilities of the financial institutions or more precisely the extent of 'money-ness' of these liabilities, (*ii*) the extent to which the institution is able to bring about a multiple creation of credit/liabilities, and (*iii*) the significance or the proportion of financial operations akin to banking activities (*i.e.*, acceptance of deposits from the public for the purpose of lending or investment) in the overall operations of the firm or institution. A close examination of these factors, however, suggests that none of them can serve as a criterion to distinguish banks from other financial institutions without any ambiguity. First, 'money', assuming that it is uniquely defined in the conventional sense as comprising currency and demand deposits, forms only a part of total liabilities of banks, and besides many NBFIs which may not accept demand deposits in principle, may, in practice, permit withdrawal on demand of deposits with them. Hence, there exists an inherent difficulty in identifying money from among the various existing monetary liabilities of financial institutions without bringing in some element of arbitrariness. Secondly, the use of an arbitrarily chosen value of the credit multiplier for the purpose of classifying financial institutions into banks and NBFIs is also not devoid of conceptual and practical difficulties because of the following reasons : (*a*) even if the value of the multiplier is small as is presumed in case of NBFIs, the latter still is 'creating' money ; (*b*) the difference in credit multipliers between a NBFI and a bank may not even be as great as

between one bank and another ; and (*c*) a categorisation of financial institutions on the basis of values of credit multipliers need not hold good at a future time. Thirdly, an attempt to classify financial institutions into banks and NBFIs on the basis of the proportion of 'banking' business (as generally understood in the sense of acceptance of deposits of money from the public for the purpose of lending or investment) in relation to their main business runs into difficulties for there is no reason why many a firm doing the business of 'banking' as secondary to its main activity should not in course of time develop its secondary business into its main business.

Inevitable Element of Arbitrariness

2.3 From the foregoing, two points may be underlined. First, an element of arbitrariness cannot be avoided in attempting to classify financial institutions into banks and NBFIs ; this is equally applicable to any effort which attempts the classification on the basis of factors/qualities of economic significance. Secondly, no single criterion appears to be sufficiently reliable for the purpose of drawing a distinction between banks and NBFIs.

Legal Definition

2.4 At present, in most of the countries, the term 'banking' has been defined by legislation, but in most cases the definition does not appear to meet with general acceptance and more often than not gives rise to technical difficulties. In India, 'banking' is defined in the Banking Regulation Act, 1949, as "accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise". The interpretation of such a definition is not an easy task, for those institutions which are by usage or in practice considered as banks for the purpose of regulation no doubt correspond to the definition but, at the same time, many of those which are excluded for the purpose of regulation are not necessarily outside the purview of that definition when it is understood literally. Thus, for example, loan companies or investment companies which are 'financial institutions' as defined in Chapter III-B of the Reserve Bank of India Act, 1934, and which accept deposits from the public for the purpose of their business (*i.e.*, lending or investment), though they are banking companies according to the definition have not been effectively brought under the scope of the Banking Regulation Act, 1949.

Definition for Purpose of Regulations

2.5 It may, however, be recognised that not all the provisions of the Banking Regulation Act, 1949, can be applicable *in toto* to all financial institutions falling within the purview of the definition of banking cited above. It is quite understandable that only a modified version of banking regulations

can be introduced to cover a large number of these financial institutions having in view the administrative problems arising on account of the large number and wide geographical dispersion of these institutions. It is sometimes suggested that the acceptance of deposits withdrawable by cheques can be considered to be a reasonable criterion for classifying financial institutions doing the business of banking into those accepting chequeable deposits to whom all the provisions of the Banking Regulation Act, 1949, would be applicable and those not accepting chequeable deposits to whom these provisions would be applicable only in a modified form. There is a snag even with this criterion for there are post office savings departments at certain centres offering cheque facilities on savings deposits kept with them. The post office savings banks, however, do not undertake any lending business. One does not, therefore, wish all the provisions of the Banking Regulation Act, 1949, to be extended to these institutions. Hence, even this criterion may have to be suitably qualified.

2.6 It may be mentioned at this juncture that for ensuring adequate protection to depositors and also a more effective supervision over the management of the monetary and credit system, a new act called the Banking Laws (Miscellaneous Provisions) Act, 1963, was enacted which vested powers in the Reserve Bank of India to supervise, control and regulate the activities of companies or institutions, which, though they are not treated as banks, accept deposits from the general public or carry on other business which is allied to banking.* For the purpose of this enactment, non-banking institution means a company,@ corporation† or firm‡ and "financial institution" means any non-banking institution (*i*) which carries on as its business or part of its business the financing, whether by way of making loans or advances or otherwise, of trade, industry, commerce or agriculture, or (*ii*) which carries on as its business or part of its business the acquisition of shares, stock, bonds, debentures or debenture stock or securities issued by a Government or local authority or other marketable securities of a like nature, or (*iii*) which carries on as its principal business hire-purchase transactions or the financing of such transactions.

2.7 From our viewpoint, we may note the following : First, the current definition of the term 'banking' is evidently an arbitrary one. Secondly,

* The following objectives were mentioned by the Minister while explaining the Banking Laws (Miscellaneous Provisions) Bill in the Lok Sabha :

"...... deposits which are now received and handled outside the banking system, should be controlled, not only in the interests of the depositors themselves, but also in the general and wider public interest. We also intend that the activities of loan, investment and hire purchase companies or firms, or other financial institutions, which grant loans and advances for a variety of purposes, or purchase securities or shares, and thereby influence or affect the money and capital markets, should be controlled by the central bank of the country, so far as these activities are concerned...."

Lok Sabha Debates, 16-12-63 to 20-12-63, p. 5682.

@ "Company" means a company as defined in Section 3 of the Companies Act, 1956, (1 of 1956) and includes a foreign company within the meaning of Section 591 of that Act.

† "Corporation" means a corporation incorporated by an Act of any legislature.

‡ "Firm" means a firm as defined in the Indian Partnership Act, 1932, (9 of 1932) of which the capital subscribed by its partners exceeds one lakh of rupees.

even the existing legal definition does not help in drawing a line of distinction between banks and NBFIs without any ambiguity. It may be mentioned here that the various issues relating to the definition of banking are being considered by the Study Group to Review Legislation Affecting Banking.

Scope of the Study

2.8 Having in view the difficulties involved in the foregoing taxonomic problem, it was decided that the Group would study the following financial institutions :

(*i*) Hire-purchase finance institutions,

(*ii*) Investment companies,

(*iii*) Chit funds/kuris,

(*iv*) Nidhis or Mutual benefit funds, and

(*v*) Finance corporations.

These institutions are recognised to be important non-banking financial institutions. There is another reason which also prompted the Group to opt in favour of studying the abovementioned institutions only. The terms of reference of the Study Group themselves delineate to some extent the scope of our study. The Group was asked to cover financial intermediaries at present existing in India such as Unit and Investment Trusts, Chit Funds, Nidhis, loan companies and other finance companies. Insurance companies, statutory bodies like Life Insurance Corporation of India and the Unit Trust of India as well as development banks such as I.D.B.I., I.C.I.C.I. and S.F.Cs were excluded from the purview of the study.

2.9 Besides, as suggested by the terms of reference, the Group also included within its scope the task of considering what other types of non-banking financial institutions such as Merchant Banking Institutions and Acceptance and Discount Houses, Export-Import Bank, Small Scale Industries Bank, Specialised Savings Banks, Specialised Institutions for Housing Finance and Specialised Institutions for Consumer Credit are needed for meeting the requirements of the economy. The bases for enquiring into the need for specialised financial institutions are enunciated in a later chapter.

Limitations of the Study

2.10 Having outlined the scope, we may indicate the limitations of the study. The Group was confronted with two major constraints, namely, the non-availability of adequate data required for a thorough analysis and

the limited period of time available at its disposal. It, therefore, relied mostly on readily available data the degree of accuracy of which cannot be vouchsafed ; mostly, the statistical data used indicate only broad orders of the magnitudes involved. The Group, however, made use of information gathered in response to circular letters sent to individuals, associations, etc., and memoranda received from some of them, and also through personal interviews held in many cases. Material collected by the Banking Commission was also utilised. Every member of the Study Group prepared paper in his specialised field.

2.11 Having defined the scope of our work the next problem was to decide our general approach to the NBFIs before examining each of the institutions separately. This is dealt with in the following chapter.

Chapter 3

APPROACH OF THE STUDY GROUP

Scope of the Chapter

3.1 In this chapter we shall define the approach of the Study Group to the question whether NBFIs should be encouraged on general grounds and, secondly, if they are to be regulated, what should be the nature of regulation. There exists an extreme view against the usefulness and the very continuance itself of NBFIs in India. This argument is based both on economic and administrative grounds. It has been argued that the NBFIs in India do not have a useful role to play, particularly after the nationalisation of major commercial banks, and the assumption of additional responsibilities by the banking system in India. In other words, commercial banks are the major repositories of savings of the community and are filling up credit gaps. Hence, according to this point of view, there is hardly any useful role for the growth of NBFIs in the economy. On the other hand, it is contended that if the NBFIs are encouraged to grow, their operations could dilute the effectiveness of monetary policy. It is, therefore, suggested that steps should be taken to regulate NBFIs in such a way as to discourage their growth. This conclusion is sought to be strengthened on administrative grounds because the administrative machinery will not be able to cope with the task of regulating and controlling the activities of a very large number of NBFIs in India. We shall examine these arguments in the following paragraphs.

3.2 Since the major arguments, summarised above, revolve around the place of NBFIs in the financial system, let us examine the role that NBFIs with which the Study Group is concerned, are playing in the economy.

Role of Financial Intermediaries

3.3 Financial intermediation which represents the dichotomy between the saving and investment functions is a concomitant of modern monetary exchange economy. Indeed, the stage of development in importance and diversity of financial institutions or, putting it in another way, the existence and width of the spectrum of financial assets is often a measure of the stage of economic development itself. The evolution, growth and proliferation of financial intermediaries are essentially the reflection of the different forms of savings (resource) flows and different types of investment (uses) of such

funds—whether for current working capital needs or for capital investment and again as between different sectors of the economy. The *inter se* relationship between different constituents of the financial market is thus related to the particular clientele they serve in their role both as repositories of the community's savings and as purveyors of funds for current and investment needs.

Banks as Financial Intermediaries

3.4 In this country, as in most others, banks are by far the most important segment of financial intermediaries. Banks, however, hold (as repositories) not only savings of the community but also part of its transactions balances ; equally they provide funds both for current capital needs as well as for investment purposes. Banks can create credit, *i.e.*, by creating monetary claims against themselves by accepting assets in the form of promises to pay, though the extent of the credit-creating capacity in India is limited by institutional factors such as the high rate of cash drain. Also the credit-creating capacity differs from one bank to another. As the coverage, both functionally and geographically, of the banking system expands it is to be expected that the share of deposits in the total of monetary resources will rise ; the spread of the banking habit is calculated therefore to reduce the cash drain and *pro tanto* increase the ability of the banking system in this country also to create credit and for advances in turn to create deposits. For the present, however, the banking system in the country is more truly a financial intermediary in the sense that its ability to purvey funds depends in a large measure on the resources it is able to mobilise.

3.5 Another feature of banks as financial intermediaries is their generalist character in that as repositories of savings they provide their customers with a range of financial instruments to choose from—from current deposits repayable on demand and savings deposits for individuals to fixed deposits for various terms apart from a variety of deposits tailored to the individual depositor's needs. On the lending side also, banks provide funds to a wide variety of sectors and for maturities ranging from credit repayable on demand to term credit and also invest in various types of financial assets. They are typically to be regarded as multi-purpose agencies as against the more specialist functions either on the savings or investment side which characterise other financial intermediaries.

3.6 In order to see whether NBFIs play a role which is supplementary to that of the banking system, we will have to consider two points : (*a*) whether they compete with the banking system in attracting deposits ; and (*b*) whether the functions of the two overlap in respect of their credit operations.

NBFIs *vis-a-vis* BANKS IN DEPOSIT MOBILISATION

3.7 In terms of drawal on the pool of the community's savings NBFIs are potential competitors with the banking system to the extent to which they compete with the latter for deposits. Deposits with the banking system comprise current accounts, savings accounts and fixed deposit accounts. The bulk of the current accounts represents the transactions balances of business ; here the liquidity of the funds is of prime importance. Savings accounts also largely represent current liquid balances of individuals and thus partake of the character of transactions balances. NBFIs in this country do not generally provide facilities for withdrawal of money on demand. The reference to competition with commercial banks has therefore relevance in the main to time accounts—and, it may be added, time accounts of the household sector are the main source of funds for the NBFIs. If an individual, despite the insured character of bank deposits, prefers to put his money with a NBFI, the factors weighing with him could be the comparative rates of return on the deposits, the type of customer service or simply the easier accessibility of the NBFI. That the last named factor is considered to be important in choosing a bank by depositors is shown by a Survey of Depositors' Appraisal of Banking Services.* Proximity to residence was indicated as a reason by the largest number of depositors included in the Survey. However, this factor is of limited significance so far as the choice between a 'bank' and 'NBFI' is concerned because generally it is in the large towns and cities where the banks are well represented that NBFIs have traditionally operated and also sprouted more recently. Customer service could be a factor, though one suspects not a weighty one. The depositor of money for a term is not clearly looking to liquidity. He is concerned with safety and yield. As regards the first, it is doubtful if the bulk of individual depositors is aware of the existence of deposit insurance which offers protection to its deposits with banks, in view of the restrictions in force until recently on banks using this fact in canvassing for deposits. The fact that banks are under the surveillance of the Reserve Bank of India which has the obligation to safeguard the depositors' interests does not also seem to be sufficiently appreciated. There does not seem to be sufficient awareness of the risks a depositor runs in placing his funds in an institution, activities of which are not adequately supervised and the deposits in which do not have the protection of insurance.

3.8 It would seem, therefore, that the fact that NBFIs have been able to thrive in areas where the banking system is well spread is due to the differential in rates paid on deposits, although it may be pointed out that at present certain tax benefits are given to the depositors of commercial banks whereas

* This All-India Survey undertaken by National Council of Applied Economic Research (NCAER) on behalf of the Banking Commission covered 500 selected branches of commercial banks and 5,000 depositors. See *Technical Studies Prepared for the Banking Commission*, Vol. I Reserve Bank of India, 1972, pp. 79-105.

such benefits are not available to the depositors of non-banking financial institutions. Hardly any empirical evidence exists about the interest elasticity of savings in India. Nevertheless, it would be reasonable to assume that at the margin there would be substitution of deposits from lower yielding to higher yielding categories even at the cost of incurring greater risk. This will be particularly so on account of the phenomenon of rising price level. The importance of interest differential as a motivating factor for substitution of deposits from commercial banks to other institutions is indicated by the findings of the Survey of Depositors' Appraisal of Banking Services* that; 59% of the respondent depositors of commercial banks who also had deposits with companies said that they were motivated by the higher interest rates offered by companies ; 41% indicated 'personal reasons' as the motivating factor. Clearly some of the funds which flow into NBFIs represent funds which are already in the banking system or would have come to it but equally there is little reason to suppose that all of them represent such 'flight' deposits. It may well be that some part of the funds with them represents deposits which are transfers from currency holdings and to this extent forms part of the process of resource mobilisation by financial institutions. NBFIs indeed should be regarded as being partly in the organised sector of the financial market and partly in the twilight zone between the organised and unorganised sectors.

3.9 One of the reasons why NBFIs have succeeded in mobilising deposits by being able to pay higher rates on them is that whereas commercial banks are required to maintain specified liquidity ratios which tend effectively to limit the earning potential of their funds, NBFIs, with the exception of hire-purchase and housing finance companies are not subject to any liquidity requirements. Further, commercial banks are subject to regulation of deposit rates while NBFIs are not. NBFIs are able to attract deposits by the offer of higher deposit rates largely because they are able to recoup—or more than recoup—these rates by charging their loan customers high rates. The latter is possible because, for one thing, the major clientele they cater to—the small man—has few other sources of finance. Commercial banks—at least the larger among them—until very recently by and large neglected these sectors. A part of explanation for the high rates on NBFI lending, therefore, is represented by a monopoly element ; the risk element was another factor—in fact so weighty a factor that the lending activities of the NBFIs in several cases jeopardised the safety of the deposits placed with them. Malpractices and fraudulent practices were also in evidence. All this was possible because of the absence of supervision or control over their activities. The introduction, since 1966, of regulation by the Reserve Bank of India calling for information, imposing restrictions on the deposits which the 'financial institutions' can accept and, in the case of hire-purchase finance and housing finance companies, prescribing of liquidity requirements while

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op. cit., p. 131. Table 10.1.

not providing effective supervision may have generated the (mistaken) belief that these activities have come under the umbrella of official surveillance.* The higher rates paid on deposits are thus essentially a result of the absence of any effective supervision over their activities.

3.10 While some of the deposits at the margin may represent a shift from the organised banking sector, some part of it, as mentioned earlier, would constitute an aspect of resource mobilisation by organised institutions. The answer to the problem of flight of deposits would really lie in bringing about a degree of surveillance over both the deposit and lending operations of NBFIs and a regulation of rates, though, clearly, while indicating the rates, account will need to be taken of their different clientele which should enable them to pay somewhat higher rates on deposits and charge higher rates on advances than the commercial banks. In this sense NBFIs should be regarded as supplementing the activities of banks. Their functioning in deposit mobilisation is somewhat akin to the role of the small local non-scheduled or urban banks.

NBFIs *vis-a-vis* Banks in Lending Operations

3.11 Do the NBFIs compete with the banking system in the matter of purveying credit? One of the reasons often mentioned for the growth of NBFIs abroad is stated to be the growing sophistication and specialisation of the money and capital markets. This view needs qualification. NBFIs abroad (and indeed in India as well) are at least as old as the banks. Their growth has been parallel. Banks abroad concentrated on commercial or industrial lending while NBFIs generally concentrated on lending to the 'household' sector—for a house, a durable consumer good or just plain consumption. In India too, business lending by banks has been their major activity while lending to the small borrower has been, by and large, neglected. The activities of NBFIs in India have embraced the traditional individual lending as has been the case with nidhis or chit funds and to the individual business sectors represented by the hire-purchase finance companies. Here again, the answer would be that they would be competing at the margin but certainly not to the point of causing any significant dent in the business of commercial banks. In fact, the growth of NBFIs represents a gap-filling function inasmuch as they are catering for purposes which were not met by the organised banking system until recently and to a class of customers which may not be obtaining finance at the right time and in the right quantities from the organised banking system. The case of hire-purchase finance

* In fact many companies—both financial and non-financial—mentioned in their advertisements that they were inviting deposits from the public 'as per Reserve Bank rules.' To give an example, one firm of brokers in its advertisement has stated as follows:

> "For some time past the non-banking industrial companies have been taking loans from the public and the Government of India have started a separate department known as the Department of Non-Banking Companies, Reserve Bank of India, Calcutta, to whom companies taking deposits are answerable."

companies is an obvious example. Similarly, simple chit funds cater to the needs of the small borrower for purposes of even consumption or perhaps for the acquisition of durable consumer goods. Likewise, nidhis are performing small loan functions somewhat akin to the services of the small non-scheduled banks or urban co-operative banks. In some cases, chit funds and nidhis have evolved themselves into commercial banks.

3.12 With the increasing interest taken by the banking system in financing the small man, there may well be a shift of clientele from the NBFIs to the banking system. It is not as if this would mean that there is no scope for the NBFIs. For, there always will be an area of credit beyond the line representing what commercial banks would be prepared to finance and it is to this class of customers that NBFIs would cater. The question of competition between commercial banks and NBFIs arises only if both perform similar functions and cater to the requirements of the same sectors of the economy. While borrowers with greater creditworthiness (defined broadly in terms of repayment potential rather than security possession) could borrow from commercial banks, the residual borrowers will still go to the NBFIs. If one may parody the phrase of Keynes, we have in this country only a "fringe of satisfied borrowers". And as long as there is a large enough residual category unable to obtain bank finance on conventional terms, there will always be some scope for NBFI activity.

Basic Stand of the Study Group on the Role of NBFIs

3.13 The basic stand of the Study Group, namely, that generally NBFIs play a role supplementary to that of commercial banks is strengthened if it is realised that they could be made to play a more positive and dynamic role in the saving-investment and hence in the growth process itself in view of the fact that there exists in India the need for (*a*) raising domestic savings to bridge the saving-investment gap ; and (*b*) ensuring proper inter-sectoral flow of funds arising on account of the asymmetry in the saving-investment structure.

Saving-Investment Gap

3.14 Both the rate of gross domestic capital formation over the years and its target rate for the Fourth Plan when compared to the rate of growth of gross domestic savings reveal a wide gap between the desired (or required) gross domestic capital formation and gross voluntary domestic savings. This implies that the gap may have to be met by inflow of foreign capital and/or by forced domestic savings. The present climate of foreign aid precludes reliance to any appreciable extent on such aid as a gap filler between investment requirements and domestic savings. Forced savings imply continuance of inflationary conditions. These solutions, therefore, will evidently not find favour under the present circumstances in India. Hence, the need

for stepping up the rate of growth of voluntary domestic savings becomes all the more imperative. An equally important point is that in the process of mobilising more savings, different savings media offering varying degrees of a mix of liquidity, return and safety of the savings will be required. This in turn would mean that the scope of the working of various financial institutions will have to be widened and strengthened.

Asymmetry in the Saving-Investment Structure

3.15 Moreover, financial institutions will have to be geared to meet the asymmetry in the saving-investment structure which is expected to develop in the process of economic growth. That the process of transfer of savings is linked with the state of economic development is shown by statistics of the flow of funds in different sectors of the economy. Table 3.1 shows the extent of borrowings of the deficit sectors, *viz.*, Government and the private corporate business, and of the lending of the surplus sector, *viz.*, household sector, over a period of years. Net borrowings as a percentage of total investment of the private corporate business rose from 67 during 1951-52 through 1955-56 to 75 during 1956-57 through 1960-61 and remained at about that level during 1961-62 through 1965-66, whereas in the case of Government, the ratio rose from 60 per cent during 1951-52 through 1955-56 to 76 per cent during 1956-57 through 1960-61 and fell to 64 per cent during 1961-62 through 1965-66. The ratio of excess of savings over capital formation to total investment of the household sector fell from 416 per cent during the period 1951-52 through 1955-56 to 315 per cent during 1961-62 through 1965-66. The ratio of net borrowings to total investments of the various domestic sectors indicates the extent of asymmetry in the saving-investment structure and hence the importance of inter-sectoral flow of funds. The distribution of the household sector's net financial surplus between different domestic sectors as shown in Table 3.2 reveals that the share of the surplus directly transmitted to the investing and deficit-incurring sectors, *i.e.*, Government and private corporate business,fell from 40 per cent during the First Plan to 32 per cent during the Second Plan and finally to 24 per cent during the Third Plan. Thus, the share of the surplus routed through financial intermediaries including banking and other financial institutions rose from 60 per cent during the First Plan to 76 per cent during the Third Plan.

3.16 It would thus appear that in the process of growth of the economy, the financial institutions including the NBFIs will have to play a vital role in both mobilising deposits and in transferring the savings to investment channels. It is important to appreciate in this context that in the Indian economy, as in many underdeveloped economies, household sector is the net saving sector and provides its savings to the Government and corporate sectors. The existence of such surplus and deficit sectors and the problem of flow of funds between them in fact provide the basic rationale of the growth

of financial intermediaries. First, as financial surpluses and deficits develop in various sectors of the economy, financial intermediaries are needed to overcome certain difficulties in direct transfers of funds between surplus and deficit units arising on account of the relatively greater degree of spatial and time constraints to which individual surplus or deficit units are subjected to. Secondly, as financial intermediaries diversify the nature and enhance the attractiveness of their liabilities offered to the ultimate savers, surplus units are bound to increase their holdings of these liabilities ; in the process, the net savings and the inter-sectoral flow of funds in the economy may grow as a result of the inducement provided by the supply of diversified savings media both by banks and NBFIs.

Limitations of Banks' Operations

3.17 It will be appreciated that in spite of their noteworthy strides in recent years in terms of added strength through consolidation, increase in the volume of activities and geographical coverage, the contribution of commercial banks in mobilising the existing savings, raising the savings-income ratio, and meeting the credit requirements of all the sectors, can only be within certain limits. Traditionally, banks have felt that since a considerable portion of their liabilities consists of short-term liabilities, they should have a particular asset portfolio. Also, the lending operations of banks are conditioned by the measures taken by the monetary authorities to regulate the general supply of and demand for credit or the flow of credit to particular sectors. It is also important to note that many of the NBFIs are of indigenous origin most of which are suited to local conditions and hence can play a more useful role in the economy of the locality where they are situated.

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3.18 Once it is accepted that the economy needs both banks and NBFIs, two points remain to be examined. First, we have to see whether the growth of NBFIs affects the effectiveness of monetary policy and, second, what should be the nature of regulation which should be imposed on NBFIs.

Operations of NBFIs and Monetary Policy

3.19 It is sometimes pointed out that as a result of the activities of NBFIs, the efforts of monetary authorities to regulate credit have often been thwarted. The Radcliffe Committee, for instance, drew attention to this aspect in the U.K. In India, however, this problem has not assumed a large dimension mainly because the activities of NBFIs are confined to a comparatively narrow field. At the end of March 1968, for instance, the amount of deposits of non-banking financial companies reporting acceptance of deposits to the Reserve Bank, was less than 3 per cent of the deposits of commercial banks (Table 3.3). Also, NBFIs do not generally add to the

money supply by their operations. Their activities may, however, increase the velocity of money. This argument holds good only on the assumption that the liabilities of NBFIs are good substitutes for money in the assets' portfolio of various units or sectors in the economy whether households or firms. That is, when the liabilities of NBFIs are sufficiently good substitutes for money, they would tend to lead to an increased elasticity of demand for money and hence induce a shift from idle cash into these money substitutes. Under this mechanism, an anti-inflationary monetary policy may become ineffective when idle money balances find their way into the stream of expenditures *via* their shift into liabilities of NBFIs. This argument is based on the assumption that the liabilities of NBFIs are good substitutes for money which is not always the case. However, even if the liabilities of NBFIs are not good substitutes for money as such, the operations of NBFIs can still weaken the monetary policy by competing with banks in their intermediary role. In other words, if NBFIs, which are not as closely regulated as banks, grow faster than banks, the regulated segment in the market for loanable funds would tend to shrink relatively. It is also possible that some of the NBFIs provide margin money in respect of advances where, as part of selective credit control measures, such margins have been raised. It may, however, be pointed out that even in such cases the tightening of credit policy may lead to rise in the lending rates of NBFIs. Thus, the purpose behind credit controls, namely, to lower the net profit expectations of borrowers is not necessarily defeated by the activities of NBFIs. Yet, it has to be admitted that unless the operations of NBFIs are regulated, they might affect the effectiveness of monetary policy. It is also possible that in the absence of regulation the operations of these institutions may in future become much more extensive than they are now. This factor, along with the objective of safeguarding the interests of the depositors of NBFIs, suggests the need for regulatory measures.

Nature of Present Regulations on NBFIs

3.20 The present regulations on the activities of NBFIs do not entirely meet the requirements of the abovementioned two objectives. A series of regulations over the deposit receiving activities of non-banking financial companies as well as non-banking non-financial companies were introduced for the first time as early as in 1966, by the Reserve Bank of India which was armed with adequate powers for this purpose through amendments to the Reserve Bank of India Act in 1963. It was the rapid growth of deposits in the non-banking companies sector, the high rates of interest which were being paid for these deposits and the proliferation of the non-banking sector which made it desirable to regulate the acceptance of these deposits. The main purpose of regulation was to safeguard the interests of the depositors. The directives in regard to acceptance of deposits from the public, as they are now in force, require a non-banking company (*i*) to disclose particulars regarding its management, business, profits, dividends, capital and

reserves, and deposits and other liabilities in any advertisements which may be issued soliciting deposits from the public ; (*ii*) to refrain from accepting short-term deposits for durations of less than six months in the case of hire-purchase finance companies or less than one year in the case of other companies †; (*iii*) to give proper receipts for deposits and to maintain deposit registers ; and (*iv*) to incorporate in its annual report particulars regarding the overdue deposits which have remained unpaid, if the overdues are, in the aggregate, in excess of Rs. 10 lakhs. Besides, all non-banking companies with the exception of hire-purchase and housing finance companies, are required to set a limit to the total amount of deposits acceptable by them at 25 per cent of their paid-up capital and free reserves, the development rebate reserve being treated as a free reserve for this purpose. It may be mentioned in this connection that any loan received from or guaranteed by the managing agents, Secretaries/Treasurers or directors of a company is not treated as deposit for the purpose of this regulation. Hire-purchase and housing finance companies which are free to accept deposits without limit are, however, required to keep 10 per cent of the deposits invested in approved form as liquid assets.

Need for Regulating NBFIs

3.21 An examination of the above provisions of regulation throws into bold relief the following two points :

(*a*) The Reserve Bank of India is regulating not only non-banking financial companies but also non-banking non-financial companies which accept deposits from the general public or carry on other business allied to banking, and

(*b*) the object of the regulation seems to be the limited one of safeguarding the depositors' interests.

So far as the first point is concerned, the Study Group recognises the need for regulating also the acceptance of deposits by non-financial companies by some competent authority. It may be mentioned in this connection that in the U.K., under the Protection of Depositors Act, 1963, the Board of Trade regulates the acceptance of 'deposits' by financial and non-financial intermediaries excepting commercial banks. The Canadian Banking Commission (Porter Commission) has referred to provincial legislation (*e.g.*, Ontario) which provides for the Securities Commission regulating the acceptance of deposits by non-banking companies. Thus, the need for regulating acceptance of deposits by non-banking companies is clear. At the same time, the administrative burden of regulating the deposit-receiving activities

† In the case of mutual benefit financial companies, including nidhis, which accept deposits from their own members but not from others, deposits for short-term periods from members or associate members, are not prohibited.

of a very large number of institutions has to be taken into account. We understand that the Study Group to Review Legislation Affecting Banking is examining the question of the competent authority to regulate such deposits.

3.22 Secondly, it is doubtful whether the present regulation fully serves even the purpose of safeguarding the depositors' interests. The interests of the depositors are ultimately safeguarded by ensuring that the lending operations of the institutions concerned are sound. Also, a company inviting deposits may itself be sound but it may lend the funds obtained by way of deposits to another company about which the depositors may not know anything. The present regulation does not deal with this problem.

3.23 Summarising the arguments so far: (*a*) NBFIs can usefully supplement the activities of banks; and (*b*) they need to be regulated not only to ensure the depositors' funds but also to ensure the implementation of credit policy objectives of providing credit to neglected sectors at reasonable rates and restricting its availability for less essential purposes. Also, there is a need for encouraging the growth of NBFIs which are capable of playing a dynamic role in the economy. These issues are clearly inter-related.

Concept of 'Approved' Institutions

3.24 Regulation in the form of detailed administrative supervision and periodical inspection would pose certain problems in designing the organisation for control because of the very large number of NBFIs scattered all over the country and the widely varying nature of their operations. Also the extent of detailed supervision would vary from case to case. The administrative problem can partly be solved by passing a law which may stipulate that only corporate bodies can do the banking business in the sense of accepting deposits from public for the purpose of lending or investing. In that case it will become easier to regulate NBFIs under the Banking Regulation Act. Also, a specified minimum degree of control by enforcement of requirement of compulsory licensing, regular reporting and prescription of minimum capital and liquidity ratios should result in the weeding out of a number of unsound NBFIs. The Group took the view that while a minimum degree of control may be exercised on all NBFIs, those units — to be designated as 'approved NBFIs' — which satisfy certain additional requirements to be laid down by the regulating authority, may be accorded a special and favourable treatment. 'Approved' institutions which will be only corporate bodies besides being regulated along with 'non-approved' ones, could be made eligible for refinance facilities from the banking system and their own lending operations could also be covered under the Credit Guarantee Scheme. Eventually, even the Deposit Insurance Scheme can be extended to those of the approved NBFIs whose manner of conducting business meets the requirements of the Deposit Insurance Corporation. The criteria for recognition and for approval would naturally be different for different types of NBFIs

and would therefore be left to the regulating authority to decide. However, the basic factor to identify 'approved' institution will have to be the quality of its operations. Hence, the Reserve Bank, or any other regulating authority that may be set up in this behalf, will have to strengthen or build up its inspecting machinery so that these institutions can be inspected at least on a sample basis.

3.25 The kind of regulation suggested above would help in course of time to a reduction in the number of NBFIs into a more manageable number of viable institutions. It may also be mentioned that in dealing with the question of regulation, the approach may have to be tailored to the special characteristics of the different types of NBFIs. Some types of NBFIs would obviously need a greater degree of surveillance than others. Once the list of 'approved' institutions is given proper publicity, it is expected that the operations of the 'non-approved' institutions will progressively decline. Thus, the administrative problem in regulation will assume manageable proportions. Besides, under this approach, whenever necessary and desirable the operations of NBFIs could be integrated with those of commercial banks.

3.26 Having the foregoing in view, the Group decided that in its study it would (*a*) review the working of the existing non-banking financial institutions and make recommendations for improving their working so that savings can be channelised into proper use ; (*b*) locate areas where the existing non-banking financial institutions are inadequate ; (*c*) define the areas where highly specialised institutions may be required ; and (*d*) point out areas where changes in the legal structure may be required from the point of view of the safety of depositors' money placed with the institutions and the promotion of objectives of economic policy.

TABLE 3.1—SECTOR SHARE IN CAPITAL FORMATION AND SAVINGS*

(Rs. in crores)

		Period/Years	Total	Govern-ment	Private Corporate Business	House-hold
1. Savings	a.	1951-52 to 1955-56	1881	587	201	1093@
	b.	1956-57 to 1960-61	3564	914	273	2377@
	c.	1961-62 to 1965-66	7417	2487	574	4356@
2. Net Borrowings **	a.	1951-52 to 1955-56	417	882	416	—881
	b.	1956-57 to 1960-61	1856	2881	824	—1849
	c.	1961-62 to 1965-66	2715	4426	1596	—3307
3. Total Investment (1) + (2)	a.	1951-52 to 1955-56	2298	1469	617	212
	b.	1956-57 to 1960-61	5420	3795	1097	528
	c.	1961-62 to 1965-66	10132	6913	2170	1049
4. $\frac{(2)}{(3)} \times 100$	a.	1951-52 to 1955-56	*18*	*60*	*67*	*—416*
	b.	1956-57 to 1960-61	*34*	*76*	*75*	*—350*
	c.	1961-62 to 1965-66	*27*	*64*	*74*	*—315*

* At current prices.
@ In financial assets only.
** Financial Deficit.

Sources : (1) *Report on Currency and Finance, 1969-70*, Reserve Bank of India.
(2) "Financial Flows in the Indian Economy—1951-52 to 1962-63," *Reserve Bank of India Bulletin*, March 1967.
(3) Reserve Bank of India Bulletin, July 1969.

TABLE 3.2—DISTRIBUTION OF THE HOUSEHOLD SECTOR'S NET FINANCIAL SURPLUS BETWEEN DIFFERENT DOMESTIC SECTORS

(Rs. in crores)

Period/Years	Borrowing Sectors				
	Private Corporate Business	Govern-ment	Other Financial Institutions	Banking	Total
a. 1951-52 to 1955-56	—274.8 *(31.2)*	—73.1 *(8.3)*	—319.7 *(36.3)*	—213.5 *(24.2)*	—881.1 *(100.0)*
b. 1956-57 to 1960-61	—281.0 *(15.2)*	—301.0 *(16.3)*	—592.6 *(32.0)*	—674.8 *(36.5)*	—1849.4 *(100.0)*
c. 1961-62 to 1965-66	—253.0 *(7.7)*	—546.3 *(16.5)*	—861.5 *(26.1)*	—1645.9 *(49.7)*	—3306.7 *(100.0)*

Note : Figures in brackets denote percentages.
Source : Reserve Bank of India Bulletins, March 1967 and July 1969.

TABLE 3.3—DEPOSITS OF NON-BANKING COMPANIES* & COMMERCIAL BANKS 1962-68

End of March	Deposits of non-banking financial companies			Deposits in India of Commercial Banks‡	
	No. of Companies reporting	Amount of deposits@ (Rs. in crores)	Average deposit per reporting company (Rs. in crores)	No. of banks reporting	Amount of deposits (Rs. in crores)
	1	2	3	4	5
1962	334	38.0	0.11	276	2183.3
1963	368	41.9	0.11	252	2420.4
1964	394	50.3	0.13	156	2742.4
1965	340	48.9	0.14	109	3073.3
1966	393	54.9	0.14	100	3586.8
1967	725**	119.8£	0.23$	91	3962.1
1968	749***	123.8£	0.23$$	86	4478.0

End of March	Col. (2) as % of Col. (5)	Deposits of non-financial companies		Total deposits of non-banking companies	
		No. of Companies reporting	Amount of deposits (Rs. in crores)	No. of Companies reporting [Col. (1) + Col. (7)]	Amount of deposits@ [Col. (2) + Col. (8)] (Rs. in crores)
	6	7	8	9	10
1962	*1.74*	1208	97.5	1542	135.5
1963	*1.73*	1309	112.0	1677	153.9
1964	*1.83*	1395	135.6	1789	185.9
1965	*1.59*	1569	160.2	1909	209.1
1966	*1.53*	1964	228.5	2357	283.4
1967	*3.03*	1866	310.7=	2591	430.5
1968	*2.76*	1649	354.1+	2398	477.9++

* Including branches of foreign companies.

** Includes 201 companies which have submitted returns but do not hold deposits/exempted loans or other receipts.

*** Includes 219 companies which have submitted returns but do not hold deposits/exempted loans or other receipts.

@ Including certain loans and other receipts that have been exempted from the Directives of the Reserve Bank of India issued from time to time.

£ Includes about Rs. 1.22 crores and Rs. 2.67 crores on account of exempted loans and deposits respectively in respect of four companies on the basis of figures published in their balance sheets.

$ Average of 524 companies.

$$ Average of 530 companies.

‡ As at the end of December.

\+ Excludes about Rs. 2.33 crores and Rs. 2.15 crores representing deposits for 1967 and 1968 respectively, as published in its balance sheet in respect of one hire-purchase finance company, which did not submit returns.

= In case of one company, a sum of about Rs. 5 crores being a loan from USAID guaranteed by the managing agents has not been included under unsecured loans.

++ Excludes an amount estimated at about Rs. 2 crores received in the form of unsecured loans by three companies in one group which were not reported as on 31 March 1968.

Source: Reserve Bank of India Bulletin, April, 1971.

PART II

STUDY OF EXISTING NON-BANKING FINANCIAL INTERMEDIARIES

CHAPTER 4

HIRE-PURCHASE FINANCE INSTITUTIONS

INTRODUCTION

4.1 The institution of hire-purchase or instalment credit is quite old and well organised in some foreign countries like U.K. and U.S.A. In India, hire-purchase credit system came into existence in the years following World War I*. It grew steadily in the 1930's and 1940's. It was only after the Second World War that the growth was of large dimension. Hire-purchase credit in India is given both by institutions in the organised sector, like commercial banks, hire-purchase finance companies and State Financial Corporations (SFCs) as well as by the non-organised sector consisting of a large number of firms and individuals.

SCOPE OF THE STUDY

4.2 Two Study Groups† have recently gone into the different aspects of the problems of road transport financing. Since the bulk of hire-purchase finance in India goes to the road transport industry, these two Study Groups have discussed at length the growth of hire-purchase finance institutions and their problems. They have also made valuable suggestions with a view to encouraging the flow of hire-purchase finance to the road transport industry. In this chapter, therefore, we shall not discuss the questions already covered by these two Study Groups. Since the Study Group to Review Legislation Affecting Banking is studying different aspects of the law relating to secured transactions including hire-purchase finance, we shall also not go into the legal aspects of hire-purchase finance. We have, therefore,

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* The Travancore Banking Enquiry Committee, 1930, made a reference to hire-purchase finance in their Report (p. 102), in the following words :

"Ordinarily the man who puts a bus on the road is not a man with sufficient capital. He gets the bus on hire purchase system and finds the capital for down payment either himself or by a loan from a bank. Until he has paid all the instalments, the vehicle is not his. Any default in the payment of instalments results in the attachment of the bus. It is said that attachments are becoming more frequent which seem to indicate that the business is not thriving. When payment for an instalment falls due, the bus-owner borrows of a bank at a high rate of interest and he is unable to repay the loan in time or for ever, with the result that the bus goes into the bank's custody. Certain banks having advanced on the security of the buses had to take over and deal in second-hand buses. ...... However, it is quite clear from the evidence before us that the industry is at its nadir."

† (1) 'The Study Group on Road Transport Financing,' (Chairman : R. G. Saraiya), appointed by the Government of India, Ministry of Transport & Shipping, (1968), and

(2) 'The Study Group on the Provision of Credit Facilities for Road Transport Operators,' appointed by the National Credit Council (NCC), (1969).

highlighted in this chapter only those aspects which are vital to the efficient organisation and functioning of hire-purchase financing in this country. We have focussed our attention on three points : (*a*) an assessment of the demand for and supply of hire-purchase credit ; (*b*) an examination of the organisational structure of hire-purchase finance institutions to the extent that it has a bearing on meeting the gap between the demand for and supply of hire-purchase finance ; and (*c*) making of recommendations from the point of view of strengthening the financial structure of hire-purchase finance institutions and regulating this form of credit.

4.3 For the purpose of our analysis we relied on published material, data furnished by Reserve Bank of India and also on discussions with the representatives of a few hire-purchase finance companies. We had requested a number of hire-purchase companies to prepare memoranda for the Study Group. However, only a few companies (list given in Appendix II) submitted memoranda in response to our request. The replies to questions (questions reproduced in Appendix III) pertaining to credit facilities extended by commercial banks to hire-purchase financiers, received in response to the questionnaire issued by the Banking Commission to commercial banks were also analysed for the purpose of our discussion.

Estimates of Demand for and Supply of Credit

4.4 We have made estimates of the hire-purchase credit requirements on the basis of some assumptions. The method of estimation is given in the Annexure to this chapter. According to our estimates, the total amount of credit which will be required by the transport industry as well as for financing purchase of tractors including implements and trailers will come to about Rs. 210 crores at the end of 1973-74. If the demand for hire-purchase credit for farm machinery and producers' goods required by medium industries is also included, the magnitude of new gross hire-purchase credit required at the end of 1973-74 would be about Rs. 260 crores. It may be noted that if the prices of goods to be financed rise in the meanwhile, the estimates will be higher.

4.5 The credit made available by the State Bank group and the 14 nationalised banks has steadily increased since July 1969. Outstanding advances to transport operators which stood at about Rs. 5 crores at the end of June 1969, increased to Rs. 37 crores at the end of 1970. The number of accounts increased by seven times from 2,527 to 18,450 during the same period. With the vigorous expansion of such advances by the public sector banks, we can expect that their share may increase to Rs. 100 crores by the end of 1974. This will leave a gap of about Rs. 160 crores to be filled by SFCs and hire-purchase finance institutions in the private sector.

4.6 According to available information, the advances of SFCs to transport operators including those made for repairs and establishment of work-

shops have been increasing rapidly during the last three years. SFCs in Maharashtra, Jammu and Kashmir and Gujarat are more active in this field. Judging by the estimates of outstandings of hire-purchase credit extended by SFCs and the rate of growth of such credit, we may estimate the amount of credit advanced by them in 1974, at about Rs. 5 crores. This will leave a gap of Rs. 155 crores to be filled by hire-purchase financiers. It may be noted that this is only a gross figure and does not take into account the funds which would come back to the lenders by way of repayment of loans. In fact, an appreciable percentage of loans made in earlier years is collected in the course of the year. Thus, if the return flow of funds is taken into account, the net burden of meeting the total requirements of hire-purchase credit would be lighter.

Scope for Private Hire-Purchase Institutions

4.7 It is clear from the above that there is scope for commercial banks, SFCs as well as for private finance institutions in the sphere of hire-purchase credit. Also, there are certain characteristics of the hire-purchase finance business which ensure a place for private hire-purchase finance institutions in the credit system of the country. Commercial banks usually do not give credit for old vehicles. The road transport industry is essentially a small scale industry. A new entrant to this business does not always start with a new vehicle but first purchases a secondhand vehicle and then graduates to a new one. A large number of used vehicles is purchased by new entrants who are in need of finance. Also, follow-up action after giving hire-purchase credit requires some specialised expertise. Not only do the movable goods sold on hire-purchase basis involve problems of depreciation, but they can be easily moved to distant places and fraudulently sold to others without the knowledge of the owners. Thus hire-purchase finance has special features in which the expertise of hire-purchase financiers is of great use.

Characteristics of Hire-Purchase Finance Institutions

Uneven Spread in the Country

4.8 The characteristics which are predominant in the case of private hire-purchase finance institutions in India are the uneven distribution of such institutions in the country, weak organisation of a large number of units and shortage of financial resources to meet the entire demand for credit. Comprehensive statistics are not available regarding the operations of non-bank hire-purchase financiers. While hire-purchase finance institutions are well developed in the South, they are not so well developed and organised in the Eastern or Northern regions. It is estimated that in the four Southern States of Andhra Pradesh, Kerala, Mysore and Tamil Nadu, there are about 500 financiers. Of these, 3 limited companies and approximately 250 part-

nership firms and individuals are in Tamil Nadu only. The following table showing the estimated quantum of credit for financing the sale of commercial vehicles towards the end of 1965 according to different regions also indicates the uneven distribution of hire-purchase credit in the country.

TABLE 4.1—AVAILABILITY OF CREDIT FOR FINANCING THE SALE OF COMMERCIAL VEHICLES IN DIFFERENT REGIONS OF THE COUNTRY AT THE END OF 1965

(Rs. in Crores)

Region	Rs. in Crores
Eastern Region	12.5
Western "	17.5
Northern "	20.0
Southern "	25.0
Total	75.0

Source : *Report of the Study Group on Road Transport Financing*, Government of India, 1968, p. 15.

Large Number of Small-sized Units

4.9 Apart from the uneven coverage of the country by hire-purchase finance institutions, another problem is that a large number of them are individuals and partnership firms. High rates of interest charged or forcible repossession of vehicles for which hire-purchase finance had been extended usually characterise the operations of the smaller units.

Shortage of Funds

4.10 A third problem is the shortage of funds with private hire-purchase finance institutions in relation to demand on their resources. Even in the case of bigger hire-purchase finance companies, a major portion of liabilities consists of external borrowings. The Saraiya Committee had analysed the sources and uses of the funds of 215 hire-purchase finance companies for the accounting periods ending generally in 1965 or 1966. On the basis of this analysis, it was found that the ratio between owned funds (paid-up capital, and reserves and surpluses) and borrowings (loans from commercial banks, deposits from the public and other unsecured loans) of these 215 companies taken together was roughly 1 : 3.3. This ratio varies from institution to institution. The degree of variation is large extending from 1 : 1 in a few cases to as high as 1 : 8 or even higher in some others. The scope for increasing the capital by issuing shares in the market is rather limited because the number of well-managed companies is small. Thus, these institutions have necessarily to depend on bank loans and deposits from the public, although not all the companies accept deposits.

Commercial Banks' Credit to Hire-Purchase Financiers

4.11 Commercial banks extend credit to hire-purchase financiers. But they face many difficulties in this sphere. From the analysis of the answers given by commercial banks in response to the questionnaire of the Banking Commission, it seems that the majority of banks extend credit to hire-purchase financiers for the purchase of motor vehicles although a few of them in the category of 'other scheduled commercial banks' (*i.e.*, non-nationalised Indian scheduled commercial banks) also make advances for machinery including agricultural machinery. The factors considered by banks in making these loans are the financial position of the borrower, his reputation and managerial capacity, the nature of products involved, etc. So far as the rates of interest are concerned, none of the reporting banks has charged interest at rates below 9 per cent or above 12 per cent per annum.† Rates charged by large-sized banks are relatively lower than those charged by small-sized banks. The majority of reporting banks stated that they do not make any stipulation regarding the extent of finance charges of the financiers.

4.12 Sixteen of the fiftysix reporting banks did not face any difficulty in extending credit to hire-purchase financiers. The greatest difficulty in the case of others, it appears, was in regard to banks not having firsthand knowledge of the integrity and creditworthiness of the ultimate borrower, *i.e.*, hirer. Next in order came the difficulty regarding inspection of the vehicles charged to the lending bank. Another difficulty which the banks expressed was their inability to register their lien on vehicles charged with the Regional Transport Authority.* Other difficulties reported to have been experienced by banks were :

(1) In case of default by hire-purchase financier, it is difficult to realise bank's security if the goods involved are vehicles, trucks, etc.

(2) Valuation of secondhand vehicles is difficult.

(3) Scope for availing of credit from more than one bank on the basis of duplicate documents from original borrowers cannot be eliminated.

(4) Banks do not have effective follow-up of repayments and also have no control over security or regulation of ultimate lending rate.

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† It may be mentioned that replies from most of the banks were received after 21st January 1970, *i.e.*, the date on which the Reserve Bank of India removed the ceiling rates on advances of banks.

* Now pursuant to Section 31A of the Motor Vehicles Act, introduced in 1969, banks and financing institutions lending against hypothecation of motor vehicles can also have their charges noted in the registration certificates of the concerned vehicles on the same basis as hire-purchase financiers could do.

(5) Financiers advance indiscriminately even to unauthorised persons which is in contravention of the rules of the banks.

(6) Financiers do not maintain proper books of account and do not submit periodical statements to the banks; and

(7) Insurance companies generally delay the settlement of claims under various pretexts.

Finance Charges

4.13 The discussion of the financial position of hire-purchase financiers will be incomplete without a reference to their finance charges. The practice of hire-purchase finance companies both in India and abroad is to state their charges on a flat rate basis, *i.e.*, charges are calculated on the basis of the entire amount of advance and not on a diminishing balance basis. Therefore, the true rate of interest is far in excess of the flat rate indicated. Ordinarily, the true rate of interest is equal to 1.8 times the flat rate on an advance for one year. Considering the conditions then existing, the Saraiya Committee had recommended a ceiling on finance charges at 9 per cent flat per annum. In making the recommendation, the Committee had taken into account the rates at which the hire-purchase finance companies borrowed money from the banks, insurance premia, rates prevailing in the various States and what is considered to be reasonable charge in the light of economic conditions. It had also taken into consideration the rates prevailing in other countries, particularly the United Kingdom and Australia. Subsequently, the Study Group appointed by the NCC which went into the question, recommended a ceiling at a flat rate of 10 per cent per annum. The Joint Committee of the Parliament on Hire-Purchase Bill has introduced a provision in the Bill that the statutory charges (hire-purchase finance charges) shall be calculated at the rate of 30 per cent per annum (true rate of interest), or such lower rate as may be fixed by the Central Government in consultation with the Reserve Bank of India, but not less than 10 per cent per annum (true rate of interest).

4.14 According to the information made available to us, the rates charged in the various regions for new vehicles are as under :

Southern Region	..	9-12 per cent per annum flat
Western Region	..	10-12 per cent per annum flat
Northern Region	..	10-15 per cent per annum flat
Eastern Region	..	10-15 per cent per annum flat

Now that banks and SFCs are extending hire-purchase finance to transport operators on a large scale at reasonable rates of interest and since their share in the total business is expected to grow, the rates at present charged by hire-purchase finance companies and individual financiers will probably not increase and may even come down.

4.15 Considering the above factors, the structure of hire-purchase finance companies and the financiers, and the existing structure of interest rates, a ceiling on finance charge at a flat rate of 10 per cent per annum on new vehicles is considered to be reasonable. With the ceiling fixed at 10 per cent per annum flat, competition will bring down the rates. Already in South India the rates are reported to be 9 per cent per annum flat. So far as used vehicles are concerned, the rates charged range from 12 per cent to 24 per cent per annum flat. Since banks do not generally advance for used vehicles and the risk on such advances is greater than on new vehicles, we are of the view that a higher rate of interest with a ceiling of 12 per cent per annum flat on used vehicles would be reasonable.

4.16 We understand that hire-purchase financiers find it convenient for accounting purposes to express their charges in terms of flat rates. The hirer, however, does not always understand what is the true rate of interest he has to pay on hire-purchase finance. We suggest, therefore, that in advertisements as well as in agreements, the true rate of interest may be expressed alongwith the flat rates. We may state in this connection that the Crowther Committee on Consumer Credit* set up in U.K. has recently made a similar recommendation. It has also recommended that the Consumer Credit Commissioner with powers to grant and revoke licences to institutions falling under the proposed law (including finance houses) should publish a series of tables setting out true interest rates. Similarly, the law and regulations under the Truth-in-lending Act of the U.S.A. are designed to ensure full disclosure of the terms at which consumer credit is extended. These rules apply to banks and others—including financial institutions, issuers of credit cards, merchants and dealers—which extend or arrange for consumer credit, *i.e.*, credit to individuals for personal, family, household or agricultural purposes. Creditors must state clearly two important features of the credit transactions. One is 'finance charge' which includes all costs which are imposed on the consumer-borrower either directly or indirectly. The other is the 'annual percentage rate' which reflects the true percentage cost of credit according to the actuarial or unpaid balance method.

Policy Objective to Reduce the Number of Small-sized Units

4.17 From the above analysis two points emerge clearly. First, one of the weaknesses of hire-purchase finance in the private sector in India is the existence of a large number of individuals and partnership firms in this business. Secondly, the financial position of many institutions in the field is unhealthy. These phenomena are responsible for the high rates of interest charged to transport operators and other hirers, as well as for a number of unhealthy practices. While the proposed Hire-Purchase Finance Bill will give protection to the hirer in a number of ways, we suggest that the policy objec-

* Consumer Credit—Report of the Committee (Chairman : Lord Crowther), HMSO, London, March 1971.

tive should be to increase the size of hire-purchase financing units and reduce their number. Apart from the fact that the financial position of bigger units will be better and some of the unhealthy practices which are associated with the smallness of the size of the financing units will be remedied, two other advantages will accrue. The level of interest charges will come down and it will be easy to regulate a small number of large-sized units. As we have seen in a preceding paragraph, the interest rates charged are lower in the South where hire-purchase institutions are better organised than, for instance, in the Eastern region where there is a large number of small units. We believe that loans on better terms can be provided only by better organised corporate bodies. In the field of hire-purchase finance, institutionalisation of credit is an objective to be pursued. In view of the fact that the amount of borrowing is of crucial importance for a hire-purchase financing unit for its profitability, we suggest that the permissible debt-equity ratio may increase directly with the size of the capital of the unit.

4.18 Some changes may also be contemplated in the present regulation regarding acceptance of deposits by hire-purchase finance companies. At present, there is no limit on the amount of deposits that a hire-purchase finance company can accept. The Reserve Bank of India Regulation in this connection requires a hire-purchase finance company not to receive any deposits repayable after a period of less than six months from the date of receipt of such deposits. It has also to maintain a liquidity ratio† of 10% against its deposits. The liquidity ratio may be made higher for the smaller companies and lower for the bigger companies, with a minimum of 10% in each case.

Forms of Hire-Purchase Credit by Commercial Banks

4.19 In the above paragraphs we have made recommendations with the object of improving the structure of hire-purchase finance institutions in the private sector. Since banks are going to play an increasingly important role in this kind of credit, it is worthwhile to consider the means whereby the flow of hire-purchase credit from commercial banks will increase. Different suggestions have been placed before the Group in this connection. A suggestion was made that commercial banks may give credit only to small hirers and the larger advances may be made by the hire-purchase finance companies in the private sector. We do not appreciate this suggestion, because due to their larger resources, banks are in a better position to make such advances. In any case, experience shows that commercial banks are increasing their credit to small hirers also.

4.20 Another suggestion made before the Group was that commercial banks should not directly give hire-purchase credit on account of the risks

† Liquidity ratio consists of cash, deposit accounts with scheduled banks, investments in un-

involved and the special nature of this business. They should start, it was suggested, subsidiaries which should specialise in hire-purchase finance business. This suggestion has been made particularly in view of the fact that commercial banks in U.K. since 1958, have entered this business by acquiring interests in hire-purchase finance companies. It may be pointed out in this connection that banks in U.K. had acquired such interests because they wanted to share in the growth of hire-purchase business, which for a time was not subject to credit restrictions, and also in the profits which hire-purchase companies were making partly with the help of bank credit. Another reason was that by acquiring hire-purchase companies as their subsidiaries banks could reach a segment of the market, particularly the retail outlets, which they could not penetrate on their own. Thus, there were special circumstances under which the British banks moved into hire-purchase business through their subsidiary companies.

4.21 Banks in India are already granting sizeable credit directly to transport operators. Hence, we are of the view that it may be left to the banks concerned to decide whether they should enter hire-purchase business by having a specialised department or by having subsidiaries or in any other way. If the banks want to have hire-purchase companies as subsidiaries, an amendment to the Banking Regulation Act would be necessary. On the other hand, no amendment is required if the banks extend hire-purchase finance by creating a separate department for the purpose. The legal position is that there is a distinction between hire-purchase transaction and *financing* of hire-purchase transaction. If banks want to carry on hire-purchase business, they will have to do it only by way of financing the hire-purchase transactions entered into between persons selling and buying goods on hire-purchase basis. While banks are not allowed to form a subsidiary company for financing hire-purchase business, they can undertake this business directly, if necessary, by having a separate department for this purpose. We endorse the recommendation made by the NCC Study Group to the effect that the Reserve Bank of India may consider whether Section 19 of the Banking Regulation Act, 1949, can appropriately be amended so as to enable banks to promote subsidiary hire-purchase finance companies in which any single banking company may own shares to the extent of 51%. We also endorse the recommendation that it would be desirable for the leading banks, acting in participation and together, to form a few hire-purchase finance companies. This step would be particularly beneficial in the Eastern region where hire-purchase financing system is not well developed nor well organised.

4.22 Another suggestion made before the Group was that small non-nationalised banks should enter more vigorously into hire-purchase finance business. We agree with this suggestion particularly because small banks which form the majority of non-nationalised banking sector have the problem of idle resources. Moreover, there is a large scope and growing demand for hire-purchase finance in the economy. These banks are in a better posi-

tion to extend hire-purchase credit because being local institutions they are in a position to identify the creditworthy transport operators and to follow-up the loans. The benefits of the Credit Guarantee Scheme recently introduced for small borrowers including transport operators are available to scheduled commercial banks and SFCs. We suggest that the Credit Guarantee Corporation may consider extending the scheme to other financial institutions (like non-scheduled commercial banks) in appropriate cases.

Conclusions

4.23 Our analysis shows that there is a large scope for hire-purchase finance business in India not only for financing motor vehicles but also capital goods. Hire-purchase form of credit is specially suited to borrowers who find it difficult to offer security to the lending institution. For instance, farmers, small business units and professionals like doctors and engineers requiring finance for equipment generally find it difficult to give the security which lenders conventionally demand. In hire-purchase type of credit, the goods themselves serve as security because they remain the property of the lender until all payments have been made. In our analysis we have dealt with three major problems in the structure of hire-purchase finance institutions, *viz.*, uneven distribution of hire-purchase finance institutions in the country, a large number of small-sized units and shortage of financial resources. Although the total amount of hire-purchase credit extended in India at present is not of large magnitude, we expect that the amount will increase over the years and in course of time we shall face the same problems of monetary policy as other advanced foreign countries face as a consequence of the growth of hire-purchase business. We have not gone into the question of techniques of control by the Reserve Bank of India over hire-purchase finance business because it is outside our terms of reference. Our main suggestion is to improve the financial position of hire-purchase finance institutions in the private sector. For this purpose we suggest that all hire-purchase financing units may be under the control and regulation of the Reserve Bank of India or such other agency as may be set up in this behalf. If, as suggested by us above, hire-purchase business is institutionalised, the problem of regulation will be easier to solve. Policy instruments may be used to encourage the formation of corporate bodies in this field. Our suggestion is that all hire-purchase finance companies may be classified into two, *viz.*, 'approved' and 'non-approved'. While regulation may be extended to all hire-purchase financing units, the approved ones which will be only corporate bodies may have special advantages of the following types : (*a*) commercial banks may extend them credit on more favourable terms ; (*b*) they may be allowed to get more credit in relation to their capital ; (*c*) liquidity ratio may be lower in their case than in the case of non-approved institutions ; (*d*) the Credit Guarantee Corporation of India may consider extending the benefit of guaranteeing small loans to approved hire-purchase

finance companies ; and (*e*) ultimately insurance cover of Deposit Insurance Corporation may also be made available to their depositors. The criterion for approval would generally be the working of a hire-purchase finance company determined on the basis of inspections. Finally, we suggest that all hire-purchase finance units may compulsorily be licensed and the licensing authority may be given powers to revoke the licence in case it is satisfied that the operations of a particular unit are unsatisfactory.

ANNEXURE

ESTIMATES OF REQUIREMENTS OF HIRE-PURCHASE CREDIT

A.1 The Saraiya Committee estimated the credit requirements of the road transport industry in 1968, at Rs. 60 crores. The production of commercial vehicles has been steadily increasing year after year. In 1968-69 the total production was about 36,000 vehicles. It is roughly estimated that banks, SFCs, hire-purchase finance companies and individuals have made advances in respect of 50% of the production, *i.e.*, 18,000 vehicles. For the purpose of computing credit requirements, we take the price of the TATA goods chassis as being representative. The current retail price after taking into account all taxes, etc., is around Rs. 60,000 and the cost of spare tyre, tube and body is estimated at about Rs. 5,000. Assuming that the credit requirements per chassis is two-thirds of the total value, a credit of about Rs. 44,000 per vehicle will be required. On this basis, total finance required in 1969 is estimated at Rs. 79 crores for commercial vehicles. If we include the finance required for tractors, taxis, motors and used commercial vehicles, the total finance required will be Rs. 90—100 crores.

A.2 The Planning Commission has proposed a target of 85,000 commercial vehicles by the end of Fourth Plan (1973-74). However, taking a conservative view and based on current levels of production and demand, we may estimate the production at 60,000 units. After providing for State Transport, Government Departments and Defence consumption, we may assume that credit will be required for 30,000 vehicles (*i.e.*, 50% of the total estimated production) in 1973-74. At the current price, the aggregate amount of finance required for commercial vehicles in 1973-74, will be around Rs. 132 crores (30,000 vehicles × Rs. 44,000). Adding to this Rs. 25 crores for taxis, jeeps, motor cycles, scooters, trucks and buses, etc., and another Rs. 50 crores for tractors including implements and trailers, the total gross finance required will come to about Rs. 207 crores. This estimate does not include the credit requirements of farm machinery other than tractors and other capital goods. At present, hire-purchase finance institutions are not giving credit for producers' goods on a large scale but we expect that in due course such credit will also be required on a hire-purchase basis. According to the estimate made by the Development Commissioner, Small Scale Industries, the demand for machinery on hire-purchase basis from the small scale sector during the Fourth Five-Year Plan will be about Rs. 35 crores. This demand is expected to be met by the NSIC. The demand from the medium industries, which may have to be met by other hire-purchase finance institutions as well as commercial banks and SFCs,

can be estimated to be at least Rs. 50 crores.* If this is also taken into account, the magnitude of new gross hire-purchase credit required in 1973-74 may well be in the neighbourhood of Rs. 257 crores. It may, however, be noted that if the prices of goods to be financed rise, the estimates would have to be revised upwards.

* Small Scale Industries—Programme of Work for the Fourth Five Year Plan, May 1968, p. 113, para 18.8.

CHAPTER 5

INVESTMENT TRUST COMPANIES AND UNIT TRUSTS

SCOPE OF THE STUDY

5.1 The object of this chapter is twofold : (*a*) to review the working of investment trust companies and their role in the Indian economy, and (*b*) to examine the need for promoting or encouraging investment companies or unit trusts in India. The terms 'investment trust companies', 'investment trusts' and 'investment companies' have been used interchangeably in this chapter. As already pointed out in Chapter 2, the working of the Unit Trust of India (UTI) is outside the purview of the Study Group.

5.2 Uptodate and comprehensive data are not available about the investment trust companies in India. In the preparation of this chapter we have used the results of studies made by the Reserve Bank of India and the Research and Statistics Division of the Department of Company Law Administration. M. Y. Khan of the Delhi University was commissioned to prepare a memorandum for the Study Group (*vide* Appendix IV). A number of investment trust companies also submitted memoranda at our request. Some members of the Study Group had discussions with representatives of selected investment companies in Bombay and Calcutta. The list of companies which submitted memoranda as also those with which the Group had discussions is given in Appendix II.

RATIONALE OF INVESTMENT COMPANIES/UNIT TRUSTS

5.3 The main function of investment companies and unit trusts, as generally understood, is to mobilise savings and invest them in industrial securities with the object of providing a good return to savers and to reduce the risk of capital depreciation by diversifying investments. Thus, these companies create indirect securities to suit the asset preferences of savers and invest the pooled savings over a large number of securities. The rationale of investment companies arises from the fact that whereas a large saver is usually able to combine the advantages of yield, safety and liquidity by making a judicious selection of investments and spreading his risks over a number of securities, a small saver cannot do so. First, the amount of his saving being small, a small investor cannot make his investment over a large number of securities. Secondly, an average small investor does not ordinarily understand the intricacies and implications of investing in shares

and thus cannot make a selection of good scrips. Investment companies with professional management and expertise of the market can collect the savings of small investors and invest such savings in well chosen securities. They can offer a variety of financial assets to the savers to suit their preferences with varying emphasis on liquidity, return and safety. In the process of their operations, investment companies help to increase the flow of savings for industrial investment and thus they have an important role in determining the direction of the flow.

5.4 Investment companies and unit trusts have a common object of mobilising the savings of a large number of small investors and making investments in a large number of selected industrial securities. The major difference between the two is in respect of the method of issuing their capital and redemption of shares. Investment companies—often called investment trusts or closed-end companies—like any other joint stock companies, have a fixed amount of authorised capital and a stated amount of issued capital. Their shares are traded on the stock exchanges and the companies themselves are not required to repurchase them. Thus, they raise capital like ordinary joint stock companies and distribute the income which they earn on their investments by way of dividends. On the other hand, unit trusts, often called open-end investment companies, or mutual funds as they are called in the U.S.A., continuously offer their shares or units for sale to existing or new investors. Thus, their capital is not fixed. Moreover, they are always ready to redeem or repurchase their own shares or units presented to them at a price based on the actual market value of the company's underlying securities at a given time. This feature of redemption gives greatly increased marketability to the shares or units of the unit trusts and protects unit holder to a large extent from the vagaries and imperfections of the stock exchanges especially in times of a crisis.* There is another type of investment companies which are called investment companies but the purpose of which is really to control particular enterprises. These companies are really holding companies and, as we shall see later, cannot be considered genuine or true investment companies.

5.5 It is clear by now that the importance of these institutions in the economy would depend on the extent to which they are able to attract the savings of the community and contribute to the industrial growth of the country by investing such savings in industrial securities. It is essential for the successful working of these institutions that they have expert, professional and independent management and that they diversify their investments over

* The foregoing description of investment trusts and unit trusts is one that prevails in the Anglo-Saxon countries. In many other countries they do not carry the same connotation. For example, in Japan, there are two different types of investment trusts, namely, the Unit Investment Trusts and the Open-end Investment Trusts. The shares of the former are not offered for sale after the initial establishment of the trust, but are always redeemable by the issuing company. On the other hand, open-end investment trusts are patterned after the mutual funds of the U.S.A.

a large number of securities thereby reducing the risks of poor returns on and depreciation of capital. It is in the light of these basic criteria that we shall discuss the role of investment trust companies in India.

Brief History of Investment Trust Companies in India

5.6 Investment companies and unit trusts have a long history of successful operations in foreign countries particularly in U.K., and U.S.A. In Canada, a number of closed-end investment companies were formed in the decade following 1920. The mutual funds movement started in the thirties and has been very successful. In France and Germany, the movement took roots in the post-war years. In Japan, where the history of unit trust can be traced back to 1937, the movement has made a remarkable progress particularly since 1956. In many developing countries like Malaysia and Brazil, the unit trusts or mutual funds were started in recent years and have been functioning successfully. The salient features of the working of these companies in U.K., U.S.A. and Japan are discussed in Appendix V. Investment trust companies appeared on the Indian scene much later than in U.K. and U.S.A. Several factors are responsible for this, among which mention may be made of delayed industrial investment, low volume of savings available for investment and the absence of adequate outlets for investments owing to the slow growth of joint stock companies. The effective development of the investment trust companies commenced only in the thirties following the Report of the Indian Central Banking Enquiry Committee. The Minority Report of the Committee had suggested as early as in 1931, that the Government should encourage the establishment of investment trusts in India.@ In 1933, the Industrial Investment Trust Ltd., was started by a firm of stock brokers in Bombay (Premchand Roychand & Sons). A number of investment trusts including the Investment Corporation of India Ltd., were established in the middle thirties. Many investment trusts went into liquidation following the decline in the stock exchange prices in 1937. During the Second World War, interest in starting investment trusts was revived. Many of the investment trusts in India were set up by industrial groups with the main purpose of promoting their own interests. In the early stages of industrialisation, the initial finance required for the promotion and development of industrial companies was provided by entrepreneurs or business houses through investment holding companies controlled by them. The promotion of additional companies within their respective groups was facilitated by investments made by such holding companies. Thus, the major objective of a large number of investment trusts in India, many of which were private limited companies, was to control, manage and assist the companies within their particular groups.

@ *Report of the Indian Central Banking Enquiry Committee*, Vol. I, Part II—Minority Report, Government of India, 1931, paragraphs 360-362.

ANALYSIS OF THE WORKING OF INVESTMENT COMPANIES IN INDIA

5.7 An analysis of the working of investment companies is rendered difficult because there is no one accepted definition of investment companies in India. There is a definition of an investment company in Section 372 of the Indian Companies Act. The proviso to Section 372(10), defines an investment company as "a company whose principal business is the acquisition of shares, stocks, debentures or other securities". The Reserve Bank of India, for the purpose of its directions to non-banking institutions, has defined an investment company as "any company, not being a banking company, carrying on as its principal business acquisition of securities but does not include any company which is an industrial concern or which carries on mainly the business of purchase or sale of any goods or commodities other than securities and which also acquires in the course of its business any securities as aforesaid." Judged by the basic functions of investment companies discussed in paragraph 5.5, it will be obvious that these definitions do not serve the purpose of distinguishing a true investment company from other companies. Different definitions have been used by various authors. For instance, for his study of investment trusts, L. C. Gupta selected ten investment trust companies on the basis of the following definitions : (*a*) diversified investment trust companies—which had invested three-fourths or more of their total investment portfolio in such a way that the securities of no individual company formed more than 5% of their total investment portfolio ; (*b*) partially diversified investment trust companies—which had invested less than three-fourths but at least two-thirds of the total investment portfolio in the manner indicated in (*a*)*. Another author, K. S. Sharma selected ten different investment companies on the basis of different criteria, *viz.*, (*i*) the company is run with the stipulated provision that dividends shall be paid out of the dividends earned on its investments only, and the income from the sale of portfolio is treated as a capital gain and hence precluded from distribution, (*ii*) the company does not turn over more than one-sixth of its portfolio annually ; and (*iii*) the investment portfolio of the company exceeds 70% of its total assets.‡

5.8 From the above examples, it will be clear that there is room for controversy on the number of investment companies in India, and therefore

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* The companies selected by L.C. Gupta were : (*a*) diversified companies—(1) General Investment Trust Ltd., (2) Industrial Investment Trust Ltd., (3) Investment Corporation of India Ltd., (4) Kishore Trading Co. Ltd., (5) New India Investment Corporation Ltd., (6) Oriental Industrial Investment Corporation Ltd., and (*b*) partially diversified companies—(7) Birds Investments Ltd., (8) Investment Trust of India Ltd., (9) General Investment and Trust Co. Ltd., and (10) Investment and Finance Co. Ltd. (L. C. Gupta, *The Changing Structure of Industrial Finance in India—The Impact of Institutional Finance*, Clarendon Press, Oxford, 1969, Chapter V).

‡ On the basis of the criteria laid down by K. S. Sharma, the following companies were selected by him : (1) Investment Corporation of India Ltd., (2) Bharat Nidhi Ltd., (3) Clive Row Investment Holding Co. Ltd., (4) Mafatlal Gagalbhai & Co. Pvt. Ltd., (5) Eastern Investments Ltd., (6) Sassoon J. David & Co. Ltd., (7) Industrial Investment Trust Ltd., (8) Oriental Investments Ltd., (9) Birds Investments Ltd., and (10) Devkaran Nanjee Investment Co. Ltd. (K.S. Sharma, *The Institutional Structure of Capital Market in India*, Sterling Publishers, 1969, Chapter 10).

the value of their aggregate assets at any particular time. Thus, according to a Reserve Bank's study* as of March 1959 there were 595 investment companies with a paid-up capital of Rs. 37.7 crores as compared with 122 companies with paid-up capital of Rs. 15.2 crores in March 1936. However, according to a study made by the Research and Statistics Division of the Department of Company Law Administration† there were 542 investment and trust companies at the end of 1960-61 having paid-up capital of Rs. 42.3 crores. The Reserve Bank of India regularly publishes studies of selected financial and investment companies. Data published in these studies combine the results of both financial and investment companies and hence are not of much use for our analysis.

5.9 For our analysis, we have used the statistics collected by M. Y. Khan. He has defined an investment company as a public limited company the main object of which is holding of investments in securities and which derives at least 75% of its income from such investments. On this basis there were in 1968-69 only 56 public limited companies which could be defined as investment companies. Out of these 56 companies, 19 were listed on the stock exchange.

5.10 An analysis of the financial position of the 56 selected investment companies shows both their slow progress and their relatively insignificant position in the Indian capital market.

TABLE 5.1—FINANCIAL POSITION OF 56 INVESTMENT COMPANIES

(Rs. crores)

	1956-57	1964-65	1968-69
A. Paid-up capital	18.98	20.20	20.86
(*i*) Ordinary	16.53	17.75	18.41
(*ii*) Preference	2.45	2.45	2.45
B. Reserves & Surpluses	11.17	12.93	15.38
(*i*) Capital reserves	3.22	3.71	3.46
(*ii*) Other reserves and surpluses	7.95	9.22	11.92
C. Borrowings	7.63	7.24	6.78
(*i*) Banks	4.61	4.59	4.19
(*ii*) Debentures	0.88	0.90	1.38
(*iii*) Others including deposits	2.14	1.75	1.21
D. Current liabilities and provisions	3.02	2.85	3.24
Total Capital employed (A+B+C+D)	40.80	43.22	46.26

Source :—M. Y. Khan's Memorandum.

* *Investment Trusts*—Reserve Bank of India Bulletin, October 1960.
† *Company News and Notes*, Department of Company Law Administration, October 1963.

It will be seen from the table that the total capital employed of the companies has increased, though not significantly, from Rs. 40.8 crores to Rs. 46.3 crores during the period 1956-57 to 1968-69. This increase was accounted for entirely by the rise in the paid-up capital and accretion to reserves. In contrast, borrowings during the same period declined by about Rs. 1 crore from Rs. 7.6 crores to Rs. 6.8 crores. In the capital structure of these companies, shareholders' funds (paid-up capital *plus* reserves) accounted for a dominant share ; their contribution to the total capital employed increased from 74% in 1956-57 to 78% in 1968-69. Another notable feature of the capital structure was that investment companies built up their share capital largely in the form of equity capital, the share of equity capital in the total paid-up capital being 88% in 1968-69. In fact, it was observed from the balance sheets that only 16 of the 56 companies had issued preference shares. Likewise, investment companies have not raised capital through issue of debentures. Only three companies had resorted to this source of obtaining funds. The relatively insignificant position that investment companies included in this study occupy among the public limited companies is shown by the fact that in 1968-69, their paid-up capital formed only 1.3% of the paid-up capital of non-Government public limited companies in India.*

5.11 The pattern of use of funds by the 56 investment companies studied here is set out in Table 5.2.

TABLE 5.2—USES OF FUNDS

(Rs. in crores)

	1956-57	1964-65	1968-69
A. Net Fixed Assets	0.56	0.63	1.00
B. Investments @	28.22	33.32	32.38
Quoted	21.87	25.40	25.07
Unquoted	6.35	7.92	7.31
C. Current Assets	11.81	8.37	11.27
Of which loans & advances	10.16	5.01	6.23
D. Miscellaneous other assets	0.21	0.90	1.61
Total (A+B+C+D)	40.80	43.22	46.26

@ At book value
Source : M. Y. Khan's Memorandum.

* This is based on figures of paid-up capital of non-Government public limited companies at work as on 31st March 1969, (Report on Currency & Finance, 1969-70). The ratio of paid-up capital of public limited investment and trust companies (included under the industrial group code 6.52 of the Department of Company Affairs, Government of India) to the total paid-up capital of all non-Government public limited companies worked out to 2% at the end of March 1966.

The bulk of their funds was employed in investments, particularly in quoted industrial securities. There was, however, no clear trend discernible over the period under review. Thus, in 1956-57, the proportion of investments to total assets constituted 69% which rose to 77% in 1964-65, but declined to 70% in 1968-69. Another feature of the utilisation of funds was the relatively large proportion of loans and advances in the asset portfolio of these companies. They formed almost 25% in 1956-57, but declined to 13% in 1968-69. In fact, in the case of some individual companies included among these 56 companies, the proportion was as high as 42% to 75%. The relatively high proportion of loans and advances in their assets portfolio is explained by the fact that most of these companies, as will be explained later, belong to particular industrial groups and, in times of need, make advances to companies in the same group.

5.12 The composition of the investment portfolio of these companies according to the type of securities is given in Table 5.3 which shows that a predominant portion of their portfolio consisted of investments in ordinary shares.

TABLE 5.3—COMPOSITION OF INVESTMENT PORTFOLIO

(Rs. in crores)

	1956-57	1964-65	1968-69
1. Ordinary shares	24.41	30.50	29.85
2. Preference shares	2.29	2.55	2.26
3. Debentures	0.53	0.18	0.22
4. Government securities	0.99	0.09	0.05
5. Shares of subsidiary companies	0.76	2.72	2.76
6. Total investments (1+2+3+4)	28.22	33.32	32.38
7. Market value of quoted investments	27.86	32.27	35.59

Source : M. Y. Khan's Memorandum.

The proportion of investments in ordinary shares to total investments increased from 86% in 1956-57 to 92% in 1968-69. The market value of quoted investments showed an appreciation of 10% between 1964-65 and 1968-69. In the same period, however, the Reserve Bank of India index number* of variable dividend industrial securities in all industries (1961-62 = 100) went up by 7.7%. As a proportion of the book value of total investments, the value of unquoted investments of these companies formed 23% in 1968-69.

* As on the last Saturday of the relative years.

5.13 The declining role of investment companies in the investment market is shown by their position *vis-a-vis* other institutional investors in India.

TABLE 5.4—INVESTMENTS IN JOINT STOCK SECURITIES INCLUDING DEBENTURES AT BOOK VALUE

(Rs. in crores)

	1956-57	1964-65	1968-69
L.I.C.	69	156	210
U.T.I.	—	21	60
I.D.B.I.	—	7	34
I.C.I.C.I.	1	15	26
I.F.C.	—	9	17
S.F.Cs.	—	6	10
Investment companies	27	33	32

Sources: (1) Reports on Currency and Finance.
(2) Reserve Bank of India Bulletins.

It is evident from the table that till 1964-65 investment companies were the second largest investors in joint stock securities. However, they were relegated to the fourth position in 1968-69. The principal reason for their declining role in recent years was the relative lack of resources which, in turn, can partly be explained by their functioning as holding companies and not as investment companies as they are generally understood in the West.

5.14 Barring a few investment companies, most of the investment companies in India are really holding companies which have tended to concentrate their investments in the companies of certain industrial or business groups. This is shown by Table 5.5.

TABLE 5.5—GROUP ASSOCIATION OF INVESTMENT COMPANIES—1968-69

Group investment as % of total investments	No. of groups
100%	5 [JK (2), Jardine Henderson (1), Jaipuria (2), Agarwala (4) and Advanis (1)]
50% and more but less than 100%	6 [Birlas (2), Bangur (8), Bird Heilgers (4), Dalmia Jains (4), Andrew Yule (2) and Goenkas (4)]
More than 25% but less than 50%	3 [Tatas (2), Kothari (1) and Shapoorji Palanji (1)]

Note :—Figures in round brackets refer to number of companies in the Group.
Source : M. Y. Khan's Memorandum.

It will be seen that as many as 38 companies out of a total of 56, were 'group associated' companies. Only in the case of 18 companies, the group investment as a percentage of total investments was less than 25%. Almost all the prominent industrial groups maintained investment companies. Thus, Bangurs had 8 companies followed by Bird Heilgers, Dalmia Jains, Goenkas and Agarwala (4 companies each), and Birlas, Tatas, JK, Andrew Yule and Jaipurias (2 each).

Characteristics of Investment Companies in India

5.15 The above analysis shows the following characteristics of investment companies in India. Their role in the capital market is relatively insignificant when judged from the point of view of savings mobilised by them and the investments made by them. Except for a handful of investment companies, all of them have associations with industrial groups. From the material that the Study Group collected, it was clear that many of the investment companies were satisfied with their present role and were not eager to convert themselves into genuine investment companies. In fact it appeared that in many cases their major function was to act as an intermediary between commercial banks and the industrial companies in their respective groups. Some of them gave loans to third parties by borrowing from commercial banks. Their shares are not popular because most of them do not regard it as their major function to mobilise the savings of a large section of the community and invest them in a large number of industrial securities. In fact, in the investors' minds they can hardly be differentiated from other joint stock companies. They perform many functions unrelated to those of true investment companies. They lend money to companies under their control, guarantee loans, act as Secretaries and Treasurers and even deal in real estate.

5.16 Thus, the Indian investment trust companies are of three types : (*a*) holding companies the main object of which is to control the companies in the same industrial or business groups ; (*b*) finance companies the main object of which is to borrow and re-lend the money either to industrial companies or to others ; and (*c*) genuine investment companies which sell their shares to the investors and have a diversified portfolio of investments.

Scope for Unit Trusts/Investment Trusts in India

5.17 In the spectrum of investment companies and unit trusts, on the one side there is the Unit Trust of India which was established in 1964, and which has mobilised sizeable savings and made investments over a wide field of industrial securities. At the other end, there are investment companies which are really holding or finance companies. The holding companies are not really financial intermediaries and hence fall outside the purview of the work of the Study Group. In between, there are a few genuine investment companies which have not so far played a very important role.

5.18 Two pertinent questions which arise are : (*i*) do we need more unit/investment trusts in India ? and (*ii*) what is the scope for the existing genuine investment companies ? The answer to the first question will really depend on whether there is at present a lacuna in the Indian capital market, which may be filled up by the creation of new unit/investment trusts.

5.19 The UTI has been able to create a new financial asset which combines the advantages of liquidity, safety and return. However, there is scope for introducing new financial assets with a different mix. In foreign countries there are various types of unit trusts which cater to different asset requirements of investors. A survey undertaken in the U.S.A. in 1964, for instance, showed that out of 176 open-end investment companies included in the survey nearly half of them had only one of the following major investment objectives : (*i*) capital appreciation or growth, (*ii*) present and/or future income from investments, and (*iii*) capital preservation or stability. There were 69 companies pursuing growth, 15 companies pursuing income and only one pursuing capital stability. The rest of the companies had two or three major objectives. The most important investment objective was growth followed by income, with capital preservation a long way behind.* This may or may not apply to the Indian investors. The point, however, is that there is scope for introducing financial assets with greater emphasis on capital growth. It is understood that new schemes are under the consideration of the UTI. Hence, from this point of view, it does not appear that we need new investment or unit trusts.

5.20 Another point made in favour of starting new unit/investment trust companies is that the creation of new institutions will widen the capital market by triggering off much larger total investments involved in new projects. In the Fourth Five-Year Plan an investment of Rs. 2,000 crores is postulated in the field of industries and mining in the private sector. If the momentum of industrial growth is maintained, the quantum of investment in the future Plans is expected to be still higher. It is, therefore, sometimes suggested that new unit or investment trusts may be created in order to buy industrial securities which will come into the market. It may, however, be pointed out that UTI and LIC which are the two major institutional investors in the capital market find it difficult to invest their funds in good scrips. The success of the UTI indicates that it can mobilise more savings and the growth of existing institutions will take care, to a large extent, of the expected increase in the number of industrial securities which would come in the capital market.

5.21 An argument is sometimes put forth for the creation of investment companies rather than unit trusts because, it is said, the compulsion to value the units on a daily basis makes it difficult for unit trusts to make

* D. C. Corner and H. Burton, *Investment & Unit Trusts in Britain & America*, Elek Books, London, 1968, pp. 222-224.

investments in unquoted securities. Thus, the medium and the small industries whose shares are often not quoted cannot get the benefit of the services of unit trusts. It appears to us that this is not a strong argument because with the techniques available for valuing unquoted securities, nothing prevents the unit trusts to invest in good unquoted securities.

5.22 It would appear from the above analysis that there is no immediate or even a foreseeable need for having more unit trusts or investment trusts in the economy. However, the question remains as to the scope for the existing genuine investment companies. The Group is of the view that they can play a more active role in the economy if they are given proper encouragement. They can create new financial assets by differentiating their objectives according to what the investors want. The competitive spirit may usher in efficiency in the management and operating techniques, the benefits of which can be passed on to the shareholders.

5.23 In order to encourage the existing genuine investment companies to play a more active role in the economy, it has been suggested that they may be given the same tax concessions which at present are available to the UTI. At present the investee company pays corporate tax usually at 55%. Then the dividend incomes of the investment companies are taxed at the rate applicable to inter-corporate dividends, usually at an effective rate of 22%. Finally, the dividends distributed by them are taxed in the hands of the shareholder at his personal income-tax rates. The only difference between the tax position of investment companies and the UTI is that the latter does not have to pay the inter-corporate tax. So far as the shareholders of the investment companies are concerned, they are on par with the unit holders in regard to tax advantages after the tax concessions provided for in the 1970-71 budget. The point, therefore, is whether genuine investment companies should be exempted from the inter-corporate tax. It may be pointed out in this connection that the UTI is obliged to diversify its investments and under the Regulations framed by the Reserve Bank of India, it can invest only upto 5% of its own funds or 10% of the outstanding capital of any one company ; further it must distribute 90% of its net income. Also, it is under the effective supervision of the Reserve Bank of India. If genuine investment companies are prepared to have the same obligations as the UTI, we suggest that the Government may consider the question of exempting them from inter-corporate tax.

Criteria for a Genuine Investment Company

5.24 If tax concessions are to be given to investment companies which are genuine, the criteria of genuineness may be clearly spelt out. In our view the following may be the basic criteria for a genuine investment company : (*a*) It should have independent management and independent investment policy. (*b*) It should have a diversified investment portfolio. Limitation

should be placed on the investments of an investment company in any one company as well as on its investments in the companies belonging to the same industrial group. For instance, an investment company may not invest in any one company more than, say, 5% of the value of its total investible funds nor may it invest more than, say, 25% in the companies in the same industrial group. (*c*) There should be adequate public participation in the share capital and it should ensure listing of the shares on the stock exchanges. (*d*) A major portion of its funds should be invested in shares, stocks, bonds and other securities. (*e*) It should regularly distribute not less than a specified proportion of its net income to members.

Need for Special Legislation

5.25 The need for identifying the genuine investment companies and providing for the protection of the interests of members of these companies require that separate legislation may be enacted for investment companies. At present, investment companies are governed by the Companies Act and, as pointed out earlier, in the public mind they are in no way different from other industrial or trading companies. If a separate legislation is passed, it will not only serve the purpose of safeguarding the interests of the members of investment companies but also serve another purpose in the case of those investment companies which accept deposits. We would suggest that the provisions of Investment Companies Act of the U.S.A. can be taken as providing broad guidelines. The legislation, among other things, should incorporate provisions forbidding investment companies from entering certain fields.

5.26 In the memoranda submitted to the Study Group, it was pointed out that investment companies can usefully perform the role of merchant banks in India. Merchant banking services are important in the economy and the question will be discussed in Chapter 10. In our view investment companies should concentrate on their function of creating suitable financial assets in order to mobilise the savings and making judicious and diversified investments in industrial securities in the interest of their members. The proposed law may incorporate the provision that no industrial company should be permitted in any event to hold any shares in investment companies because such investments tend to become circular, the funds return to the starting point indirectly and enable the companies concerned to purchase their own shares.* It will also be useful to provide for the appointment of a Government nominee on the Boards of Directors of genuine investment companies.

Conclusions

5.27 To sum up, our study shows that there are very few genuine investment companies in India. While we do not see the advisability of starting

* R. K. Hazari, *Structure of the Corporate Private Sector*, Asia Publishing House, 1966, p. 369.

new unit or investment trusts, we are of the view that existing genuine investment companies may be encouraged to play a more active role in the economy. In this connection we suggest that they may be brought on par with the UTI so far as tax concessions are concerned provided they undertake to abide by the same obligations which apply to the UTI. Also, the criteria of genuineness of investment companies may be clearly spelt out and a separate legislation enacted to protect the interests of the members of investment companies. Since there are very few genuine investment companies at present working in India, this legislation may be applied if and when a large number of investment holding companies convert themselves into genuine investment companies.

Note : One of the members, Shri A. B. Bilimoria does not agree with the main conclusions and recommendations of the Group on the subject of Investment Companies and Unit Trusts. His note of dissent is appended to the chapter.

A NOTE OF DISSENT

D.1 It is with a sense of regret that I have to write this note of dissent to Part II, Chapter V (Investment Trust Companies and Unit Trusts) of the Study Group's Report, as I disagree not only with the tenor, but also with the conclusions and the recommendations made in this chapter.

D.2 In my working paper on Investment Companies and Unit Trusts submitted to the Study Group, I had endeavoured to examine the historical development of investment companies in India and submitted what I believed were some constructive suggestions and recommendations for the future. In this note, it is not possible for me to deal at length with the various aspects of investment companies, but I shall briefly mention the areas of disagreement with the Report of the Study Group.

D.3 The Study Group Report falls mainly into four parts :

(*a*) The first part is an examination of the investment company and unit trust movement, and the rationale behind their origin and development ;

(*b*) the second part gives an analysis of the working of investment companies in India and the conclusions drawn from it ;

(*c*) the third examines the scope for unit trusts and investment companies in India; and

(*d*) the fourth part deals with the role of genuine investment companies and recommendations concerning concessions, safeguards, legislation and other criteria that might be evolved to ensure development on sound lines.

D.4 I have no quarrel with the first part of the Study Group's report, but I disagree with some of the conclusions and recommendations in the 2nd, 3rd and 4th parts.

I. Past Performance of Investment Companies in India

D.5 It is true that in India there are primarily two types of investment companies, *viz.*, (*i*) genuine investment companies and (*ii*) investment holding companies. There are justifiable historic reasons to explain how these holding companies originated, and why they were developed by entrepreneurs, most of whom have made some significant contribution to the industrial development of the country. I regret that the Study Group report, far from recognising the vital and important role played by these investment holding companies in India's industrial development during the difficult pre-independence years, gives, on the contrary, the impression that

many of these investment companies were set up by the industrial groups purely to promote their own narrow self-interest. I also regret that it has come to the conclusion, without any supporting arguments, that the reason for their declining role in recent years in the provision of capital for joint stock enterprise is, because they have functioned as investment holding companies and not as genuine investment companies. Admittedly, owing to various reasons and difficulties, the past performance of some of these companies has not been inspiring, but to summarily reject the contribution they have made in the field of industrial investment and to shut them out from playing any role in the future, is to deny the country the services of a fund of expertise in the field of industrial finance which the country can ill-afford to do without. It would have been appropriate if the Study Group had recognised the part that these investment holding companies had played in the past, pointed out that these companies in most cases were not intended to be public investment companies of the type that the Study Group is now really concerned with, and then suggested that these companies could still play a significant role in the changing industrial scene of India if they converted themselves into public investment companies on the lines suggested by the Study Group.

II. Scope for Unit Trusts and Investment Companies in India

D.6 I agree with the finding of the Study Group that, barring the investment holding companies, there are only about fifty companies which can be treated as public investment companies, and there has been a tendency in many of these to concentrate their investments in companies of the industrial and business groups which promoted these investment companies. However, this finding does not by itself debar these companies from being classified as public investment companies, or minimise the role they can play in mobilising savings and channelising them into productive industrial investment. I do recognise that, if the primary purpose of investment companies is to provide a medium of investment for the small investor in a diversified group of industrial securities, it is necessary that both in the ownership of the capital of investment companies and in their investment portfolios, there should be less concentration and greater diversification. I would have, therefore, agreed with any reasonable restrictions suggested in order to achieve these twin aims. However, I disagree with the conclusion of the Study Group that there is no need for new unit trusts or investment companies in the economy on the ostensible grounds that :

(*a*) the Unit Trust of India is devising new schemes which will meet the requirements of the new types of savers who look forward not so much to the steady return on capital, but the appreciation of capital;

(*b*) it is difficult for the UTI and the LIC to find an outlet for their investible resources and even if industrial development gathers

momentum they will be able to take care of the financial needs of new projects and new companies ; and

(*c*) with the modern techniques of valuation, it is not difficult for unit trusts to invest in unquoted securities.

D.7 In my paper, I had comprehensively dealt with the reasons why I feel India needs more unit trusts and genuine investment companies. Indeed, this suggestion has found support in many quarters in the past and in the present, and I can do no better than to quote from the Reserve Bank of India's Bulletin which published an article on Investment Trusts in 1960, and made the following recommendations :

> "There is sufficient scope for making a beginning with the establishment of *some unit trusts* by well-known industrial houses, brokers' firms and insurance companies in India with active encouragement from Government. Apart from the mobilisation of savings of the relatively small investors, the success of the Unit Trusts would also contribute to the democratisation of industrial share ownership and thus, to the furtherance of some of the objectives of the Directive Principles of State Policy."

In my judgement, this conclusion is eminently applicable to the current Indian scene.

D.8 My arguments against the Study Group's findings on the scope for investment companies and unit trusts in India are as follows :

(*a*) The Study Group's report does not deny the need for devising schemes with different investment objectives. But, it argues that these schemes are likely to be devised by the UTI and hence there is no need for more unit trusts. It is heartening to know that the UTI is to come out with new schemes with different investment objectives. Everybody would wish them success, just as they have been successful in their existing operations. However, the sphere of different investment objectives is not likely to be exhausted and there is enough scope for others to apply their ingenuity and devise many more schemes which would meet the requirements of the growing body of sophisticated investors. The existence of UTI with its capital growth scheme does not necessarily preclude the scope for establishment of more unit trusts. Moreover, the establishment of more unit trusts would usher in an era of competitive efficiencies in management and operating techniques and would provide yardsticks to measure the performance of the UTI *vis-a-vis* other unit trusts as well as with each other.

(*b*) The argument that the LIC and the UTI are finding it difficult to invest their resources in good scrips today and will face the

same difficulty in the future can be sustained only if one assumes the rate of industrial growth to remain around 4 per cent—5 per cent. If the country wishes to settle down to this rate of growth, there is, of course, no need for more unit trusts or investment trusts. But then, there is indeed no need for the Fourth Plan and subsequent plans. If, however, we are to have a respectable rate of industrial growth, say 12 per cent to 15 per cent, the financial requirements of companies are likely to rise significantly. Added to this would be the increasing financial costs of capital goods and probably the relatively declining availability of bank finance. All these factors would tend to enhance the capital requirements of both existing and new ventures. In the decade of the seventies, at least Rs. 100 crores of equity capital, if not more, would be required to be raised annually. Obviously, in such an eventuality, neither the LIC nor the UTI will find it difficult to invest their surplus resources. If anything, they would be short of funds to meet the burgeoning demands for capital emanating from industries.

(*c*) My disagreement with the central policy conclusion of the Study Team becomes all the more fundamental in view of the profound changes that are already taking place in the Indian economy in general and in the Indian investment picture in particular. There are at least three factors currently discernible. *Firstly*, with the rates of taxation being what they are, the sources of entrepreneurial capital which were previously available are drying up. *Secondly*, there is a noticeable diversion of incomes from the urban centres to the now-prospering rural areas. *Thirdly*, it is in fact Government's policy to diffuse both entrepreneurship and incomes within the country. I submit that in this changing picture, the necessity for innovating new techniques of raising investible resources becomes all the more imperative. We now need financial systems and financial institutions which will help recruit investible funds from different sources than the erstwhile affluent pockets. We must penetrate the rural areas ; we must provide institutions which will create a "shareholders' democracy;" and we must in this context give full play to creativity to both the public and private sector financial institutions. Capital is a commodity that is woefully in short supply in India and, in this context, it is tragic that in a country where the national income is over Rs. 30,000 crores, the total annual equity capital raised is a bare Rs. 30 crores. It is inconceivable but true that when the total market value of shares listed on the seven stock exchanges of India is about Rs. 2,000 crores, all that can be raised by new equity capital is Rs. 30 crores. I find it incomprehensible in the face of such statistics to come to the conclusion that all that can be done has al-

ready been done, or that whatever needs to be done can be done only by a public sector financial institution like the Unit Trust. I plead that if the mobilisation of resources in new ways and in new areas is the real need of the hour, without which a desired national savings rate of 15 per cent by 1973-74 will never be achieved, there must be provided, sooner rather than later, a congenial atmosphere for growth, diversification and innovation in both the public and private sector financial institutions.

(*d*) The UTI at present is prohibited from investing in any one company more than 5 per cent of its investible resources and more than 10 per cent of the value of securities issued and outstanding of such a company. Investments of the LIC are also circumscribed by similar types of restrictions. Hence, dependence on these two institutions alone, may cause considerable hardships to up and coming entrepreneurs.

(*e*) The concentration of the corporate investment portfolio in the hands of one or two public sector institutions, which usually do not sell the securities, imparts rigidities to stock prices. The greater the number of institutions, the greater mobility of shares on the stock exchange. The greater the number of agencies, buying and selling shares, the better the supply of floating stock and negotiability of such stock. Institutionalisation of investment is taking place all over the world, but in countries which have encouraged their capital markets to grow in order to provide the finance for expanding industry, the number of institutions which mobilise savings and make investments in industrial securities have also grown. I am convinced that a larger number of investment companies and unit trusts, many with local associations, will not only assist in the mobilisation of savings, but will also result in an increase in the turnover of stocks and shares in the market and thereby improve marketability, which, of late, has tended to be restricted due to the concentration of investment decisions and potential in only a few giant institutions.

(*f*) Finally, the argument that it is not difficult for the UTI to invest in unquoted securities because of the availability of modern techniques of valuation is erroneous for the simple reason that they permit valuation at the end of the year when the balance sheet of a company is published. They do not give the guidelines for evaluating a scrip on a day-to-day basis which is necessary for the assets valuation of unit trusts.

III. Genuine Investment Companies

D.9 The Study Group has rightly asked two pertinent questions :

(1) whether we need more unit and investment trusts in India ? and

(2) what would be the scope for existing genuine investment companies?

It has come to the conclusion, in my opinion too facilely, that there is no immediate or even a foreseeable need to having more investment companies or unit trusts in the economy. I have already explained why I disagree with these conclusions. The Group grants, however, that there is some scope for existing genuine investment companies — which, in any case, according to their findings are few in number — provided they observe certain criteria and safeguards. I have no dispute regarding the criteria laid down by the Group and disagree with only the one which seeks to lay down restrictions on investment by specifying that "an investment company may not invest in any one company more than 5 per cent of the value of its total investible funds nor may it invest more than 25 per cent in companies in the same industrial group."

D.10 For one thing, with the abolition of the Managing Agency system, the concept of 'Group' has become obsolete.

D.11 Even if one wants to adhere to the concept of 'Group', howsoever defined, the proposed limitation of 25 per cent is too restrictive. For historical reasons, investments of some of the investment companies are concentrated in the securities of the so-called erstwhile industrial groups and it would be difficult for them to immediately disgorge their investments in these securities without unduly disturbing market prices.

D.12 Hence, I would suggest that the investment companies should not invest more than 10 per cent of their resources in any one single company and not more than 50 per cent in companies in the same industrial 'group', provided a satisfactory definition of a 'Group' is evolved.

IV. Tax Concessions for Investment Companies

D.13 It is hard to understand how the Study Group's Report can state that "many of the investment companies were satisfied by their present role and were not eager to convert themselves into genuine investment companies." No evidence to this effect was given in the oral interviews taken by me. On the contrary, almost everyone of the parties who gave evidence, complained about the burden of taxation, and I am glad that the Study Group has recognised that, if genuine investment companies are to be encouraged, tax concessions will have to be provided.

D.14 In respect of new unit trusts which may be allowed to be set up, I agree that the same tax concessions should be granted which are, at present, available to UTI in respect of income tax as well as capital gains tax. New unit trusts should certainly abide by the same restrictions on investments as are imposed upon the UTI.

D.15 With regard to genuine investment companies also, the same tax concessions should be granted. The Study Group has, however, argued that tax concessions should be made available only if genuine investment companies, like the UTI, distribute 90 per cent of their income as dividends. I disagree with this view as Investment Companies, unlike unit trusts, are close-end companies which cannot continuously raise capital from the market by issuing new shares. It is imperative for them to build up reserves in order to :

(*i*) expand the area of their operation,

(*ii*) maintain a steady dividend, and

(*iii*) provide for an investment depreciation fund.

I would therefore suggest that investment companies may be required to distribute 65 per cent of their incomes as dividends and 75 per cent when their reserves equal the paid-up capital.

V. Separate Legislation for Investment Companies

D.16 The Study Group has recommended separate legislation to govern the working of investment companies with a view to safeguarding the interests of their shareholders. It has also suggested the appointment of a Government nominee on the Board of Directors of each investment company.

D.17 I do not see any useful purpose would be served by having such a separate legislation for the investment companies. At present, these companies are governed by the Indian Companies Act. Whatever amendments are required in respect of functioning of investment companies, such as limitations on investment policies, could be made in the Indian Companies Act. Once this is done, the Company Law Department should be able to keep a watchful eye on their functioning. Multiplicity of legislation and multiplicity of agencies to implement laws do not necessarily lead to efficient and honest functioning of companies. What is imperative is the strict enforcement of existing laws.

D.18 I also disagree with the proposal for the appointment of a Government nominee on the Board of Directors of unit trusts and investment companies. A nominee of the Government or of the Financial Institutions on the Board is acceptable when, as in the case of UTI, the initial

capital is contributed by the Government and public financial institutions. In the absence of any capital contribution by Government or the financial institutions, there is no justification for this proposal. More so, if the investment companies are made to operate under laws which restrict the maximum investment they can make in any one company or group of associated companies.

VI. Investment Companies and Allied Activities

D.19 The Study Group has recommended that investment companies should be forbidden from entering certain fields which have not been specified. I am against investment companies themselves having any industrial or commercial activity, but there are certain ancillary lines of business which originate from, and are closely associated with, the main business of investment in stocks and shares, and I feel that investment companies should be allowed to take up these lines as they would be well qualified to do so. These would be to act as Share Registrars and Transfer Agents, investment and financial consultants, underwriters and issue houses. If, in future, India's industrial development is to depend upon a large number of new and small entrepreneurs, they will require these specialised investment and financial services to be provided not by two or three giant institutions or Merchant Banks, but by a number of experienced local institutions who are well-known in the areas they operate and who would be more familiar with local entrepreneurs and business conditions.

Conclusion

D.20 Let me repeat. It has given me no pleasure to submit this Minute of Dissent. It has not been my thesis that all is well with all the investment companies, and that no improvements in their operations are necessary. Constructively, I have suggested several directions in which improvements and innovations are both desirable and necessary. However, I believe that the task of mobilising savings, and of converting them into corporate industrial investment, is at once so urgent, enormous and diverse that no one agency, or group of related agencies, can be relied upon for this task.

D.21 If the annual rate of growth of our industrial production must double from the present level of 5 per cent to the level of 9 to 10 per cent (a target desired by the Planning Commission itself), if the challenge of mobilising savings from the new areas and sectors of growth in the Indian economy is to be met, and if some degree of freedom is to be ensured to potential investors in their choice of investment outlets, we need, I submit, to encourage more investment companies and unit trusts both in the public and private sectors.

A. B. Bilimoria.

CHAPTER 6

CHIT FUNDS

INTRODUCTION

6.1 In this chapter it is proposed to study the working and role of one of the oldest of the indigenous NBFIs, *viz.*, Chit Funds. We have, in particular, examined the role of chit funds as a saving and lending institution. Our analysis and observations are based on published material, data collected by the Reserve Bank of India, memoranda received from various chit fund companies as well as material submitted by the representatives of some of the leading chit funds to the Banking Commission. The annual reports of a few chit funds have also been made use of. The Study Group received in all twelve memoranda (listed in Appendix II). The Banking Commission had issued a questionnaire to commercial banks and the replies received in response thereto pertaining to their chit fund business have been analysed and used for our discussion.

ORIGIN

6.2 Chit Fund is perhaps the oldest indigenous financial institution in India. The origin of chitty or kuri or chit fund is traceable beyond more than a century in the rural parts of Southern India.† Periodically, a fixed measure of grain could be deposited with a trustee and received back when sufficiently large quantity was collected. The needy person was ascertained through draw of lots. The word 'chit' suggests its origin. Chit means a written note on a small piece of paper. Since the winner of the chit amount was to be ascertained through draw of lots, it involved writing of names of eligible members on separate chits, as in a lottery. The scheme thus came to be known as 'chit funds'. Its equivalent in Malayalam 'kuri' is derived from 'Kurippu' which is a synonym of chit.

6.3 The trustee's reputation for honesty attracted more savers to him. In the earlier stages when the idea of modern banking had not reached the people, chit fund institution developed quickly and spontaneously. It was an expression of co-operative efforts of mustering savings through instalments and advancing the pooled savings as loan to the members with facilities of repayment in instalments. With the growing importance of com-

† E. J. Simcox, *Primitive Civilisations*, Vol. I, Swan Sonnenschein & Co., London, 1894, p. 568. "The Institution of chit funds resembles an institution in China which seems to be about 2000 years old." (*Ibid*, Vol. II, pp. 332-33).

merce and industry and the consequential rise in the population of towns and cities, chit fund was brought to the urban areas.

Types of Chit Funds and Their Working

6.4 Gradually, payment of instalments in kind lost popularity even in rural areas and among agriculturists. The role of trustee — later called Foreman — became more dominant and the chit prizes (amount received by the winner at the lot/auction), by and large, consisted of cash. There are three varieties of chit funds, *viz.*, (*a*) Simple Chits, (*b*) Prize Chits and (*c*) Business Chits. The main features of these types of chits are discussed in the following paragraphs.

(*a*) *Simple Chits*

6.5 In the 'simple chit', members agree to contribute to the fund a certain amount at regular intervals. Lots are drawn periodically and the member whose name appears on the 'chit' gets the periodical collection. His name is then removed from the subsequent lots ; he, however, has to continue to pay his subscriptions. Thus, every member gets the whole of the chit amount by turns. There is no loss of capital. Also there is no foreman or even if there is one, he does not charge any commission. This is a form of mutual help and co-operative effort at savings.

(*b*) *Prize Chits*

6.6 In the 'prize chit', there is a foreman who ostensibly charges no commission and promises to return the whole of the contributions made by a member back to him at the end of a certain period. Periodically, the names of 'non-prized' members are put to draw and the lucky member gets the prize either in cash or in the form of an article of jewellery or utility. Once a person gets a prize, he does not have to pay further instalments. The lucky member will get the prize irrespective of the number of instalments he has paid provided all the due instalments till the drawal of prize have been paid; he will then be exempted from further liability to pay. On the contrary, the majority of the members may not have got the prize when the scheme closes though they get back their total contributions without any deduction or its equivalent in the shape of an article. This is a scheme which is nothing short of a lottery which is an offence punishable under Section 294-A of the Indian Penal Code. The name 'chit fund' is rather a misnomer in this case.

(*c*) *Business Chits*

6.7 In this case, there is a promoter called foreman who enrols a number of subscribers and draws up the terms and conditions of the scheme in

the form of an agreement. Every subscriber has to pay his subscription in regular instalments. The foreman charges, for his service, a commission on which there is a ceiling fixed by law in some States. He also reserves the right to take the entire chit amount at the first or second instalment as prize. Depending on the terms of agreement, a fixed amount is also sometimes set aside for distribution among the non-prized members. After making provision for the above deductions the balance is put to auction (except at the last instalment) and given as prize to the member who is prepared to forgo the highest discount. The amount of discount is distributed as dividend either among all the members or only among the non-prized members. In some States a ceiling has been fixed on the discount that a member can offer. In case more than one person is prepared to offer the same discount or when there are no bidders, lots are drawn to choose the prize winning member. The number of subscribers in a chit series equals the number of instalments so that every member is assured of the opportunity of getting the prize. Sometimes with a view to catering to as many subscribers as possible, a chitty comprises a series expressed in terms of a sub-division or fraction of a full ticket (ticket means the share of a subscriber which entitles the holder thereof to the prize amount at any one instalment). In such cases the number of subscribers can exceed the number of instalments. In some cases only auctions are held to determine the prize winner while there are chit funds in which prize winning tickets are determined both by lots and by auction.

6.8 The prize winner can get the prize only on furnishing security acceptable to the foreman for the payment of the remaining instalments. In the event of default by subscribers in payment of instalment on due dates, penalties are imposed in various forms, *e.g.*, forfeiture of dividends or levy of penal interest.

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6.9 The above are the essential features of a business chit scheme although there are any number of variants. Chit fund can thus be described as a mutual recurring deposit scheme under which every member is entitled to receive prize amount as loan from the chit fund ; for the last prize winner, however, the prize amount cannot be considered as loan. Although no rate of interest is specifically mentioned, the deductions on account of discount and the foreman's commission make the loan in a majority of the cases, an interest-bearing one, the interest rate depending on the specific terms and conditions under which the scheme operates. For the foreman, however, no interest rate is involved on his 'loan'.

6.10 It will be seen from the above account of different types of chit funds that no financial intermediation is involved in the simple chit and the prize chit is essentially a lottery. Hence these two types of schemes fall outside the purview of the Study Group. Business chit scheme, on the other hand, is an institution represented by the foreman, which involves intermediation and which has many features common to deposit taking and

lending business. Our analysis is, therefore, mainly confined to business chit fund scheme.*

GROWTH OF CHIT FUNDS

6.11 Comprehensive statistics relating to chit fund business are not available. Available data, however, show that chit funds are more popular in Kerala and Tamil Nadu States than in others. Estimates of the total turnover of chit business of chit fund companies in India in 1966, varied between Rs. 40 crores and Rs. 100 crores. One estimate of the present turnover of chit funds is Rs. 110 crores per year. According to available information, of the total annual turnover of Rs. 100 crores in 1965-66, Kerala accounted for as much as Rs. 68 crores followed by Tamil Nadu (Rs. 15 crores), Delhi (Rs. 9 crores), Maharashtra (Rs. 3 crores) and Uttar Pradesh (Rs. 1.4 crores). These figures relate to chit fund companies only and as such are not exhaustive. Still, they show the relative orders of magnitude. It would thus be seen that about 84 per cent of the total turnover of chit fund business was accounted for by companies in Kerala and Tamil Nadu. Companies in the South have spread out their activities practically to all big industrial cities like Ahmedabad, Bombay, Calcutta, Delhi, Jamshedpur and Ranchi. Some chit funds are fairly big. One of them has 70 branches all over India with a turnover of Rs. 30 crores and membership of about 1,50,000. An idea of the growth of chit funds and kuries in Kerala and Tamil Nadu can be had from Tables 6.1 and 6.2. The representatives of the Kerala Government informed the Banking Commission that the number of working chitties at the beginning of 1969 was 5,257 with *sala* amount (capital value) around Rs. 5.4 crores.

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6.12 According to the Tamil Nadu Government, there were, at the end of 1969-70, as many as 5,795 chit funds registered with the Government. Their monthly turnover was estimated at around Rs. 2.7 crores. These figures refer only to the registered institutions. There were in addition unregistered chit funds whose number was not known.

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* All the laws which have been enacted so far with the object of controlling chit funds and even the proposed bills have defined chits so as to cover only business chit schemes and specifically exclude the simple and the prize chits. As an illustration, the relevant extract from the Tamil Nadu Chit Funds Act 1961 (Madras Act No. 24 of 1961) is given below :

"Chit means a transaction by which its foreman enters into an agreement with a number of subscribers that every one of them shall subscribe a certain sum or certain quantity of grain by instalment for a definite period and that each subscriber in his turn as determined by lot or by auction or by tender or such other manner as provided for in the agreement, shall be entitled to a prize amount.

Explanation : A transaction is not a chit within the meaning of this clause, if in such transaction—(*a*) some alone, but not all of the subscribers get the prize amount without any liability to pay future subscriptions or (*b*) all the subscribers get the whole of the chit amount by turns with a liability to pay future subscriptions."

Similar definitions are to be found in Travancore Chitties Act, Cochin Kuries Regulations and Mysore or Kerala Bills on the subject.

TABLE 6.1—GROWTH OF CHIT FUNDS IN KERALA—1956-57 TO 1967-68

Year	No. of Chitties/Kuries registered under the Travancore Chitties Act and the Cochin Kuries Regulation by						Total	Capital (Rs. lakhs)
	Industrialists	Co-operative societies	Funds	Other Individuals	Banks	Other Institutions		
1956-57	4	81	51	728	126	38	1028	36.78
1957-58	5	55	53	544	70	27	754	30.86
1958-59	2	71	43	588	95	42	841	33.77
1959-60	1	79	50	573	99	44	846	37.63
1960-61	2	109	37	622	101	37	908	40.52
1961-62	8	119	56	696	49	46	974	44.80
1962-63	5	162	69	706	42	53	1037	54.72
1963-64	5	155	67	770	20	58	1075	62.20
1964-65	7	131	72	815	27	67	1119	55.47
1965-66	4	151	108	980	25	98	1366	85.38
1966-67	8	203	124	1160	15	132	1642	107.81
1967-68 (Upto July, 1967)	4	104	89	633	14	57	901	64.55
Total	55	1420	819	8815	683	699	12491	654.50

Source : *Scheme for Starting Chitties under State Auspices*, Kerala Government, 1967, p. 8.

TABLE 6.2—GROWTH OF CHIT FUNDS@ IN TAMIL NADU—1966-67 TO 1969-70*

	1966-67	1967-68	1968-69	1969-70
1. No. of chits commenced functioning during the year ..	1470	1680	2213	3280
2. No. of chits functioning at the end of the year	2255	3043	4016	5795
3. Total chit amount of the chits functioning at the end of the year** (Rs. lakhs)	73.94	120.16	235.51	269.16
4. Total value of securities held by Chit Registrars at the close of the year (Rs. lakhs)	41.62	100.38	154.62	186.14

@ Registered under the Act.
* Year ending on March 31.
** Annual turnover of the Chits will be roughly equal to twelve times the amount shown against this item.

Note : The Tamil Nadu Chit Funds Act, 1961, was introduced with effect from 8th July, 1964, in Kanyakumari, Tirunelveli and Palayamkottai Registration Districts. The Act was extended to City of Madras with effect from 1st August, 1965, and to the entire State with effect from 1st December, 1969.

Source : Memorandum submitted by the Government of Tamil Nadu to the Study Group.

ROLE OF THE FOREMAN

6.13 At this stage it would be useful to study the foreman's role in the chit transactions. Subject to law, he decides practically everything about the chit — the number of members, the amount of instalments, the chit amount, his commission, the instalment at which he himself would retain the prize, the penalties to be imposed on defaulting members, etc. It is easy for him to exercise his powers because the number of subscribers is in many cases large and they are usually scattered over many places.

6.14 Some foremen, in addition to carrying on the business of chits, also accept deposits from third parties. These are utilised as working funds and lent at high rates of interest to subscribers and perhaps to others. According to Reserve Bank's survey, the amount of deposits of 106 reporting chit fund companies at the end of March 1968, was about Rs. 1.1 crores.† In terms of Reserve Bank's Directions,* a chit fund company cannot accept deposits repayable after a period of less than 12 months from the date of receipt of such deposits nor can the amount of such deposits exceed 25 per cent of its paid-up capital and free reserves. It may be noted that the subscriptions received from the members of chit funds in terms of contract are not treated as 'deposits' for the purpose of Reserve Bank's Directions. According to available information, one-third of the outstanding loans and advances@ as on 31st March 1967, given by the foremen of 100 chit fund companies were personal loans ; 27 per cent were meant for the commerce sector and 15 per cent were professional loans. 'Industry' and 'agriculture' got a negligible proportion, these advances accounting respectively for 0.5 per cent and 0.1 per cent of the total.

6.15 The foreman derives his income in different ways, both legal and illegal. In the former category can be included items such as admission fee from members, penal interest or penalty fee from defaulting members and forfeiture of their dividend, interest on loans to non-prized chit holders, fees for transfer of shares in the chit, deduction from the subscription paid by a member who wants to resign, dividends on the chit reserved for himself, interest on chit prize taken without deduction, interest on the chit prize which the prized member may not be in a position to collect immediately, and subscriptions paid by members who discontinue in the middle of the scheme but do not care to claim refund.

6.16 The unscrupulous among the foremen resort to some unfair methods to secure illegal gains. A few of these methods are briefly mentioned below :

(*i*) Enrolment of fictitious members to complete the required number

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† Including the amount of exempted loans or other receipts not counting as deposits in terms of Reserve Bank of India Regulation.

Source : Reserve Bank of India Bulletin, April 1971, p. 569.

* No. DNBC. 1 /ED (S)-66 dated the 29th October, 1966.

@ Prize amounts distributed to the prized members are not treated as loans and advances.

of members in a chit series. If a real and needy non-prized member is not able to come forward to offer a high discount at the auction, one of these *benami* members is shown to get the prize thereby depriving the real members of the opportunity. (*ii*) Similarly, it is possible to exploit needy non-prized member or a new member so that he gets the prize only at the maximum discount. (*iii*) The prized member is supposed to get the amount soon after the draw or auction is over — of course on furnishing the security. But the foreman adopts tactics which delay the actual payment for a considerable time. Meanwhile he uses the money interest-free. If he succeeds in delaying the payment till the succeeding draw, the earlier prize winner is given the prize out of the collections of the succeeding draw. Thus, one instalment is perpetually in the hands of the foreman to be utilised in any way he likes.

6.17 The above are only examples to illustrate the way in which some foremen maximise their profits. They do not take into account the cases where the foreman and his associates disappear from the scene and are untraceable. The police have many such cases on their record. During 1962-66, as many as 255 chitties collapsed in several districts of Kerala on account of such malpractices.

6.18 It may be noted that the foreman has to undertake some responsibilities and risks. He is responsible for regular collection of subscriptions from a widely scattered body of members. He has to conduct the draws or the auction and maintain accounts. He is under obligation to pay the prize amount on the due date whether or not all the members have paid their subscriptions. In case of defaults, he has often to make good the deficit out of his own resources. If the prized member defaults in his instalments, litigation follows to recover the amount. If the defaulter is a non-prized member, the foreman has to find out a suitable substitute or, in the alternative, has to take over the chit himself and continue the business. According to the memoranda submitted by some chit funds to the Banking Commission, the foreman requires finance from banks as well as moneylenders and other private sources. Some companies have also pointed out that their profits are not very large in relation to the risks involved. According to memoranda submitted to the Study Group, 15 to 18 per cent of the subscribers fail to pay their subscriptions after getting the prize amount.

6.19 The Bureau of Economics and Statistics, Kerala, had undertaken a sample survey of 64 chitties. For the purpose of analysis, these units were classified into 4 slabs on the basis of turnover of the chit series conducted by them. A classification of these 64 chitties according to expenditure incurred in running the chit business is given in Table 6.3. It will be seen therefrom that 44 per cent of the chit funds incurred an expenditure of below 2 per cent of chit amount.

TABLE 6.3—64 CHIT FUNDS IN KERALA CLASSIFIED ACCORDING TO THE EXPENDITURE INCURRED IN RUNNING THE CHITTY AS PERCENTAGE OF CHIT AMOUNT

Range (Expenditure*) \ Range (Turnover)	Slab-I (Rs. 0-4999)	Slab-II (Rs. 5000-9999)	Slab-III (Rs. 10,000-19,999)	Slab-IV (Rs. 20,000 & above)	Total all slabs
0—1% ..	*20%*	*22.7%*	*11.7%*	—	*15.6%*
1.1—1.5% ..	*6.7%*	—	*41.3%*	*10%*	*14.1%*
1.6—2% ..	*6.7%*	*18.2%*	*5.9%*	*30%*	*14.1%*
2.1—2.5% ..	*6.7%*	*9.1%*	—	*20%*	*7.8%*
2.6—3% ..	*13.2%*	*9.1%*	*11.7%*	*20%*	*12.5%*
3.1—3.5% ..	*20%*	*18.2%*	*5.9%*	—	*12.5%*
3.6—4% ..	*6.7%*	*9.1%*	*5.9%*	*10%*	*7.8%*
4.1—4.5% ..	*20%*	*13.6%*	*11.7%*	*10%*	*14.1%*
4.6—5% ..	—	—	*5.9%*	—	*1.5%*
	100%	*100%*	*100%*	*100%*	*100%*

* As percentage of chit amount.
Source : Scheme for Starting Chitties Under State Auspices, Kerala Government, 1967, p. 13.

6.20 The findings of the survey also throw light on the pattern of expenses of chit funds. 58 per cent of the chitty foremen in Kerala State incurred no expenses by way of rent for housing their office establishment, and in the case of others, the percentage of rent to their total expenses in the conduct of chitties worked out to only 7.9 per cent on an average. But the amount of miscellaneous and incidental expenses involved in the conduct of chitties was comparatively high ; it worked out to about 34 per cent of the total working expenses. Generally speaking, all foremen conducting chitties involving a capital amount of over Rs. 10,000 had employees on their pay rolls. The proportion of foremen having employees declined according to the amount of turnover of their chit fund business.

6.21 The Survey showed that the profits of foremen in all cases were below 5 per cent (Table 6.4).

TABLE 6.4—PROFITS OF CHITTY FOREMEN

Range (Profit) \ Range (Turnover)	Slab-I (Rs. 0-4999)	Slab-II (Rs. 5000-9999)	Slab-III (Rs. 10,000-19,999)	Slab-IV (Rs. 20,000 & above)	Total all slabs
Below 5% ..	*100.0%*	*100.0%*	*100.0%*	*100.0%*	*100.0%*
Below 4% ..	*80.0%*	*77.3%*	*94.1%*	*100.0%*	*84.4%*
Below 3.5% ..	*73.3%*	*77.3%*	*52.8%*	*90.0%*	*70.3%*
Below 3% ..	*66.6%*	*59.1%*	*41.1%*	*60.0%*	*56.2%*
Below 2.5% ..	*59.9%*	*50.0%*	*41.1%*	*40.0%*	*48.4%*
Below 2% ..	*46.7%*	*40.9%*	*29.4%*	*20.0%*	*35.9%*
Below 1.5% ..	*26.7%*	*22.7%*	*23.5%*	*20.0%*	*23.4%*
Below 1% ..	*20.0%*	*13.6%*	*17.6%*	*10.0%*	*15.6%*
Below 0.5% ..	*0%*	*0%*	*5.9%*	*0%*	*1.5%*

Source :— Ibid, p. 12.

6.22 In interpreting the data in Tables 6.3 and 6.4, it may be remembered that the figures were furnished by the foremen themselves and, therefore, the estimates of net profits are likely to have been underestimated and those relating to expenses overestimated.

Pecuniary Aspects of Chit Funds from the Point of View of Subscribers

6.23 The phenomenon of rising popularity of chit funds in recent years requires some explanation. Chit funds serve both as saving institutions and institutions providing credit to their members. Since the return on savings for a subscriber who joins a chit fund in order to earn interest on his savings and the interest which is involved for a prize winner who joins chit fund for credit are of crucial importance in deciding the place of chit fund as a saving and lending institution, these aspects are discussed in the following paragraphs.

6.24 The gain or loss of a subscriber depends on a number of factors and assumptions. It depends, among other things, upon the stage at which the chit prize is taken, the discount offered, the commission of the foreman, the period for which a prize winner has to wait before he actually gets the prize, the interest that he might have earned on his savings elsewhere, the return that can be obtained by investing his prize amount, duration of the chitty, etc. Before we examine the question in detail, some general points may be made. Normally, in every chit, a member has to pay the whole of the chit amount while he can expect to get a prize which is less than the chit amount at least by the foreman's commission. Only a few members may be able to derive more by way of prize *plus* dividends than what they pay as their subscriptions. In this category will be included those members who do not get a prize till the late stages but who get a share in substantial discount offered by prize winners. In no case can *all* members get more than what they contribute because unlike a commercial bank the chit fund does not get any return on the capital employed, from anybody except the members of the chit itself.

6.25 Chit fund transaction can be viewed from two angles : in the case of a borrower the transaction can be considered advantageous only if the rate of interest he pays on the loan, *i.e.*, the prize amount, is less than that prevalent in the money market ; from the investor's point of view, the transaction is advantageous only if the rate of interest he receives on the subscriptions by way of dividends is higher than what he can normally and reasonably expect elsewhere.

6.26 As mentioned above, the profit and loss involved from the point of view of subscribers depends on the facts of each case and the assumptions made. Some examples have been worked out in the District Monograph

of Quilon of the All-India Rural Credit Survey, 1951-52. In one example the following assumptions were made : chit amount was Rs. 1,000 ; number of instalments and subscribers was 20 each; each subscriber had to pay Rs. 50 p.m. ; the foreman kept for himself the collection of the second instalment and his commission per instalment was 5.18% (Table 6.5). The purpose of the example was to find out the implicit rate of interest involved in 'making deposits' with the chit fund and in 'borrowing' from it, the amount of subscription being treated as deposit in the institution and the prize amount as advance from it. Assuming various rates of interest on deposits, a minimum rate of interest was worked out at which the prize winner should invest his funds in order that he is not a loser. In other words, it can be assumed to be the rate of interest paid to the chit fund on borrowings.

TABLE 6.5—IMPLICIT RATES OF INTEREST INVOLVED IN CHITTY

ASSUMPTIONS : (1) Chitty Amount : Rs. 1,000. (2) No. of Instalments : 20. (3) No. of Subscribers : 20. (4) Foreman's Instalment : 2. (5) Foreman's Commission : 5.18%.

(Rates of interest in per cent per annum)

Instalment Number	Prize amount (treated as borrowing from the chitty) (Rs.)	Rate of interest on borrowings for r = 0 ('r' being the assumed rate of interest on subscriptions treated as 'deposits' paid into the chitty)	r = 1	r = 2	r = 3	r = 4	r = 5
1	2	3	4	5	6	7	8
1	712.3	*17.1838*	*17.7935*	*18.4032*	*19.0129*	*19.6226*	*20.2323*
2*	948.2	*—2.9600*	*—2.4766*	*—1.9932*	*—1.5098*	*—1.0264*	*—0.5430*
3	722.8	*17.9010*	*18.5725*	*19.2440*	*19.9155*	*20.5870*	*21.2585*
4	744.8	*16.2426*	*16.9350*	*17.6274*	*18.3198*	*19.0122*	*19.7046*
5	758.8	*15.5298*	*16.2547*	*16.9796*	*17.7045*	*18.4294*	*19.1543*
6	774.8	*14.5254*	*15.2861*	*16.0468*	*16.8075*	*17.5682*	*18.3289*
7	801.0	*12.1118*	*12.9042*	*13.6966*	*14.4890*	*15.2814*	*16.0738*
8	815.3	*11.1370*	*11.9803*	*12.8236*	*13.6669*	*14.5102*	*15.3535*
9	836.9	*9.0203*	*9.9166*	*10.8129*	*11.7092*	*12.6055*	*13.5018*
10	846.7	*8.4186*	*9.3931*	*10.3676*	*11.3421*	*12.3166*	*13.2911*
11—13	873.4	*5.6160*	*6.7969*	*7.9778*	*9.1587*	*10.3396*	*11.5205*
14—16	913.7	*—1.9963*	*—0.1903*	*1.6157*	*3.4217*	*5.2277*	*7.0337*
17—19	938.1	*—20.4669*	*—16.0692*	*—11.6715*	*—7.2738*	*—2.8761*	*+1.5216*
20	948.2						

* Foreman's instalment.

Source : District Monograph—Quilon, All-India Rural Credit Survey—1951-52, Reserve Bank of India, 1958, p. 132.

6.27 It will be seen from Table 6.5 that the interest rate on 'borrowing' was higher for a prize winner who got a prize at an earlier stage than for one who got it later ; in fact the last few prize winners generally earned a net rate of interest from the chit fund. The interest rate on borrowing for a given rate of return on subscriptions differs from subscriber to subscriber. If, for instance, the 'deposit rate' (*i.e.*, assumed rate of return on subscriptions) is taken at 5% per annum, a member who gets the prize of Rs. 723, at the third instalment will have to earn an interest at least at 21.3% per annum on his prize amount (Column 8) if he is not to be a loser. If the subscriptions paid by a subscriber are treated as current deposits, *i.e.*, without earning any interest, the maximum rate of interest payable by a prized subscriber on his prize in order not to be a loser would be 17.9% (Column 3). Subscribers who bid at the fourteenth and later auctions make clear profits. When the rate of interest on subscriptions is assumed to be 5%, the minimum rate of interest at which the prize winner should invest his prize amount remains, in a majority of cases above 13% per annum. Thus, the majority of subscribers in this particular case can be considered to be paying 13% or more to the chit fund on their 'borrowing'.

6.28 In order to find the financial implications of kuris as an institution for borrowing as well as for investment of savings and in respect of the benefits accruing to the foreman in his capacity as a subscriber, the Travancore Cochin Banking Inquiry Commission, (1956), called for particulars of some terminated kuris from a few banks. These examples are given in Tables 6.6 and 6.7. In the illustration in Table 6.6 the chit ran for a long period of 15 years and two tickets were prized at every instalment—one by auction and the other by lot. The non-prized subscribers were entitled to share among themselves at each instalment the discount offered by the prize winner and a minimum discount on each ticket in terms of the agreement. The foreman was entitled to the entire kuri amount without any deduction at the second instalment. If interest rate is calculated at 6% per annum on both the prize amount received by a subscriber as well as on the periodical subscriptions made by him, it will be seen that the prize winners upto the 12th instalment, with the exception of the foreman, paid more to the chit fund than they received from it. The amount of loss showed a declining trend with every succeeding instalment. On the other hand, members of the chit, winning the prize from the 13th instalment always received more from the chit than they paid to it. For this category of subscribers the amount of the gain increases with succeeding instalments.

6.29 Table 6.7 illustrates the scheme of a chit which ran for a period of 24 months and in which the discount offered by the successful bidders was distributed equally among both the prized and non-prized subscribers. If, as in the previous example, a rate of interest at 6% is assumed both on the prize amount and on the subscriptions, it would appear that every subscriber except the foreman is a loser. It may be pointed out that the gains

TABLE 6.6—PROFIT AND LOSS TO SUBSCRIBERS

ASSUMPTIONS : (1) Duration of kuri : 15 years. (2) No. of tickets : 32. (3) No. of instalments : 16. (4) Two tickets are prized at each instalment: One by auction and the other by lot. (5) Instalment amount per ticket : Rs. 500. (6) Fixed dividend per instalment : Rs. 1,987 As. 8. (7) Foreman's commission : Rs. 12 As. 8. (8) Dividend is distributed among non-prized subscribers only.

(In Rs. As. P.)

Serial No. of Prize Winner	Prize Amount	Subscription paid *less* dividend*	Dividend per ticket at each instalment	Columns (2) — (3)	Interest on prize amount till the close of kuri at 6%	Total of columns (2) & (6) (Receipts)	Interest on subscription at 6%**	Total of columns (3) & (8) (Payments)	Columns (7)—(9)
1	2	3	4	5	6	7	8	9	10
1	4450 0 0	7827 5 6	172 10 6	—3377 5 6	4005 0 0	8455 0 0	3444 9 9	11271 15 3	—2816 15 3
2	8000 0 0	@7827 5 6	—	+ 172 10 6	6720 0 0	14720 0 0	3444 9 9	11271 15 3	+3448 0 9
3	4800 0 0	7642 8 4	184 13 2	—2842 8 4	3744 0 0	8544 0 0	3300 7 2	10942 15 6	—2398 15 6
4	4950 0 0	7449 4 0	193 4 4	—2499 4 0	3564 0 0	8514 0 0	3161 4 8	10610 8 8	—2096 8 8
5	5200 0 0	7250 4 8	198 15 4	—2050 4 8	3432 0 0	8632 0 0	3029 15 7	10280 4 3	—1648 4 3
6	5400 0 0	7042 5 5	207 15 3	—1642 5 5	3240 0 0	8640 0 0	2905 3 3	9947 8 8	—1307 8 8
7	5685 0 0	6827 13 5	214 8 0	—1142 13 5	3069 14 5	8754 14 5	2789 6 0	9617 3 5	— 862 5 0
8	5995 0 0	6606 11 8	221 1 9	— 611 11 8	2877 9 8	8872 9 8	2683 3 11	9289 15 7	— 417 5 11
9	5995 0 0	6357 15 8	248 12 0	— 362 15 8	2517 14 5	8512 14 5	2578 12 4	8936 12 0	— 423 13 7
10	6000 0 0	6074 0 10	283 14 10	— 74 0 10	2160 0 0	8160 0 0	2476 8 11	8550 9 9	— 390 9 9
11	6000 0 0	5742 12 10	331 4 0	+ 257 3 2	1800 0 0	7800 0 0	2377 2 11	8119 15 9	— 319 15 9
12	6000 0 0	5345 4 10	397 8 0	+ 654 11 2	1440 0 0	7440 0 0	2281 12 6	7627 1 4	— 187 1 4
13	6000 0 0	4848 6 10	496 14 0	+1151 9 2	1080 0 0	7080 0 0	2192 5 6	7040 12 4	+ 39 3 8
14	6000 0 0	4185 14 10	662 8 0	+1814 1 2	720 0 0	6720 0 0	2112 13 6	6298 12 4	+ 421 3 8
15	6000 0 0	3192 2 10	993 12 0	+2807 13 2	360 0 0	6360 0 0	2053 3 6	5245 6 4	+1114 9 8
16	6000 0 0	1204 10 10	1987 8 0	+4795 5 2	—	6000 0 0	2053 3 6	3257 14 4	+2742 1 8

* Amount of dividend includes share in the fixed discount of Rs. 1987-8-0 per ticket drawn by lot at each instalment. After the subscriber gets the prize, the subsequent instalments are fixed at Rs. 500 each.

**For 15 years on the first instalment ; for 14 years on the second, and so on.

@Foreman's ticket.

Source : Report of the Travancore Cochin Banking Inquiry Commission, 1956, pp. 44-45.

TABLE 6.7—PROFIT AND LOSS IN CHIT FUND

ASSUMPTIONS : (1) Duration of Chitty : 24 months. (2) No. of tickets and instalments : 25. (3) Instalment amount per ticket : Rs. 500. (4) Dividend is distributed amongst all subscribers. (5) Foreman's commission : Rs. 625.

(In Rs. As. P.)

Sl. No. of prize winner	Prize amount	Dividend per ticket at each instalment	Subscription paid *less* dividend	Columns (2) — (4)	Interest on prize amount till close of chitty at 6%	Total of columns (2) & (6) (Receipts)	Interest on subscription at 6%*	Total of columns (4) & (8) (Payments)	Columns (7) — (9)
1	2	3	4	5	6	7	8	9	10
1 ..	.. 9154 0 0	108 13 5	11568 4 3	—2414 4 3	1098 7 8	10252 7 8	668 8 9	12236 13 0	—1984 5 4
2 ..	.. 12500 0 0@	Nil	11568 4 3	+ 931 11 9	1437 8 0	13937 8 0	668 8 9	12236 13 0	+1700 11 0
3 ..	.. 9203 0 0	106 14 1	11568 4 3	—2365 4 3	1012 5 3	10215 5 3	668 8 9	12236 13 0	—2021 7 9
4 ..	.. 9579 0 0	91 13 5	11568 4 3	—1989 4 3	1005 12 9	10584 12 9	668 8 9	12236 13 0	—1652 0 3
5 ..	.. 10026 0 0	73 15 4	11568 4 3	—1542 4 3	1002 9 7	11028 9 7	668 8 9	12236 13 0	—1208 3 5
6 ..	.. 10026 0 0	73 15 4	11568 4 3	—1542 4 3	952 7 6	10978 7 6	668 8 9	12236 13 0	—1258 5 6
7 ..	.. 10166 0 0	68 5 9	11568 4 3	—1402 4 3	914 15 0	11080 15 0	668 8 9	12236 13 0	—1155 14 0
8 ..	.. 10007 0 0	74 11 6	11568 4 3	—1561 4 3	850 9 6	10857 9 6	668 8 9	12236 13 0	—1379 3 6
9 ..	.. 10436 0 0	57 9 0	11568 4 3	—1132 4 3	834 14 1	11270 14 1	668 8 9	12236 13 0	— 965 14 11
10 ..	.. 10670 8 0	48 2 11	11568 4 3	— 897 12 3	800 4 7	11470 12 7	668 8 9	12236 13 0	— 766 0 5
11 ..	.. 10963 8 0	36 7 4	11568 4 3	— 604 12 3	767 7 1	11730 15 1	668 8 9	12236 13 0	— 505 13 11
12 ..	.. 11025 0 0	34 0 0	11568 4 3	— 543 4 3	716 10 0	11741 10 0	668 8 9	12236 13 0	— 495 3 0
13 ..	.. 11002 0 0	34 14 9	11568 4 3	— 566 4 3	660 1 11	11662 1 11	668 8 9	12236 13 0	— 574 11 1
14 ..	.. 11307 0 0	22 11 6	11568 4 3	— 261 4 3	621 14 2	11928 14 2	668 8 9	12236 13 0	— 307 14 10

TABLE 6.7—PROFIT AND LOSS IN CHIT FUND—(*Contd.*)

ASSUMTIONS : (1) Duration of Chitty : 24 months. (2) No. of tickets and instalments : 25. (3) Instalment amount per ticket : Rs. 500. (4) Dividend is distributed amongst all subscribers. (5) Foreman's commission : Rs. 625.

(In Rs. As. P.)

Sl. No. of prize winner	Prize amount	Dividend per ticket at each instalment	Subscription paid *less* dividend	Columns (2) — (4)	Interest on prize amount till close of chitty at 6%	Total of columns (2) & (6) (Receipts)	Interest on subscription at 6%*	Total of columns (4) & (8) (Payments)	Columns (7) — (9)
1	2	3	4	5	6	7	8	9	10
15 ..	.. 11358 0 0	20 10 11	11568 4 3	— 210 4 3	567 14 5	11925 14 5	668 8 9	12236 13 0	— 310 14 7
16 ..	.. 11416 0 0	18 5 9	11568 4 3	— 152 4 3	513 11 5	11929 11 5	668 8 9	12236 13 0	— 307 1 7
17 ..	.. 11489 0 0	15 7 0	11568 4 3	— 79 4 3	459 8 11	11948 8 11	668 8 9	12236 13 0	— 288 4 1
18 ..	.. 11526 0 0	13 15 4	11568 4 3	— 42 4 3	403 6 7	11929 6 7	668 8 9	12236 13 0	— 307 6 5
19 ..	.. 11547 0 0	13 1 11	11568 4 3	— 21 4 3	346 6 7	11893 6 7	668 8 9	12236 13 0	— 343 6 5
20 ..	.. 11660 0 0	8 9 7	11568 4 3	+ 91 11 9	291 8 0	11951 8 0	668 8 9	12236 13 0	— 285 5 0
21 ..	.. 11715 8 0	6 6 1	11568 4 3	+ 147 3 9	234 5 0	11949 13 0	668 8 9	12236 13 0	— 287 0 0
22 ..	.. 11805 0 0	2 12 10	11568 4 3	+ 236 11 9	177 1 3	11982 1 3	668 8 9	12236 13 0	— 254 11 9
23 ..	.. 11875 0 0	Nil	11568 4 3	+ 306 11 9	118 12 0	11993 12 0	668 8 9	12236 13 0	— 243 1 0
24 ..	.. 11875 0 0	Nil	11568 4 3	+ 306 11 9	59 6 0	11934 6 0	668 8 9	12236 13 0	— 302 7 0
25 ..	.. 11875 0 0	Nil	11568 4 3	+ 306 11 9	Nil	11875 0 0	668 8 9	12236 13 0	— 361 13 0

* For 24 months on the first instalment ; for 23 months on the second, and so on.
@ Foreman's instalment.
Source : Ibid, pp. 47-48.

or losses in the examples have been worked out in absolute terms after assuming the same rate of interest on payments to the chit fund and receipts from it.

SOME BASIC ISSUES

6.30 As emphasised earlier, the rate of return on the savings of a subscriber to a chit fund and the interest rate that is involved for a subscriber joining the chitty as a borrower, will vary according to the terms and conditions of the chit fund. In fact, examples can be worked out on the basis of certain assumptions where the rate of return to prized subscribers at late stages will be quite high and the interest rate involved for a prize winner will be comparatively low. The essential point is that the rate of interest involved in chit funds is discriminatory and varies from person to person so that there is an irrational distribution of gains and losses. Ordinarily, the more needy a person, the higher will be the discount that he would be prepared to offer for winning a prize. Therefore, the more urgent his need the higher the rate of interest that a borrower has to pay. Another point is that there are institutions which offer savings schemes which are superior to the one involved in a chit fund. The savings and fixed deposits, recurring deposits, monthly income deposit schemes, cash certificate schemes, annuity or retirement schemes, insurance linked deposit schemes, small savings, provident funds and insurance schemes have features which are superior to those in the chit funds. The popularity of chit funds can be explained by the fact that a subscriber is entitled to borrow from it. Also, long standing social habits and the gaming element involved in the scheme, which perhaps provide an added attraction to some subscribers are also factors accounting for popularity of this institution.

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6.31 So far as the end-use of the prize is concerned, there are conflicting views.* It would appear that the likelihood of productive use of the prize money is small. A prospective producer would not depend on the uncertainties involved in a chit fund. The rates of interest generally involved for a prize winner in a chit fund are so high that an inference can be drawn that the prize money is mostly used for consumption or speculative purposes. Some persons join chit funds and are prepared to pay high rates of interest by way of large discount for the purpose of hoarding certain scarce commodities. They are not only able to recover the interest but also earn a profit

* According to a memorandum submitted to the Banking Commission, a study of the utilisation of prize amounts by subscribers showed that about 95% of the big prize amounts (above Rs. 5,000) are either turned into investments in industries or agriculture or into trade and transport. About 20% of the medium prize amounts (between Rs. 1,000 and Rs. 5,000) and about 57% of the small prize amounts (below Rs. 1,000) are, however, spent on unproductive or consumption purposes. The memorandum also points out that the prize amounts of small and medium chits formed only a small proportion of the big prize amounts. It is understood that these figures are based on the enquiries made from some foremen and a very few prize winners.

Source : Appendix IX to the Memorandum on *A Framework for an Optimum Banking and Credit System in India* submitted to the Banking Commission by P. R. Brahmananda.

on account of the difference between the relatively low price at which they buy the goods and the high price at which they sell them later.

6.32 As pointed out in paragraph 6.16, some foremen take advantage of the gullibility and ignorance of the subscribers. Most of the persons who join chit funds do so in order to get a prize, or in other words to get credit. Hence if alternative agencies are available and if the persons who are at present joining the chit funds are educated about the disadvantages (*i.e.*, risks and high interest rates involved on borrowing) in joining chit funds and, moreover, if they are assured of getting credit from alternative sources at reasonable terms, chit funds would die a natural death.

6.33 In spite of the disadvantages of chit funds as saving/lending institutions and the malpractices involved, the fact remains that they continue to be popular not only in the Southern States but many chit funds are coming into existence in Ahmedabad, Bombay, Calcutta, Delhi, etc. A banker from the South told us that the deposit schemes offered by the banks do not appeal to the common man in the South as much as chit funds schemes do. According to him, any chit fund series advertised in the newspapers by a bank is usually oversubscribed in a very short time whereas the new deposit schemes even with attractive features do not succeed in mobilising very large deposits. Since chit funds are of indigenous origin, their removal without offering alternative schemes will create a big gap. The problem, therefore, before the Study Group is to recommend measures to remove the unhealthy practices in chit funds, pending the development of banking habit in the country.

6.34 We considered three approaches to the question : (*a*) starting of chit funds in the public sector ; (*b*) encouraging commercial banks to carry on chit fund business ; and (*c*) legislative measures.

Public Sector as Foreman

6.35 A committee appointed by the Kerala Government went into the question of the feasibility and desirability of chit funds being run by the public sector. As a result, in Kerala, a Government company—the Kerala State Financial Enterprises Ltd.—started functioning with effect from April 1970, and has been running chit funds in addition to performing other activities.

6.36 The most important points in favour of the public sector entering the chit fund business are : (*a*) chit funds which will be run by the public sector will be free from the unhealthy practices which are usually associated with private chit funds ; (*b*) the subscribers will have more confidence in such chit funds and therefore they will be able to mobilise more savings ; and (*c*) the Government will get some revenues. The arguments against

are based on the general criticism against public sector entering any commercial business. It is said, for instance, that chit funds in the public sector would be saddled with red tapism, delays and corruption. It may be pointed out here that some of the chit fund companies which had discussions with the Banking Commission, were not at all worried about the public sector entering the chit fund business. In fact, one of the companies even suggested that chit fund business should be nationalised. Thus, there are no basic arguments against the State entering the chit fund business so long as efficiency can be ensured and the primary purpose of running chits is not to collect revenues for the State. However, the Study Group would not recommend that all the States should enter the chit fund business because it involves a large number of small transactions. If the State Governments start chit funds on a large scale, they would have to carry a heavy administrative burden. Some State Governments may, however, think of starting chit funds at strategic places as model foreman.

Commercial Banks as Foremen

6.37 Another way whereby discipline can be introduced in chit fund business is by encouraging commercial banks to undertake chit fund business and give effective competition to the private chit funds. Before we examine the arguments for and against this proposition, let us take a look at the factual position.

6.38 At present under the Banking Regulation Act, there is nothing to prohibit the banks from operating chit funds. Although it is not banking business proper, commercial banks can conduct chit funds as an agency business under Section 6(1)(b) of the Banking Regulation Act. Therefore, a bank does not require prior approval of the Reserve Bank for starting chits. Depending on the circumstances of each case, instructions are issued by the Reserve Bank. Generally they contain the following points : (*i*) the concerned bank has to take effective steps to recover speedily the outstanding dues in respect of the terminated kuris and also to collect the arrears and the subscriptions in respect of the running kuris ; (*ii*) the bank has to take steps so that the prized subscribers who are already indebted to the bank and whose record is not satisfactory are disallowed from withdrawing the chit prize money. In such a case, the prize amount should be utilised in liquidating/reducing the advance taken by him and the limits should be curtailed or cancelled depending on whether the advance is reduced or liquidated ; (*iii*) substitution, transfer, etc., should be done only with the prior approval of the Board of Directors of commercial banks ; (*iv*) the bank should transfer every year a fixed percentage from the net earnings of kuri department to a separate fund earmarked for writing off loans, if any, from the kuri business.

6.39 The number of banks running chits has come down in recent years. Most of the banks which used to transact this business were the

small unit banks in the South. With the process of merger starting from 1961-62, and with the Reserve Bank taking a strict view of this business, only a few banks now transact this business.

6.40 The Banking Commission in its questionnaire addressed to commercial banks had included some questions (Appendix III), relating to their chit fund business. From the replies received from the banks it is clear that only 9 banks were engaged in chit fund business in 1968. Table 6.9 shows the number of banks and their deposits in relation to chit fund business.

TABLE 6.9—CHIT FUND BUSINESS OF COMMERCIAL BANKS

	End 1966	End 1967	End 1968
1. Total No. of banks addressed	81	81	81
2. No. of banks reporting chit/kuri business	9	9	9
3. Total deposits of 81 banks (Rs. lakhs)	361467.4	395913.6	447536.7
4. Total amount of chit fund capital of 7 banks@ (Rs. lakhs)	24.3	23.6	22.4
5. Item (4) as percentage of Item (3)	*0.007*	*0.006*	*0.005*

@ Of the nine banks reporting chit fund business, two banks did not state the amount of chit fund capital in their replies. The data against item 4, therefore, relate to seven banks only.

Note : 81 banks had given replies to that part of the questionnaire which included questions on chit fund business. 8 banks, however, did not reply to the questions relating to chit funds. It is assumed in this analysis that these banks do not have any chit fund business.

Sources : 1. Replies received from commercial banks in response to questionnaire issued by the Banking Commission.
2. Statistical Tables relating to Banks in India.

6.41 It will be seen that the percentage of chit fund business to total deposits is negligible and has shown a declining trend during the period 1966-68. As expected, all the 9 banks reporting chit activity are from the South. It would be interesting to judge their position against the background of the 43 banks having offices in the South.

TABLE 6.10—CHIT FUND BUSINESS OF COMMERCIAL BANKS IN THE SOUTHERN STATES*

	End 1966	End 1967	End 1968
1. Total No. of banks having offices in Southern States	43	43	43
2. No. of banks reporting chit/kuri business	9	9	9
3. Item (2) as percentage of item (1)	*20.9*	*20.9*	*20.9*
4. Total deposits of 43 banks having offices in the South (Rs. lakhs)	67954.2	70755.1	80021.9
5. Total amount of chit capital of 7 banks@ (Rs. lakhs)	24.3	23.5	22.4
6. Item (5) as percentage of Item (4)	*0.04*	*0.03*	*0.03*

* Andhra Pradesh, Kerala, Mysore and Tamil Nadu.

@ Of the nine banks reporting chit fund business, two banks did not state the amount of chit fund capital in their replies. The data against item 4, therefore, relate to seven banks only.

Sources : 1. Replies received from commercial banks in response to questionnaire issued by the Banking Commission.
2. Statistical Tables relating to Banks in India.

Even in the case of the 7 banks which have supplied figures of their chit fund business, it will be seen that chit fund business was less than 1 per cent of the total deposits of the 43 banks having offices in the Southern States. Even in relation to the deposits of the 7 banks themselves, chit fund business hardly constituted one-half of one per cent.

6.42 Some interesting light is thrown by the data on the commission charged by banks as foremen. Table 6.11 shows the distribution of foremen banks according to commission charged by them.

TABLE 6.11—DISTRIBUTION OF BANKS ACCORDING TO COMMISSION CHARGED BY THEM AS FOREMEN OF CHITTIES

Commission (per cent)	No. of banks
1 to 2	3
2 to 4	3
4 to 5	1
Above 5	—
Information not supplied	4

Source : Replies received from commercial banks in response to questionnaire issued by the Banking Commission.

6.43 None of the 9 banks reporting chit business, had a chitty of an amount below Rs. 5,000. Two banks conducted chits between Rs. 5,000 and Rs. 10,000.

6.44 We may now turn to examine the arguments for and against the commercial banks conducting chits. There are two opposite views on the question. The Travancore Banking Enquiry Committee (1930) came to the conclusion that :

> "Since the institution (chit funds) is an impediment to the growth of true banking and the starting of chitties by banks results in serious irregularities, we would recommend either that banks should be prohibited absolutely from starting any more chitties or that permission be granted only when a bank has a general reserve fund equal to twice the chitty capital".*

The reasons adduced by the Committee for this view were : (*a*) loans were advanced to non-prized subscribers of the chitty on the security of the subscriptions paid by them, (*b*) land was accepted as collateral security, against the prize amount paid to the winner ; thus the funds of the banks were

* The Report of the Travancore Banking Enquiry Committee, (1930), Volume I, Para 268.

locked up in land, and (c) not infrequently, to keep a previous chitty going, a second or third chitty was started. It may be stated that in the discussions with the Banking Commission, the representative of a bank, which runs chit funds, expressed the opinion that chit funds were not intended for first class banks because they were at a disadvantage as compared to those run by private institutions. Another argument against commercial banks running chitties is that they are not in a position to ascertain the purpose for which the prize amount would be used. Banks also do not follow up the purpose of the prize after disbursal.

6.45 The opposite point of view was expressed by the Cochin Kuri Committee (1939). According to the Committee, banks can be more efficient than individuals and other institutions in conducting kuris on account of their ability to draw upon the banks' funds in case prize amounts had to be disbursed even if there were certain defaults in the payment by subscribers.

6.46 Thus, there are two opinions on the desirability of banks conducting chit fund business. According to one, chit fund business is not proper banking business and banks should not be encouraged to undertake it. The opposite view is that if banks run chit fund business, this may operate as a disciplining factor for private chit fund foremen. Examining the first viewpoint, the main argument is that chit fund business cannot be reconciled with the recognised principles and practices of commercial banking. A banker accepts deposits and makes loans after satisfying himself about the creditworthiness of the borrower and the purpose of the loan. In the final analysis, a banker is doing almost the same business as chit funds, namely, receiving periodical deposits and advancing the amounts so collected to subscribers against proper security. Looked at from this angle, there does not appear to be any divergence in principle between the chit business and commercial banking. An important point, however, is that the rates of interest both for savers and borrowers are discriminatory. Also a needy subscriber who offers a high discount is not often in a position to pay his future subscriptions. He becomes a defaulter and the promoter (foreman) is forced into litigation to recover the amount. There is yet another point. We gather that the kuri departments of many banks conducting chitties had to resort to continuous and excessive borrowings from the banking departments to make up the arrears of subscriptions due so as to enable the kuri departments to meet their obligations towards prized subscribers. Realisability of amounts lent to the kuri department is affected to the extent that subscriptions are not made by a prized subscriber. It may, however, be pointed out in this context that the risk in kuri business is probably as much as that involved in any bank's advances.

6.47 The most important point in favour of the view that banks should be encouraged to conduct chits is that if the banks conducted business

more efficiently than private foremen, they could give effective competition to the latter and thus many of the abuses usually associated with chits could be reduced. Also the business adds to the working funds of the foreman bank. The prize drawn might be deposited back in the bank. The prize amount is available to the foreman bank until the prize winning subscriber furnishes the security for payment of future instalments. Thus the prize amounts are available to the bank at least temporarily for varying periods of time and for profitable utilisation. Moreover the business opens new avenues for investments. Loans advanced to non-prized subscribers are evidently safe and are promptly and automatically realised when such subscribers get the prize.

6.48 A very important point which deserves examination is whether the running of chit fund business by commercial banks attracts sizeable deposits to them. In this connection it would be interesting to examine the point of view of banks themselves. Table 6.12 shows the advantages enumerated by the banks carrying chit fund business in reply to the questionnaire issued by the Banking Commission.

TABLE 6.12—ADVANTAGES OF CHIT BUSINESS TO COMMERCIAL BANKS

Advantages in the banks' carrying on chitty business	No. of* banks
1. Profit without using banks' own funds (by way of commission and interest on defaults)	9
2. Mobilisation of deposits	2
3. Chits are a form of compulsory savings to suit the requirements of many categories of savers	1
4. Small borrowers can obtain credit on easy terms	4
5. Banks have more resources to run chits efficiently	1
6. Advances made by banks are repaid easily by persuading borrowers to join chits	2
7. Conducting of chits by banks familiarises small income groups with the banks	3

* Some banks have indicated more than one advantage.

Source : Replies received from commercial banks in response to questionnaire issued by the Banking Commission.

It will be seen from the table that a number of banks pointed out that one advantage of running chits was that they could make profit without using their own funds. It was also suggested that conducting of chitties by banks familiarises small income groups with them.

6.49 In considering the question whether commercial banks should enter the chit fund business, we may also examine the reasons why even some depositors of commercial banks join chit funds. In the Survey of

'Depositors' Appraisal of Banking Services' made by NCAER, depositors of commercial banks who also joined chit funds were asked as to why they joined chit funds. Table 6.13 shows the classification of their replies :

TABLE 6.13—PERCENTAGE DISTRIBUTION OF DEPOSITORS ACCORDING TO REASONS FOR KEEPING DEPOSITS WITH CHIT FUNDS

Subscribe regularly	*63.90* %
For specific need	*46.63* %
Good discount and prize money	*20.09* %
Would subscribe even if there was no need	*9.27* %

(Reasons are counted in accordance with occurrence. Some depositors have indicated more than one reason.)

Source: *Technical Studies Prepared for the Banking Commission, Vol. I*, Reserve Bank of India, p. 132, Table 11.

It will be seen from the table that most of the depositors of commercial banks joined chit funds either because they wanted to subscribe to a scheme where they could make regular savings or in order to borrow for a specific need. In fact, these two may not be mutually exclusive. Many depositors of commercial banks probably join chit funds because in a chitty they can get the combined benefit of regular savings and borrowings for specific needs. These advantages are not usually available to the depositors of commercial banks.

6.50 It will thus be seen that it will be useful for commercial banks to think of certain instruments of deposits and credit having features similar to those in chit fund but without the disadvantages inherent in it. One can, for instance, think of banks accepting recurring deposits from persons planning holidays or marriage, etc., and, depending on the conduct of the account and integrity of the depositors, granting overdrafts in deserving cases. Pending the introduction of such schemes and their acceptance by the public, commercial banks may enter the chit fund business subject to proper safeguards. They will be able to compete with private chit fund foremen successfully on account of their resources and wide dispersal of branch network. By entering this business, commercial banks may also be able to attract more customers. Also they will be more amenable to control than the private chit fund foremen.

6.51 We understand that the Reserve Bank of India has already advised commercial banks regarding the precautions that they should take in conducting chit funds. Also, the Reserve Bank's policy is to discourage banks from conducting long-term (*i.e.*, above 5 years) chits. Although a long-term kuri is more beneficial from the point of view of a subscriber because

of the relatively longer period of repayment of 'loan' than in the case of a short-term chit, we endorse the Reserve Bank's policy because the element of risk involved in the conduct of long-term chits is greater than that in the case of short-term chits. According to available information, the percentage of dues from defaulters to the total amounts due from the prized subscribers is considerably more in the case of long-term kuris than in the case of short-term kuris run by commercial banks.

LEGISLATIVE MEASURES

6.52 We considered the above two suggestions, *viz.*, starting of chit funds in the public sector and the commercial banks entering the chit fund business with a view to eliminating, through competition, the malpractices usually prevalent in private chit funds. It may be noticed that most of the unhealthy practices arise from the lack of integrity of the foreman. It was, therefore, natural that the regulation of chit fund business assumed high priority in the States where the business is concentrated, *i.e.*, in the Southern States.

6.53 At present State legislation regulates the running of chit funds in the areas where such legislation is in force. The Tamil Nadu Chit Funds Act of 1961, seeks to regulate chit fund business in the State of Tamil Nadu. With appropriate changes, this Act was adopted, with effect from 15th July 1964, in the Union Territory of Delhi. The Union Territory of Pondicherry has the Pondicherry Chit Funds Act, 1966, which came into force from 1st August 1967. In Kerala, the Travancore Chitties Act of 1945, and Cochin Kuris Regulations, 1932, are in force in some areas of the State. The question of introducing a uniform enactment in Kerala has been under the consideration of the Government for some time. Some States are in the process of amending or enacting laws to regulate chit fund activity. In Andhra Pradesh a bill on the lines of the legislation in the neighbouring State is under consideration. Mysore and certain other State Governments are also contemplating passing of legislation for regulating chitties. Punjab Government is contemplating the starting of chit funds in the public sector on the lines of Kerala Government. In Uttar Pradesh, chit funds, lotteries, etc., are regulated by the provisions of the Manual of Government Orders. According to these regulations, publication of advertisements in newspapers, of any proposals regarding lotteries not authorised by the Government is an offence under the Indian Penal Code. Also local authorities have been asked not to accord sanction for holding lotteries nor should they authorise advertisements regarding such undertakings.

6.54 The object of legislation is to regulate the conduct of chit funds by requiring the foreman to obtain permission of competent authorities before a chit fund can be started, stipulating security to be provided by the foreman to the Registrar, detailing his rights and obligations and providing for punishment for infringement of law. Wherever legislation is in force,

no foreman can start a chit fund until the Registrar is satisfied about the bye-laws of the fund and the security offered by the foreman.

6.55 In the view of the Study Group a uniform legislation for regulating chit funds should be applied in all the States. Depending on the legal position either the Central Government can enact legislation to be applied to all the States or model legislation may be framed which each State may adopt.

6.56 We can only indicate broad guidelines for such legislation. The Tamil Nadu Chit Funds Act contains most of the essential features of such legislation. This can be strengthened by fixing the ceiling for the foreman's commission at 2% of the chit value and providing for the ceiling on the discount on the basis of a downward sliding scale. For example, a maximum discount of 25% can be prescribed for the first 10% of the members, 20% for the next 10% and so on with a minimum percentage of discount also prescribed. This latter suggestion is likely to reduce the rate of interest which a borrower-subscriber has to pay on the prize amount. Major objects of the legislation should be to safeguard the interests of members of the chit fund and bring the foreman more or less to the position of a manager so that the wide powers which he enjoys at present are restricted.

6.57 We also recommend that pending enactment of an All-India Chit Funds Act, chit funds carried on in the States where no legislation exists may also be regulated. It is the *situs* of the agreement that now determines the application of the chit fund legislation to a particular chit. If the foreman of a chit fund company registered in Tamil Nadu runs a chit series in Maharashtra (where there is no such chit fund regulation), then if the chit agreement relating to that series is entered into Maharashtra, the Tamil Nadu legislation does not extend to such business. Since a large number of chit funds operating in States having no chit fund legislation, are branches of the chit funds registered in States having such legislation (*e.g.*, Kerala and Tamil Nadu), it will be useful if the provisions of chit fund legislation in the latter States are applied to branches functioning in the former States. Thus, *e.g.*, a chit fund registered in Tamil Nadu will be governed by the Tamil Nadu Chit Funds Act not only in respect of its chit fund business in the State but also that of its branches operating in States having no chit fund legislation.

6.58 As earlier indicated in this chapter, the running of prize chits amounts to a commission of an offence of running a lottery under Section 294-A of the Indian Penal Code. However, the police regard it as a 'civil' transaction and the offence remains a non-cognisable one. As it is, here is a field where the police remain passive and the chit fund legislation does not touch it. The chit fund legislation evidently excludes this as what is prohibited by law cannot be regulated. As the law prohibits the running of prize chits, what could be considered is only the adequacy of the machinery

for the effective enforcement of a legal bar against prize chits. This perhaps may be necessary in the interests of the public and in the interests of those who participate in the prize chit schemes. This is so also because courts may not lend their assistance to enforce the prize chit agreement (in the view that it is one for an unlawful object) in the event of the foreman of a prize chit defaulting or defrauding. As it is a matter of common knowledge that prize chits are being conducted on a fairly large scale, the Group makes the following suggestions with reference to them :

(*a*) The offence under Section 294-A of the Indian Penal Code may be made a cognisable one ; and

(*b*) The Registrar of Chit Funds may be authorised to take note of any prize chit that may be run and may either himself initiate action against those responsible or request the Police to do so.

Conclusions

6.59 To sum up, the Study Group recognises that chit fund is an indigenous institution and as such cannot be eliminated without creating a credit gap. At the same time, we are of the view that chit funds are not efficient as saving or lending institutions. Chit funds also encourage consumption spending and in some cases hoarding of scarce commodities. The major reason for their popularity is that a large number of persons who join them are not aware of the risks and disadvantages involved. Ultimately the solution would lie in commercial banks endeavouring to wean away the chit fund subscribers by offering attractive deposit and credit schemes. But so long as commercial banks are not in a position to render the same services which the subscribers to the chit funds will expect from them, it would not be advisable to take steps for the elimination of chit funds. Even if measures are taken for their elimination, the possibility is that they will reappear in the unorganised sector.

6.60 Hence until such time as commercial banks are in a position to improve their services to their customers to an extent whereby the need for chit funds is eliminated, the logical conclusion is that chit funds have to be regulated. We have suggested above that legislation may be strengthened for this purpose ; States can start, wherever necessary and feasible, chit funds at strategic places to compete with private foremen and commercial banks may run chits subject to proper safeguards. We also suggest that since most of the malpractices occur in the case of those chit funds which are run either by individuals or private limited companies which are in effect family concerns, a law could be passed whereby no individual can start chit funds nor can a company do so unless it is a public limited one. The advantage then would be that an intending subscriber would be able to examine the accounts of the company before he joins it. Also, the profits of the company would be distributed among a large number of shareholders.

CHAPTER 7

NIDHIS

INTRODUCTION

7.1 Among the various classes of NBFIs, Nidhis (also known as Mutual Benefit Funds or Permanent Funds) occupy a somewhat unique position. The institution is peculiar to South India, particularly Tamil Nadu State, though a few nidhis exist in Bombay, Delhi and other parts of the country as well. This chapter reviews their working, examines their place in the Indian economy and suggests measures for improving their operations.

SOURCES OF DATA

7.2 For the material—both statistical and non-statistical—presented in the chapter, we had to rely mainly on the data collected by the Department of Non-Banking Companies of the Reserve Bank of India and memoranda submitted to the Study Group by the Associated Body of Nidhis as well as some individual nidhis. We also analysed the annual reports and accounts of a few selected nidhis. In addition, we took into account in our analysis the material submitted by some nidhis to the Banking Commission.

7.3 Comprehensive statistical data on the number, paid-up capital, growth and the working of the nidhis are virtually non-existent. Data on the number of companies and their paid-up capital, according to industrial classification of companies, available with the Department of Company Affairs, pertain to 31st March 1966. Subsequent figures are not available. Nidhis, chit funds, and 'other' financial institutions are all classified under Industry Code 6.59. The data given under the code include figures in respect of other types of non-banking financial institutions and do not pertain exclusively to nidhis. A brief study was published in the May 1967 issue of the Reserve Bank of India Bulletin, but that covered only one year, *i.e.*, 1965-66.

7.4 We received, in all, eleven memoranda from the nidhis including one from their Association in Madras. The statistics supplied in the memoranda, which were received between June and December 1970, are not uniform in all respects and as such could not be clubbed together to present a compact picture on relevant aspects ; however, they throw valuable light on the type of operations undertaken by nidhis. Names of the nidhis and the Association which submitted memoranda are given in Appendix II.

Working of Nidhis

Main Features

7.5 The objects of the nidhis, which confine their operations to specified localities, are mainly to encourage their members to save and enable them to borrow at 'reasonable' rates of interest to meet their various requirements which may range from defraying occasional heavy medical expenses to acquiring immovable assets like house property. A person desiring to have transaction with a nidhi has first to become its member by buying a share. The membership of the nidhis is usually confined to middle and lower middle classes. By introducing different types of deposits, like fixed, savings, recurring, etc., these institutions inculcate among small income earners the habit of thrift and compulsory saving. The Report of the Companies Act Amendment Committee, 1957, had summed up the working of the nidhis, the underlying force behind their continued existence in the economic system in spite of competition from other types of financial institutions and their aims and objects, in the following words :

> "They are Companies incorporated and registered under the Act of 1913 or the earlier Companies Acts. Their objects *INTER ALIA* are to enable the members to save money, to invest their savings and to secure loans at favourable rates of interest. They inculcate the idea of thrift and compulsory saving in the minds of the poor and middle class people. These companies have a fixed capital consisting of shares of rupee one each. The shares are not offered to the public for subscription but allotted to those who desire to take advantage of the benefits offered for depositing or borrowing money. These companies have transactions only with the members and not with the public. They help the members to save money by receiving from them recurring deposits of small sums every month and repaying the accumulated sum at the end of 4, 5, 6 or 7 years, as the case may be, with interest calculated on the amount standing to the credit of the depositor each month. Loans are granted to members on the security of their Recurring Deposits or of Jewels or House property repayable with a moderate rate of interest during a period of 4 to 7 years in monthly instalments ..... All these companies deal only with their members and their business is restricted to receiving deposits from and lending money to the members; their main source of income or profits is the difference between the interest paid to and earned from the members. They do not open current accounts. Some of these companies by reason of thrifty management have built up reserves and acquired assets in the shape of buildings, Government securities, etc."

7.6 The salient features that emerge from the foregoing are the following : First, the face value of the shares of the nidhis in an overwhelming

majority of cases, is Re. 1 each, which is within the reach even of a person belonging to the lower income class. Secondly, all the transactions of these companies are with their members only. Thirdly, besides offering various schemes for small savings of the members, they advance secured loans on reasonable rates of interest, the repayment of which is spread over a conveniently long period, the security for such loans being the members' own recurring deposits or jewellery or house property situated within the limits prescribed by the nidhis.

7.7 Nidhis are somewhat like urban co-operative banks. Unlike the urban co-operative banks, however, the amount of advance is not generally linked to the amount of shareholding. They are governed by the Companies Act whereas urban co-operatives are controlled under Banking Regulation Act† and the State Co-operative Societies Acts. Most of the deposits of nidhis are fixed deposits and most of the loans are secured long-term loans. The purpose of the loans is mainly consumption or house construction. Although nidhis deal only with their members, the conditions of membership are so easy that almost anybody can become a member. They are, thus, in a limited sense, banking institutions but do not enjoy any advantages offered to commercial or urban co-operative banks.

7.8 Some of the nidhis are quite old. One of them, *viz.*, Egmore Benefit Society, has recently celebrated its centenary. Table 7.1 shows the age distribution of 59 nidhis* studied by the Department of Non-Banking Companies of the Reserve Bank of India.

TABLE 7.1—CLASSIFICATION OF NIDHIS BY THE NUMBER OF YEARS FOR WHICH THEY HAVE BEEN IN EXISTENCE

(At the end of 1965-66)

	Nidhis, which have been in existence for	Number
1.	More than 75 years	12
2.	More than 50 years but not more than 75 years	16
3.	More than 25 years but not more than 50 years	16
4.	25 years and less	15
	TOTAL	**59**

Source : Reserve Bank of India Bulletin, May 1967.

† Only if capital and reserves exceed Rs. 1 lakh.

* At the end of November 1966, 65 Nidhis had been granted concessions in the form of the relaxation or modification of some of the provisions of the Companies Act, 1956, so as to relieve them of unnecessary or burdensome expenditure, having been notified for this purpose under Section 620A of the Act. Of these 65 Companies, 6 were reported to be in liquidation. Hence the study related to the remaining 59 nidhis.

7.9 According to one estimate, there were about 150 nidhis with total balance sheet assets of Rs. 25 crores at the end of 1966. According to a study@ conducted by the Department of Non-Banking Companies, of 64 nidhis reporting deposits from public as at the end of March 1968, as many as 59 were public limited companies and 5 were private limited companies.

Capital of Nidhis

7.10 At the end of 1965-66, the total paid-up capital and reserves of 59 nidhis were Rs. 100.33 lakhs and formed about 9% of the total liabilities. Paid-up capital alone formed about 1.5% of the total liabilities.

TABLE 7.2—COMBINED BALANCE SHEETS OF ALL NIDHIS—1965-66

(Amount in lakhs of Rs.)

LIABILITIES			ASSETS		
1. Paid-up share capital		16.72 *(1.50)*	1. Fixed assets		9.97 *(0.90)*
2. Share premium account		— (—)	2. Investments		37.40 *(3.36)*
			(*a*) Government and other Trustee securities	28.46	
3. Earmarked or specific reserves		28.46 *(2.56)*	(*b*) shares, debentures and bonds	0.32	
4. General reserves		55.15 *(4.95)*	(*c*) immovable properties	0.24	
5. Deposits		909.85 *(81.71)*	(*d*) deposits in banks	4.57	
(*a*) fixed	418.97 [*46.05*]				
(*b*) recurring	423.61 [*46.56*]		(*e*) deposits in M.I.I.C.	2.96	
(*c*) chit	38.32 [*4.21*]		(*f*) other investments	0.85	
(*d*) savings	21.15 [*2.32*]				
(*e*) other	7.80 [*0.86*]				
6. Secured loans		2.47 *(0.22)*	3. Loans and advances		986.68 *(88.61)*
7. Unsecured loans		1.05 *(0.09)*	4. Cash and bank balance		31.67 *(2.84)*
8. All other liabilities		99.78 *(8.96)*	5. All other assets		47.76 *(4.29)*
TOTAL LIABILITIES		1,113.48 *(100.00)*	TOTAL ASSETS		1,113.48 *(100.00)*

Notes: (1) Figures in round brackets are percentages to total liabilities/assets.
(2) Figures in square brackets are percentages to total deposits.
Source : Reserve Bank of India Bulletin, May 1967.

@ Reserve Bank of India Bulletin, April 1971.

There are, however, large variations in the size of capital and turnover of different nidhis. It may be mentioned here that quite a few nidhis, in addition to offering shares of Re. 1 each, also offer shares of the face value of more than a Rupee. In some cases there is restriction on the number of shares a member can hold. It was observed in one case that the authorised capital was Rs. 3 lakhs and the issued and paid-up capital was Rs. 2.10 lakhs while in another, though the authorised capital was Rs. 33 lakhs, the paid-up capital amounted to only Rs. 25,071. The business turnover in the latter case was about Rs. 51 lakhs.

Deposits

7.11 The major source of funds of nidhis is deposits of their members. According to the combined balance sheets of all nidhis, deposits accounted for 81.7 per cent of the total liabilities at the end of 1965-66. The deposits accepted by the nidhis are commonly of three types, *viz.*, fixed deposits, recurring deposits and savings deposits. According to 1965-66 data referred to above, of the total deposits of Rs. 9.10 crores, recurring and fixed deposits accounted for nearly equal proportions (46% each) with savings and other types of deposits constituting a mere 7%. Besides the main categories stated above, some nidhis have introduced other types of deposits to suit the convenience of the members and also to attract more working funds. For instance, some nidhis accept short-term deposits upto 3 months in multiples of Rs. 100 from their members. In some cases bonus is also paid to depositors.

7.12 Detailed data showing the trend of deposits of all nidhis over years are not available. According to Reserve Bank's study, the amount of deposits at the end of March 1967, of 59 reporting nidhis stood at Rs. 10.1 crores while that at the end of March 1968, of 64 reporting nidhis was Rs. 10.7 crores. A broad idea of the progress made by some established nidhis can be obtained from the study of their annual reports. The Nungambakam Saswatha Dhana Rakshaka Nidhi Ltd., Madras, for instance, increased its deposits from Rs. 25.7 lakhs at the end of 1957, to Rs. 89.7 lakhs at the end of 1968, showing an average annual growth rate of 22.6% within 11 years. The proportion of savings deposits in the total continued to be nominal. It was 3.5% in 1957, and 4.3% in 1968. The relative shares of fixed and recurring deposits in the total deposits were 72.8% and 23.7% in 1957, and 64.9% and 30.8% in 1968, respectively. However, this is not an invariable pattern. In the case of some nidhis the proportion of recurring deposits is higher. The deposits of the Triplicane Permanent Fund Ltd., Madras, which were only Rs. 0.51 lakh at the end of August 1927, increased to Rs. 38 lakhs at the end of 1957, and to Rs. 58 lakhs at the end of 1969. Thus, over the last 12 years, deposits increased at an annual average rate of 4.3%.

Rate of Interest Paid on Deposits

7.13 The rates of interest paid by the nidhis on different types of deposits vary according to the type and the period of deposits, the maximum, according to the Associated Body of Nidhis being 9% per annum. There is no one fixed rate of interest on any category of deposits. Table 7.3 gives a broad pattern of the rates of interest paid by the nidhis.

TABLE 7.3—RATES OF INTEREST PAID ON DEPOSITS

(Per cent per annum)

Type of Deposit and Period	Rate ranging between		
I. *Savings Deposits*	4	—	4½
II. *Fixed Deposits upto*			
3 months	6	—	6½
6 months	5¼	—	7
1 year	5¾	—	7½
2 years	6¾	—	8
3 years	7¼	—	8½
4 years	7½	—	8½
5 years	8	—	8½
III. *Short-term Deposits*			
1 month		4½	
2 months		4¾	
3 months		5½	
IV. *Recurring Deposits*	5½	—	8½

Source : Memoranda submitted by various nidhis.

Modes of Payment of Interest

7.14 The modes of payment of interest also vary from nidhi to nidhi. In the case of savings deposits, one nidhi pays interest on the minimum balance to the credit of the account holder between 6th and 26th of the month and the maximum balance on which the interest is payable is Rs. 10,000. Another prefers to pay interest on daily balances and the maximum amount of deposit on which interest is paid is fixed at Rs. 5,000. In yet another case, the interest is payable on the minimum balance during the month.

7.15 Similar differences are observed in the case of fixed deposits also. Usually, the interest is payable half-yearly, though payment on monthly

basis is not uncommon. In one case, it was observed that if the amount of deposit exceeded a certain sum, *i.e.*, Rs. 5,000 and Rs. 10,000 an extra interest payment at ¼% and ½% respectively, was allowed over and above the prescribed rates. The periods for which fixed deposits are accepted also vary from one nidhi to another.

7.16 There is not much variation in the method of payment of interest on recurring deposits as the whole amount paid by the depositor by way of monthly instalments is repayable to him only at the end of the stipulated period together with interest. An example based on a scheme introduced by a nidhi is given in Table 7.4 for illustrative purposes.

TABLE 7.4—RECURRING DEPOSIT SCHEME OF A 'NIDHI'

(Amount in Rs.)

Amount of Monthly Deposit	Amount repaid after payment of				
	12	24	36	45	84
	monthly instalments				
2	25	51	79	100	200
4	50	102	158	200	400
6	75	153	237	300	600
8	100	204	316	400	800
10	125	255	395	500	1000

Source : Memorandum submitted by the nidhi.

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Loans and Advances

7.17 The other important function of the nidhis is making loans and advances to the members against adequate security. Advances are usually made against house property, gold, jewels, shares of registered companies, life insurance policies and recurring and fixed deposits of the members with the nidhi, etc. Some nidhis have stated that they do not advance against the life insurance policies as the procedure involved in realising the amount of the policy in the event of the death of the borrower is too cumbersome. Sometimes nidhis ask the borrower to open a recurring deposit account with them earmarked for a specific mortgage loan. At the end of the period, the mortgage loan gets automatically discharged and the borrower gets his property back. Some nidhis advance simple or personal loans also, but the percentage of these loans to the total is negligible. According to one rough estimate about 70% of the total loans at the end of March 1967, were given against real estate, 12% against jewellery and 5% against shares and debentures of joint stock companies. The relative share of different kinds of loans, however, varies according to the lending policy of nidhis.

Purposewise Classification of Loans and Advances

7.18 Precise data are not available to show the purposewise classification of the advances of nidhis. According to rough indications, advances for industrial, agricultural*, and commercial purposes constitute a negligible proportion of the total amount of advances of the nidhis. Practically the entire amount is lent out for house construction and for domestic purposes like marriage, repayment of prior debts, extensions and repairs to house properties, medical expenses, etc.

Rates of Interest on Loans and Advances

7.19 According to the Associated Body of Nidhis, the interest charged is generally 7½% to 10½% per annum on loans made against house property and 12% on special loans. The interest charged on advances made against the members' own deposits is 1% to 1½% above that paid to them and on advances on the security of jewels, etc., usually, 9% per annum. As in the case of deposits, the rates of interest charged on various types of loans are not uniform ; these vary from nidhi to nidhi. Table 7.5 based on data supplied to us by some nidhis shows the ranges of rates of interest charged on different kinds of loans and advances by nidhis.

TABLE 7.5—RATES OF INTEREST CHARGED ON LOANS & ADVANCES BY NIDHIS

(per cent per annum)

Type of Loan and Period	Rate ranging between
1. Ordinary mortgage Loan (usually long-term with recurring deposit)	10 — 12
2. Short period Special mortgage Loan (usually two years)	10
3. Special mortgage Loan (4 to 5 years)	10 — 12
4. Pledge of Gold, jewellery, etc.	10 — 13½
5. Against Life Insurance Policy	12 — 13½
6. Simple Loans (including Loans against Deposits)	7 — 10
7. Special Loans	11 — 12
8. Produce Loans	12½

Source : Memoranda submitted by various nidhis.

7.20 Though it is not a general practice with all the nidhis, some of them charge a higher rate of interest on loans exceeding certain limits or charge rates varying according to the amount of loan. It was thus observed that one nidhi charged an additional 1½ per cent on loans exceeding Rs. 5,000 while in another case the rate varied directly according to the size of the loan.

* However, one nidhi pointed out in its memorandum that "its operations were of immense help to agriculturists."

Other Aspects of the Working of Nidhis

7.21 The Associated Body of Nidhis, in its memorandum submitted to the Study Group, has stated that these institutions are not commercial or speculative in nature and do not function merely with a view to earning profits, but are run on co-operative principles and are of immense service in catering to the needs of lower middle and poor classes of society. The management of nidhis is generally in the hands of persons with good financial experience and status in the locality. The procedures followed are not cumbersome and the disposal of applications for loans is prompt and efficient. They are very vigilant in the realisation of the outstandings and there are hardly any cases of default.

7.22 The activities of nidhis are mainly confined to the locality where their offices are situated. The management has intimate knowledge of the financial standing and creditworthiness of their members. As we have seen above, the main source of funds of nidhis is acceptance of deposits. It is observed that they very rarely resort to accommodation from commercial banks. Commercial banks appear to serve as lenders of last resort rather than as a regular channel of finance. An overdraft limit is obtained from a commercial bank as a measure of safety and it is utilised only when an excessive pressure on funds is felt. Thus, nidhis generally try to be self sufficient. This is shown by the fact that loans (both secured and unsecured) formed less than 0.5% of the total liabilities of nidhis in 1965-1966 (Table 7.2).

Low Establishment Expenses

7.23 One notable feature of the working of the nidhis is that their establishment expenses are lower than those of scheduled commercial banks ; the percentage of such expenses to total operating expenses worked out to about 21 in the case of nidhis (included in the study of the Department of Non-Banking Companies for the year 1965-66) as against 36 for the commercial banks for the same period. Even for non-scheduled banks the percentage was 32.

7.24 It may also be mentioned that for a period of several years before the decision of the Supreme Court in a case*, nidhis enjoyed immunity from direct taxation. Since the Supreme Court's decision, however, they have been subjected to income-tax. This had made a significant difference to their profits. Still, their operating expenses continue to be relatively low because their operations are confined to compact areas, mostly within the cities or towns in which they are incorporated. Also in recognition of the fact that persons in the lower and middle income groups have become

* Commissioner of Income Tax, Madras *vs* Kumbakonam Mutual Benefit Fund Ltd., 1964 (II) I.T.J. S.C. 229.

members of nidhis in large numbers, the Central Government has granted concessions in the form of relaxation or modification of some of the provisions of the Companies Act, 1956, so as to relieve them of unnecessary or burdensome expenditure.‡

Some Illustrations of Malpractices

7.25 It has been observed that the activities of nidhis are, by and large, carried on with a high degree of integrity. The overdues of well managed nidhis are very small. There are, however, a few instances where Board of Directors misused the power and trust vested in them by their members. A few such instances can be mentioned here to serve as illustrations. The case of a nidhi which became insolvent and was unable to meet its liabilities to depositors, may be cited in this connection. Advances were made by it to a company of which the Chairman was a director and no interest was charged on these advances. The borrowing company, to make matters worse, invested the amount so borrowed in ventures in which the Chairman and the Managing Director were interested and these ventures ultimately failed. Similarly, prompt action was not taken to recover the advances made to the relatives and friends of the directors in time and consequently these loans became time-barred. In the case of the same company, it was also observed that it had accepted not only fixed deposits but demand deposits also. All these factors put together impaired the soundness of the concern, bringing its depositors to grief. In some cases it has been found that the Board of Directors appoint a number of Sub-Committees to perform certain specified duties, such as House Inspection Committee, Jewellery Examination Committee, Legal Committee, Tea Garden Committee, Loan Application Processing Committee and even a Share Allotment Committee. Sizeable amounts are paid to the members of these Sub-Committees by way of sitting fees, conveyance charges, incidental expenses, etc. This is clearly to circumvent the provisions of Section 198 of the Companies Act, which prescribes certain limits on the amounts of remuneration

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‡ Thus, the nidhis notified under Section 620A of Companies Act, are allowed :

(*a*) to serve documents on, or to furnish copies of the audited balance sheet to, members holding shares of less than one hundred rupees or less than one per cent of the paid-up capital whichever may be less, by displaying notices on the notice board, followed by publication in two local newspapers, one in English and one in the regional language ;

(*b*) to issue further capital without being restricted to the provisions of Section 81, as regards members' rights to participate in the issues in proportion to their existing holdings (the voting rights of individual members have also been restricted in each case to 5% of the total voting rights);

(*c*) to intimate dividends of twenty five rupees or less by publication of a notice in the newspapers and also on the notice board, and to credit the dividends due to the members to their accounts with the nidhis if they are not claimed for payment in cash within forty two days ;

(*d*) to grant loans and advances to directors within certain limits in relaxation of the provisions of Section 295 and without obtaining the previous approval of the Central Governmnt; and

(*e*) to furnish the annual return under Section 159 in a considerably simplified form and to file certain documents with the Registrar of Companies, on payment of reduced, instead of the normal fees as in the case of other companies.

to be paid to the directors. In some cases, the Board of Directors consists of members of the same family.

Liquidity Ratios

7.26 Some nidhis maintain a low level of liquidity. Table 7.6 shows that the liquidity ratio (ratio of cash, bank balances and investments in Government and other trustee securities to total deposits) was less than 10% in the case of 56% of nidhis studied and less than 5% in the case of 37%.

TABLE 7.6—LIQUIDITY RATIO—1965-66

Liquidity Ratio of	Number of Nidhis
1. Less than 1%	1
2. 1% or more but less than 2%	6
3. 2% or more but less than 3%	5
4. 3% or more but less than 5%	10
5. 5% or more but less than 10%	11
6. 10% or more but less than 15%	5
7. 15% or more but less than 20%	9
8. 20% or more but less than 30%	4
9. 30% or more	8
Total	59

Source : Reserve Bank of India Bulletin, May 1967.

7.27 It also appears that not all nidhis make profits. The balance sheets of a few nidhis showed that some of the very small companies were either making losses or making negligible profits. Also, in the case of some, the proportion of establishment expenses to total expenses appeared to be as high as 50%. The ratio of capital and reserves to total deposits, on the other hand, is higher than the corresponding ratio in the case of commercial banks. A survey of deposits with non-banking companies conducted by the Reserve Bank showed that at the end of March 1967,the ratio of paid-up capital and reserves to total deposits was 6.7%. It is interesting to observe that in the case of commercial banks the ratio of paid-up capital and reserves to total deposits was the same in 1956. At the end of 1967, it was a mere 2.9%.

QUANTITATIVE ESTIMATES OF OPERATIONS OF NIDHIS

7.28 As noted earlier, the number of nidhis is estimated to be only 150. According to the survey of deposits of Non-banking Companies, the amount of deposits with the 64 nidhis studied in the survey, was Rs. 10.7

crores at the end of March 1968. Even if this figure is blown up for all the 150 nidhis, their deposits may be estimated* to be about Rs. 25 crores. Thus, their deposits were not even 1% of the total commercial bank deposits in 1968. Judged in the above perspective, nidhis cannot be said to occupy an important place in the economy but they occupy an important position in the localities where they function. Also their importance should be judged from the point of view of the potential role that they can play in future in the economy.

ROLE OF NIDHIS AS SAVING AND LENDING INSTITUTIONS

7.29 In order to examine the role of nidhis in the economy, let us discuss the part that they play as saving and lending institutions. As already pointed out, the estimated deposits of nidhis are negligible as compared with those of commercial banks. Even if the deposits of nidhis are considered in relation to the deposits of commercial bank offices operating in the four Southern States (*viz.*, Andhra Pradesh, Kerala, Mysore and Tamil Nadu) the proportion of deposits of nidhis to deposits of commercial banks in these States would come to about 3 per cent only. Even in localities where nidhis are actively at work, it is unlikely that they divert deposits from the commercial banks, because their clientele is different from that of commercial banks. The loss of deposits to nidhis would not necessarily mean accrual of deposits to commercial banks. The rates of interest that they offer are higher than those offered by commercial banks as is shown by Table 7.7.

TABLE 7.7—RATES OF INTEREST PAID ON DEPOSITS—COMMERCIAL BANKS AND NIDHIS

(per cent per annum)

Type of Deposit and Period	Range of interest rates for: Commercial Banks*	Range of interest rates for: Nidhis
I. *Savings Deposits*	3½ — 4	4 — 4½
II. *Fixed Deposits*		
6 months	4 — 4½	5¼ — 7
1 year	4½ — 5½	5¼ — 7½
2 years	5½ — 6	6¾ — 8
3 years	6 — 6½	7¼ — 8½
4 years	6½ — 7 }	7½ — 8½
5 years	}	8 — 8½
Above 5 years	6¾ — 7½	N.A.
III. *Short-Term Deposits*		
1 month	N.A.	4½
2 months	N.A.	4¾
3 months	N.A.	5½

* These rates were the maximum rates which the commercial banks were allowed to pay on deposits according to their size, before 11th January 1971. We have used these rates, rather than the current rates which were revised consequent upon the rise in Bank Rate with effect from 11th January 1971, because we had received information from nidhis before that date.

Notes : (1) 'N.A.' indicates information not available.
(2) The rates of interest paid by the Nidhis are taken from the Memoranda submitted by the nidhis.

* Assuming that all nidhis were of equal size.

Competition from Commercial Banks

7.30 Some nidhis have expressed a fear that with commercial banks opening branches in rural and semi-urban areas and particularly with their acceptance of recurring deposits, they would face competition from commercial banks. Also, their depositors are deprived of the tax benefits enjoyed by those of commercial banks in terms of tax concessions of the 1970-71 Finance Act. Nidhis are also concerned about the competition from other NBFIs which offer high interest rates on deposits. It is also reported that due to stiff chit fund legislation in Tamil Nadu State, some nidhis had to close their chit fund business. Commercial banks, however, do not offer competition to nidhis in loan business. A number of nidhis have in fact pointed out in their memoranda that the demand for their funds is so large that they cannot satisfy all their borrowers.

Popularity of Nidhis

7.31 The popularity of nidhis can be attributed to their easy approachability and absence of cumbersome procedures. They have intimate, often first hand, knowledge of the financial standing of their member-borrowers and their procedures are not time consuming. It is possible that the persons who keep their surplus funds with nidhis do so because the members of management of the nidhis are known to them. Also, as one nidhi has claimed, nidhis are perhaps among the very few institutions which offer long-term loans on the security of immovable properties at moderate rates of interest and offer facility for repayment of loans in instalments over a long period.

Basic Issues

7.32 Having examined the working of nidhis and their role in the economy, we proceed to discuss some policy matters regarding their future. In this connection, the following two issues may be specifically examined, *viz.*, (1) should the nidhis be encouraged and, if so, in what way, and (2) is it necessary to lay down any measures to regulate the working of these institutions?

7.33 From our analysis it is clear that although nidhis do not occupy a very significant place in the economy as a whole if their operations are judged in comparison with the operations of financial institutions like commercial banks, they are quite popular in Tamil Nadu and other South Indian States, and play an important part in the economy of the locality where they operate. Also, they are a unique institution among the financial institutions of the country in so far as they are perhaps the only ones which offer saving schemes with reasonable assurance to their depositors of the availability of credit on moderate terms.* In fact they have many common

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* Some commercial banks have recently begun to offer such schemes, but their progress is not known.

features with Savings and Loan Associations of the U.S.A., particularly, as one of the important purposes of their loan is to enable a member to acquire or repair his house. Their local character helps them to fill up a credit gap as they can cater to the requirements of a section of the community which commercial banks may not be able to approach in the near future.

7.34 We are thus of the view that nidhis are discharging useful functions, though their operations are confined to the locality where they are situated. It is also seen from the available evidence that they are generally run with efficiency and their lending operations are fortified with caution. Very few nidhis have failed to meet their obligations. They meet the long-term as well as short-term credit requirements of the borrowers who are mostly from the poor and the lower middle sections of the society. There is no gaming element as in the case of chit funds and charges of profiteering and malpractices with a view to bypassing the banking laws cannot be made in the case of most of these institutions. Many of them are so old that they have become an inseparable part of local, social and economic life. Their disappearance from the scene might leave a big vacuum in the localities where they operate.

7.35 Taking into consideration the above points, the Study Group is of the view that it would be desirable to encourage the growth of nidhis. In this connection we should consider certain specific problems that are hindering their growth and also the measures that would be necessary to convert them into modern expanding institutions so that they might serve the interests of the society better.

Suggestions made by Nidhis

7.36 The Associated Body of Nidhis and some individual nidhis have made certain suggestions in the memoranda submitted to the Study Group. All of them are concerned that the tax concessions which were given in the 1970-71 Finance Act, to the depositors of commercial and co-operative banks have not been made available to them. Under the provisions of the Act, income upto Rs. 3,000 is exempt from income-tax if it is derived from one or more of the categories of investments enumerated in the Finance Act. In addition, the tax on interest payable by banks to their constituents was hitherto deductible at source. Now tax on interest on deposits with banking companies including co-operative banks is not deductible at source. These concessions are not available to nidhis. Also, the wealth-tax relief upto Rs. 1,50,000 which is available to the depositors of the banking companies, co-operative banks and land development banks (as well as to certain other investors) is not available to depositors of nidhis. We suggest that the Government may consider the question of extension of these tax reliefs to the depositors of nidhis.*

* For a discussion of 'approved' nidhis see paragraph 7.44.

7.37 A nidhi has suggested that the provision of the Companies Act restricting borrowings by directors should not be applicable to the nidhis because persons otherwise qualified to become directors are scared away and get discouraged to serve on the Boards of Directors. We do not see much force in this plea because this provision is mainly intended to prevent certain malpractices by the directors, and obviously serves a useful purpose.

Paucity of Resources

7.38 The preceding paragraphs dealt with the question of removing some of the difficulties that nidhis are facing at present. Their major problem, however, is that of shortage of resources. A few of them have pointed out that they have to decline loan proposals on account of shortage of funds. They have suggested that the Reserve Bank or commercial banks should provide them the necessary finance. One nidhi has even suggested that out of the funds allocated for building construction for middle class people, the Governments should channelise some funds through the nationalised banks, as loans and overdraft, to nidhis so as to enable them to serve their members, who are mainly from middle class, in a better manner.

7.39 The question of augmenting the resources of nidhis, coupled with the fact that not all nidhis are free from malpractices, brings us to the discussion of the question of regulating these institutions.

Regulation of Nidhis

7.40 At present, the provisions of the Companies Act, 1956, apply to them. They have also to submit regular returns to the Reserve Bank of India, but their deposits are expressly excluded from the purview of the regulation of the Bank. The situation, therefore, is that nidhis which are little different in their operations from commercial or urban co-operative banks, are not subject to any of the controls which are usually applied to banking companies. There is a view that if nidhis have made satisfactory progress without any regulation, they should be left alone, particularly as one control tends to breed another. This view ignores two important points. First, it is better to regulate the growth of nidhis rather than risk the interest of depositors. Secondly, in order to encourage nidhis to play a more important role in the economy, it is desirable that they are converted into fast developing and forward looking institutions. For this purpose links should be established between nidhis on the one hand, and the rest of the banking system on the other. This will serve a double purpose. Nidhis will be assured of more resources. Also, schemes can then be devised whereby the special advantages enjoyed by nidhis on account of their local character, low operating costs, etc., can be more fully utilised. All this implies that nidhis should be brought in a framework of regulation to achieve stated objectives.

7.41 It may be noted in this connection that in March-April 1969, some senior officials of the Reserve Bank had a conference with the leading nidhis in Madras with a view to finding out whether they would be interested in handling small loans on behalf of banks for various productive purposes, such as loans to individual artisans and transport operators including those plying scooters and taxicabs, advances to retail traders, advances against hypothecation of stocks of fertilisers, pesticides, improved seeds and agricultural implements, etc. It was considered that nidhis, formed on the basis of self-help and with a tradition of conservative management, were ideally suited for making these very small loans. Another advantage in the case of nidhis was that they were confined to a compact locality and their operating costs were relatively low. It was thought that the advantage of routing some of the smaller advances of banks through nidhis, as an alternative to the grant of direct loans by banks, was that it might be cheaper for banks to handle these loans through an intermediary with low operating costs rather than to employ their own highly paid staff for this purpose. The supervision of the loan through intermediaries like nidhis would also be easier for the financing banks. If intermediaries were to bear a portion of the risk involved in these loans, they might be willing to undertake such supervision in their own interest, in order to reduce or to eliminate the risk for which they might be liable. However, it was not acceptable to nidhis mainly because it involved grant of unsecured loans which nidhis had not handled so far. They were reluctant to accept any portion of the risk involved or to undertake the supervision of the use of such loans.

7.42 It appears to us that this showed an excessive conservatism on the part of nidhis. Schemes can be devised whereby the risk of nidhis is minimised. It may be added in this connection that in the memorandum which the Associated Body of Nidhis has submitted to us, it has been pointed out that any risk involved in any scheme meant to augment the resources of nidhis should be sufficiently guaranteed by Government.

Classification of Nidhis into Two Categories

7.43 In the above context, the Study Group makes the following recommendations. Since nidhis operate like commercial banks, they may be subject to certain regulations to safeguard the depositors' interests. The nidhis which accept demand deposits may be subjected to the same regulation as the commercial banks. In the case of other nidhis, the regulation need not be the same. Especially, we are of the view that, among other things, the regulations may include the following provisions :

(*a*) All nidhis may be licensed by the Reserve Bank of India.

(*b*) A minimum level of liquidity ratio may be prescribed, which may be lower than that in the case of commercial banks. As in the

case of hire-purchase finance institutions, the liquidity ratio may currently be prescribed at 10% of deposits.

(*c*) There may be periodical inspections of nidhis. The degree of detail may be tailored to their size and character of operations.

(*d*) A minimum amount of paid-up capital and reserves may be prescribed and every nidhi must allocate a certain proportion of its profits to reserves.

7.44 While these regulations may be applicable to all nidhis, incentives may be provided to those among them—to be designated as 'approved institutions'—which satisfy certain requirements. As in the case of scheduled banks the 'approved' nidhis will be those nidhi companies : (*a*) which operate on sound lines and (*b*) whose affairs are conducted in a manner not detrimental to depositors' interests. We shall not go into the details of these requirements because they would mainly depend on the subjective judgment of the approving authority as well as the object of policy. We may, as an illustration, mention that if the objective is to utilise the services of nidhis for extending loans to small industrial units or small artisans, facilities of refinance from commercial banks/Reserve Bank of India may be offered to those nidhis which extend such loans. Similarly, in order to meet the housing shortage in India, LIC and nationalised banks may channel funds through nidhis so that they can give more housing loans.* The benefit of guarantee of loans may also be extended to 'approved nidhis'. Ultimately, the deposits of approved nidhis may also be covered by the insurance facility offered by the Deposit Insurance Corporation. The Government may also consider extending the tax concessions available to depositors of commercial and co-operative banks, to the depositors of approved nidhis too. Nidhis in the 'non-approved' category will of course not be eligible for any of the benefits and facilities that will be available to those in the 'approved' category. The very fact that a nidhi is on the 'approved' list of the Reserve Bank will create further confidence in the minds of the public dealing with it.

7.45 We believe that the scheme as proposed by us would be ideally suited to nidhis and especially the forward looking nidhis would take advantage of the benefits under the scheme. Ultimately, a large number of nidhis are likely to be included in the 'approved' category. Insurance of deposits and extension of tax benefits to the depositors of 'approved' nidhis on the same lines as in the case of depositors of commercial banks are likely to increase their resources. Refinance facilities offered by commercial banks to 'approved' nidhis will enable them to increase their turnover and take greater risks, particularly if their loans are guaranteed by the Credit Guarantee Corporation. The commercial banks on their part may find that they can channel their funds in certain localities in a more economic and efficient way

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* See Chapter 14, paragraph 14.46

by utilising the services of nidhis. Thus, a useful link will be established between nidhis and the organised banking system. In short, nidhis which have so far been isolated from the mainstream of the money market will be able to play a more active and useful role in the economy.

7.46 We would also like to add in the end that paucity of data is a great handicap in analysing the working of nidhis. We suggest that comprehensive statistics may be collected on a regular basis to enable the policy makers to devise an appropriate policy.

CHAPTER 8

FINANCE CORPORATIONS

INTRODUCTORY

8.1 In this chapter we shall deal with a type of NBFI, which is of relatively recent origin and has been making rapid progress in certain places. Finance corporations, which are mostly partnership firms accepting deposits from the public and making advances at high rates of interest, have been increasing in number in recent years, particularly in and around Bangalore and Ahmedabad. In our study, we were handicapped by the paucity of adequate statistical data and the non-availability of details of the working of these corporations. The Study Group made an on-the-spot study of finance corporations in Bangalore, where the progress of these corporations has been specially rapid. We had discussions with the representatives of the Mysore State Government, the Federation of Finance Corporations, Bangalore, a few selected finance corporations and some bankers. We also received memoranda from the Federation and some of the finance corporations. Some corporations also supplied us statistical data in response to our request. Most of the information pertains to rates of interest at which deposits of various types are accepted and at which loans are made. The list of finance corporations which submitted memoranda and of finance corporations and bankers with whom we had discussions is given in Appendix II. We also tried to collect some material from the finance corporations in Ahmedabad through the Reserve Bank of India. The data—which were inadequate—were received from very few units and hence could hardly be used for meaningful analysis. Also, we could not make any investigations about their operations because of the limitation of time. Hence, the analysis in this chapter is related mainly to the Bangalore type finance corporations.

GROWTH OF FINANCE CORPORATIONS

8.2 As stated above, the finance corporations are of recent origin, perhaps belonging to the early part of the previous decade. But, both in terms of number and magnitude of operations, they are stated to have made very rapid progress. The place of origin of the finance corporations seems to be Madanapalle in Andhra Pradesh. It is only recently that the number of finance corporations has increased in Bangalore. A large number of such corporations were started in 1969 and 1970. The oldest, *viz.*, the South India Finance Corporation, was started in 1966. Precise statistics, however, are not available on their number, turnover, etc. According to Mysore

Government sources, the number of finance corporations at the end of August 1970 was 72 in the city of Bangalore and 137 in the whole of Mysore State. The deposits with corporations in Bangalore are estimated to be about Rs. 2 crores. If the unregistered units are included, the figures will be higher. In Madanapalle (Andhra Pradesh) there were as many as 50 finance corporations operating as at the end of June 1970. It is understood that in Anantapur District, there are 60 finance corporations of which, 42 are located in Anantapur city itself. Total deposits of all the finance corporations working in the district are estimated to be Rs. 75 lakhs.

General Features and Operations of Finance Corporations

8.3 The finance corporations are, in an overwhelming majority of cases, partnership concerns with 10 partners or less. In fact they should not be called 'corporations'. These partners generally belong to business community, *e.g.*, Vaishya Community. Common partnership in more than one firm is quite usual. The paid-up capital of these partnership firms is invariably less than Rs. 1 lakh.

Acceptance of Deposits

8.4 The major source of their funds is deposits from the public. Some corporations informed us that they also have long-term deposits from their partners. But the practice in this regard is not uniform. In fact, there are some corporations which do not have any deposits from their partners. It is estimated that the total deposits of the finance corporations in Bangalore, are at present about Rs. 2 crores, varying from a few thousands in the case of one corporation to a high of Rs. 53 lakhs in the case of another. There are quite a few corporations with deposits around Rs. 10 lakhs. The number of depositors also varies from about 100 in the case of one corporation to more than 1,000 in another. Most of the deposits (75% or more) are fixed deposits ranging from 30 days to two years or more. Some corporations also accept call deposits (at 15 days' or 45 days' notice or even demand deposits). Some of them maintain savings deposits but the amount of such deposits appears to be small. The purpose of such accounts is usually to credit the interest accrued on fixed deposits. The size of individual deposits also varies from Rs. 100 to Rs. 1 lakh. But according to the corporations, the major part of their deposits consists of amounts of about Rs. 5,000 or less. The depositors are mostly middle class people like retired civil servants, petty merchants, self-employed persons and salaried employees. The merchants keep their deposits with corporations during the slack season when they do not need their funds. According to some bankers, the corporations also accept *benāmi* deposits to suit the convenience of tax evaders.

8.5 These corporations have been able to attract deposits mainly by offering very high rates of interest. These rates vary from 4%—6% on short-

term deposits to 13%—14% (and in some few cases even more) on fixed deposits of a year or more. Educational and charitable institutions are offered rates which are half to one per cent higher than those offered to other depositors. Savings deposits which are withdrawable by withdrawal slips, fetch 7%—8%. Some corporations collect savings deposits from many small savers. Collections are made at the doors of the depositors in very small amounts, sometimes 50 paise per day. The interest rate on such deposits is usually 5%—6% per annum. The method of payment of interest to depositors varies from corporation to corporation. The general practice seems to be that depositors with larger deposits, say with more than Rs. 5,000, are entitled to monthly payment of interest while those having smaller deposits get interest on a quarterly or half-yearly basis. It is stated that deposits are repaid promptly on due dates. Deposits cannot be withdrawn before maturity but it is reported that the corporations advance amounts equivalent to 90 per cent of deposits at interest rates of 1% to 2% higher than those paid on deposits.

8.6 These finance corporations have introduced interesting and even imaginative schemes for attracting deposits. The salient features of a few schemes introduced by some finance corporations are briefly stated below to serve as an illustration :

(*i*) *Prize and Gift Schemes :*

Some corporations have introduced gift schemes. One corporation gives a gift of Rs. 1,000 to one of the deposit holders by a lucky draw from among those depositors whose deposits are more than Rs. 5,000. Similarly, a gift of Rs. 500 is given to one of the depositors from among those whose deposits are less than Rs. 5,000. Ultimately, all depositors receive the amount deposited by them, along with the agreed rate of interest. The schemes serve the purpose of inducing depositors to save regularly during the period of the schemes.

(*ii*) *Insurance Cover :*

The corporations cover personal accident insurance upto a maximum of Rs. 10,000 at no extra cost to the depositor. The insurance premium is paid subject to a minimum deposit of Rs. 5,000 for a period of one year and above.

(*iii*) *Automatic Reinvestment Plan :*

This is a compound interest scheme under which the depositor earns interest every quarter or four times in a year. At the end of each quarter, the interest is added to the deposit amount.

(*iv*) *Interest Free Accommodation :*

Interest free loans are given upto 10% of the deposit amount for 15 days. This facility can be utilised only once during the operation of the deposit.

(*v*) *Additional Interest to Women and Children :*

Women and children depositors get an extra half per cent on their deposits irrespective of the period of deposit.

(*vi*) *Recurring Deposit Plan :*

Under this scheme, a fixed amount is deposited every month for a stipulated period of time and a lump sum is paid at the end of the period with dividend. For instance, if a deposit of Rs. 100 p.m. is made for 77 months, a lump sum of Rs. 10,500 can be withdrawn at the end of the 78th month or a regular monthly income of Rs. 100 can be taken in perpetuity. If the depositor does not draw Rs. 100 monthly and reinvests the amounts under the plan for another 75 months, the initial investment swells to Rs. 20,000 at the end of 152 months. The scheme gives similar further benefits in case the depositor continues to reinvest his money for longer periods.

8.7 It may be seen that apart from attracting deposits, the main purpose of these schemes seems to be to persuade the depositors to continue to keep both the principal and interest as deposits with the corporations. It is also worth noting that under some of these schemes actual interest rate paid on deposits will be higher than the interest rate stated. Thus, for instance, under the automatic reinvestment plan of a corporation, the interest rate stated is 13% but actually it works out to a higher simple interest rate per annum.

Lending Business

8.8 So far we have been discussing the sources of funds of these corporations. Coming to the uses of funds, the major outlet for their funds is by way of making advances to traders —both wholesalers and retailers— small scale industries and employed persons. Some corporations informed us that they gave advances also for agricultural purposes. The amount of such advances is, however, likely to be negligible. The bulk of the advances goes to traders like cloth (mainly silk) merchants and *mandi* merchants dealing in foodgrains, oilseeds, oil, etc. Some corporations also give advances for the purchase of new and old vehicles. They also lend to salaried persons for the purchase of durable consumer goods like radios, refrigerators and fans. These advances are repaid in instalments. It is also understood that borrowers approach corporations in emergencies, *e.g.*, whenever they have to lift raw materials or have to pay to their creditors at short notice.

These corporations are also approached in cases where commercial banks either refuse to grant advances or their procedures are too cumbersome and time consuming to be acceptable to the borrowers. Also, at times, the corporations advance money for financing of margins fixed under the selective credit controls. They also fill up the gap between the total requirement of the borrowers and the money advanced by their bankers. The rules and regulations of most of the corporations disallow their directors obtaining advances from the corporations.

8.9 The *modus operandi* of the lending business of these corporations is as follows : Advances are given on the basis of partners' personal knowledge of the parties. Some corporations maintain a list of creditworthy borrowers. One or two corporations also have a 'loan screening committee' composed of partners. Some of them take tax returns into account while assessing the loan applications. A few others, on the other hand, informed us that they do not insist on tax returns. A pronote is taken from the borrower. Loans are also made on hundis. The loans are generally unsecured except in cases where the creditworthiness of the party is not known. In such cases loans are given against sureties or against shares, jewellery, property, etc.

8.10 We were informed that the major portion of advances made by these corporations is of a short-term nature, generally for periods not exceeding 90 days. The statement submitted by one corporation shows, however, that instalment loans of more than three months were also made. The amount involved in this case was small relative to its total advances (only about 3%). A borrower has to repay his loan at the end of the stipulated period although it is possible for him to borrow from one corporation to repay another. There is at present no system of exchange of information between the corporations although the recently established Federation of Finance Corporations has, as one of its objectives, the establishment of credit information service. The amounts advanced to borrowers are stated to be small—ranging from Rs. 100 to Rs. 5,000 and in some cases more.

8.11 The corporations also perform certain other functions. They run chit funds, collect dividends for their customers, purchase and discount hundis, negotiate lorry receipts and discount post-dated cheques. The last is an interesting item and deserves some explanation. Post-dated cheques in Bangalore—which is a silk weaving centre—arise mainly in two ways. Weavers are given post-dated cheques by merchants and these are discounted by the finance corporations. Sometimes the suppliers in Bangalore get their post-dated cheques discounted, pending the receipt of money from their customers elsewhere. The rate of interest is 6 paise per Rs. 100 per day, *i.e.*, about 22% per annum. A pronote as well as a letter is taken as a safeguard against default. Cheques are discounted only for known parties. Cheques are usually post-dated only for 15 days or less. By discounting post-dated cheques they also save the stamp duty. Some corporations also work as trustees and executors and offer agency and advisory services.

8.12 Interest rate charged by the corporations on their advances is stated to be 18% per annum—the maximum allowed under the Mysore Moneylenders' Act for unsecured loans. We have, however, been told that, this is only the nominal or recorded interest rate and the actual rate charged is 24%—36% per annum (*i.e.*, 2%—3% per month). Interest is collected in advance. The method of recovering the principal varies from corporation to corporation. While many corporations informed us that their advances were repaid only at the end of the stipulated period of the loans, at least two of them informed us that they recovered their loans on a daily basis. In one case, it was stated that interest was remitted on a *prorata* basis whenever daily payment was made by the borrower. In another case, however, there was no such remission of interest. If interest rate is charged at 18% per annum on a 90-day loan, interest is taken in advance and the principal is taken on a daily basis, the actual rate of interest would work out to more than 30 % per annum.

8.13 These corporations are in essence banks in the sense that they accept deposits from the public and carry on the business of lending. Like any other bank, they may be expected to maintain a certain portion of their assets in a liquid form. Although the corporations keep some money as cash and in current accounts with banks, there is no standard liquidity ratio maintained by them. The ratio between the money that they keep in cash or in current accounts to their deposit liabilities varies between 5% and 10%, and at times it is even below 5%. However, no particular ratio is maintained as a matter of policy. Similarly, no particular ratio is maintained between the owned funds of the corporations and their deposits. This ratio varies from 1 : 1 in some cases to 1 : 54 in the case of the largest corporation. It is interesting to note in this connection that some corporations seem to be aware of the need for self-discipline. One of them is reported to have stopped accepting further deposits and had, in fact, reduced the amount of deposits from Rs. 64 lakhs to Rs. 53 lakhs in a short period. It is possible that this policy might be the result of the inability of this particular finance corporation to put its funds to profitable use or, alternatively, it may merely reflect its anxiety to reduce its liabilities to manageable proportions. During our discussions we got an impression that some of the bigger corporations were conscious of the need for limiting their deposit liabilities. The question of maintenance of liquidity and other ratios by these corporations brings us to the discussion of the regulations of their operations.

Need for Regulation

8.14 The above account of the operations of finance corporations in Bangalore shows that these corporations are making advances with the deposits taken from the public. Their own funds are meagre. In fact we were told that in one case the partners had in effect withdrawn more than 90% of their capital. Thus, these corporations are working with a very

small amount of partners' own funds and hence their own stake is small. On the other hand, deposits are not insured because the corporations are not considered to be banking institutions. Their activities are at present not controlled by the monetary authorities. It is worth noting in this connection that while all the corporations with which we held discussions informed us that they were registered under the Moneylenders' Act, the State Government was of the view that not all the corporations were so registered. Even if all of them are registered under the Moneylenders' Act, the only meaningful controls that they would be subjected to, would be the imposition of a ceiling on their interest rates on advances, and the depositors' interests would still not be safeguarded. Although the rules of most of the corporations disallow their partners from borrowing from them, it is very easy for the partners, if the situation so demands, to utilise the funds of the corporations in their own business. This situation would obviously be to the disadvantage of the depositors.

8.15 The question of protecting the depositors' interests also arises for the following reasons :

It seems that the borrowers of the corporations have so far been prompt in repaying their loans. If anything happens to trade and there is a delay in the repayment of advances, the corporations would find it difficult to repay the depositors' money. Even if there is slight irregularity in the repayment of advances by the borrowers, the same repercussions might follow. It may also be pointed out that the borrowers would repay their advances promptly if they are convinced that they could borrow again. Once they are suspicious that they may not be able to borrow again, they may not be so prompt in their repayment. The extent of danger involved in this situation can be assessed from the fact that even if one corporation does not repay the deposits of a few depositors in time, there would be a scare and even banks could suffer. Account has also to be taken of the fact that since there is at present no system of exchange of information between the corporations, a borrower can borrow from a number of corporations. The danger of overtrading is inherent in the system. Thus, it is possible to visualise a situation when the interests of the depositors could be seriously jeopardised. The point of view of the corporations is that the real protection to the depositors' money comes from the financial standing of the partners because their liability is unlimited. It appears to us that this is not a sound argument because, first, each one of the partners has a business of his own and it is unlikely that he would have surplus cash ; secondly, it is very difficult to assess the net assets of the partners.

8.16 Apart from protecting the interests of the depositors, there is the question of ensuring that advances made by these corporations are not put to undesirable uses. It is possible that some of the advances made by the corporations may be going to hoarders, thus adversely affecting the

objectives of selective credit controls to some extent. In fact, it was pointed out to us by some people that one factor behind the growth of finance corporations in Madanapalle and elsewhere was the operation of selective credit controls of the Reserve Bank of India. As pointed out earlier, some corporations make advances to borrowers in order to enable them to put up the higher margin required by the commercial banks in accordance with the provisions of selective credit controls. Some bankers also pointed out to us that the corporations could contribute to the creation and increase in the circulation of unaccounted money. A portion of deposits of these corporations may be coming from people who want to dodge taxes. Also, since there are hardly any links between the commercial banks and these corporations, the money advanced by the latter does not necessarily come back into the banking system.

8.17 Before we proceed to a discussion of the suggestions for solving the problems posed above, it may be worthwhile to stress that the business of these corporations—both relating to deposits and their advances—is increasing because there is a demand for their services. From the point of view of the depositors, these corporations are offering attractive rates of interest. As pointed out in Chapter 3, not all persons are aware of the insurance of deposits with commercial banks nor is the risk involved in keeping deposits with finance corporations universally realised. For a person who has retired from service with his provident fund amount only, the rates of interest offered by the corporations are quite attractive because they would enable him to earn an income sufficiently large to leave his capital intact. In a way this situation is the result of inflation, whereby the cost of living has increased and the return on saving has not gone up correspondingly. The difference between the interest rates offered by the corporations and by commercial banks on one year deposits is almost 7% to 8%, which is big enough to persuade depositors particularly with fixed incomes, to put their savings with the corporations even at a risk. The other side of the story is that commercial banks, at least until recently, were not making advances to the hitherto neglected sectors like retail trade. Also, complaints are sometimes heard about time consuming procedures of commercial banks and their reluctance to give unsecured loans. This has resulted in the corporations getting considerable business. If commercial banks can compete effectively and aggressively with the corporations in their lending business, thus weaning away the borrowers from the corporations, the corporations would not be able to pay high interest rates on their deposits. It should, however, be appreciated that so long as the number of unsatisfied borrowers is large, finance corporations might continue to occupy a place in the deposit and lending business.

8.18 This leads us to another point. Some bankers mentioned to us that the increase in deposits of these corporations was at the cost of the deposits of commercial banks. It may be pointed out in this connection

that the total deposits of 112 reporting banks in Bangalore at the end of September 1969, were more than Rs. 76 crores. As mentioned above, the deposits of finance corporations at Bangalore currently (*i.e.*, in 1970) are estimated to be only about Rs. 2 crores. Viewed in this perspective, it seems that the finance corporations have not been able to get a sizeable chunk of deposits from commercial banks. It is also possible that even if there were no finance corporations, some depositors would not have taken their savings to commercial banks. Still, it is possible that if the finance corporations continue to expand their operations, the growth rate of deposits of commercial banks in these areas may be affected. Figures of deposits of branches of one of the public sector banks at Madanapalle and Anantapur suggest that the growth of deposits might have been affected by the higher rates of interest on deposits offered by finance corporations operating there. The data, however, are not comprehensive and no firm conclusions can be drawn from them.

8.19 We have pointed out above that the banks should compete with finance corporations in their lending business. The number of branches of commercial banks operating in Bangalore is not small. At the end of 1968, there were 105 branches of commercial banks serving a population of about 9 lakhs. Thus, the population per office was 8,600 as compared to the All-India average of 69,000. The population per office of commercial banks in Anantapur and Madanapalle was 10,000 and 8,000 respectively. Therefore, it would appear that the depositors and borrowers are being attracted to finance corporations not because of shortage of banking offices but due to other reasons discussed in preceding paragraphs.

Regulating Finance Corporations

8.20 Having suggested that the solution to the problem ultimately and also immediately lies in the commercial banks offering competition to the finance corporations, we would now list other suggestions for safeguarding the interests of depositors and making the advances of these corporations correspond to social aims.

8.21 Since the finance corporations are partnership firms with capital below Rs. 1 lakh, they do not come under the purview of regulation of the Reserve Bank of India. In fact, the major reason why they can pay a higher interest rates to their depositors is that they are not subject to any of the regulations which govern the banking companies. Thus, for example, the minimum amount of capital and reserves that they should maintain is not prescribed for them, nor do they have to maintain minimum cash and liquidity ratios. Also, they are not subject to any regulations relating to interest rates on deposits.

8.22 Some corporations are registered under the Mysore Moneylenders' Act and it is understood that the State Government is taking measures to

have all the finance corporations so registered. The State Government is of the view that the Reserve Bank of India should extend its control over these corporations even if it involves a change in the banking laws. According to them the State Government can at best register these corporations under the Moneylenders' Act and thus ensure that they do not charge more than 18%—the prescribed ceiling under the Act—to their borrowers. This would still not ensure the safety of depositors' money.

8.23 We agree with this view. As we have noted earlier, finance corporations are in effect unregulated banks. It may be pointed out that it was as a result of an amendment to the Banking Laws (Miscellaneous Provisions) Bill, 1963, that partnership firms with a capital of more than Rs. 1 lakh were brought under regulation and those with a capital of less than Rs. 1 lakh continued to be excluded from the provisions of the proposed Act. It was explained in the Lok Sabha that "the intention of this amendment is to see that smaller firms which have a capital of less than Rs. 1 lakh are not brought within the purview of this Act. The reason is this. There are many small firms who are dealing on a small scale and they also accept deposits of a very small amount. For the time being, since this is only a beginning, those firms should not be brought within the purview of this."*

8.24 Although the total magnitude of their operations in the whole economy is still not very large, these corporations have come to occupy a significant place in the financial structure in certain localities and with their expanding operations, the question of safeguarding depositors' interests has assumed greater importance. The alternative to Reserve Bank's control is control by the State Governments through suitable amendments to their Moneylenders' Acts. However, from the legal point of view, we understand that amendment to moneylending legislation to provide for the regulation of finance corporations accepting deposits from the public might be considered to be foreign to the scope of 'money lending' which is now an entry under the State List. The Central Banking Enquiry Committee had drawn the line between 'money lending' and 'banking' by the acceptance of deposits from the public being confined only to the latter. The banking definition in the Banking Regulation Act incorporated that distinction. Hence, moneylenders accepting deposits from the public would be 'bankers' and moneylending legislation of the States might not validly regulate their business.

8.25 We, therefore, suggest that the Reserve Bank's control may be extended to finance corporations and necessary enabling legislation be passed to that effect. We recognise that the administrative task of watching and regulating the operations of a large number of small firms will be difficult. We, therefore, suggest that if the law permits, only companies may be allowed to do the banking business in the sense of accepting deposits from the public for the purpose of lending or investment. In that case, the Banking Regula-

* *Lak Sabha Debates*, December 16 to 21, 1963, p. 5917.

tion Act would govern the operations of the Bangalore type finance corporations. If, however, the law does not permit it, any scheme of regulation may have as one of its objects the reduction in the number of finance corporations besides, of course, the safeguarding of depositors' interests.

8.26 With the above objects in view, and taking into account the advantages which finance corporations enjoy regarding local knowledge and low cost of operations and which may be utilised to the country's advantage, we make the following suggestions :

(1) No finance corporation may be allowed to work without a licence from the Reserve Bank of India. The background of partners/directors may be investigated before granting a licence to a corporation. Limits may also be prescribed on inter-corporation directorship/partnership.

(2) A ratio may be prescribed between the owned funds of the corporations and their deposit liabilities. When this suggestion was put to the corporations, many of them were in favour of it. The ratio of 1 : 10 or 1 : 15 could be considered for this purpose. As pointed out earlier, many corporations are conscious of the need for keeping their deposits within limits.

(3) Just as the banking companies and some non-banking companies are required to maintain liquidity ratios, these corporations may also be required to maintain similar ratios.

(4) The prescription of liquidity ratio or the ratio between owned funds and deposit liabilities would not ultimately prove to be a safeguard for the depositors' interests if the lending business of these corporations is of a risky nature. It is, therefore, suggested that periodical inspections of the corporations on a sample basis may be undertaken by the Reserve Bank. The atmosphere of vigilance created thereby would itself bring an element of discipline into the affairs of the corporations.

(5) Maximum deposit rates may be prescribed which would, however, be higher than those prescribed for commercial banks.

8.27 In addition to the regulation mentioned above, which may be applicable to all finance corporations, they may be classified into two categories, namely, (*a*) approved and (*b*) non-approved. Approved finance corporations which may only be corporate bodies, would get the benefit of refinance facilities from commercial banks and the Reserve Bank. This category of institutions can be used as agents of commercial banks for their small advances, *e.g.*, to small traders. The benefit of guarantee of loans can be extended to approved corporations. Ultimately, the deposits in these corporations can be insured by the Deposit Insurance Corporation.

8.28 The criteria for according the status 'approved' to a corporation will have to be based on the judgment of the Reserve Bank of India as to whether its affairs are being conducted in a way which is not detrimental to the interests of depositors. The 'non-approved' finance corporations should not be given the facilities of advances, cheque discounting, etc., by commercial banks. If adequate publicity is given to the list of 'approved' and "non-approved' corporations, many depositors would transfer their deposits from 'non-approved' to 'approved' institutions. Also, the scheme of providing refinance facilities by commercial banks to approved institutions will ensure that the finance corporations would become part of the organised banking system.

8.29. Before concluding we would like to emphasise that legislation in this connection may be helpful but would not meet the requirements of the situation partly because it is not always easy to administer laws. This is particularly true when the number of units which have to be regulated or controlled is large. Also, loopholes can always be found. Therefore, we cannot over-emphasise our conclusion that the solution to these problems really lies in the commercial banks refashioning their policies and procedures in a way so as to satisfy the demands of borrowers and depositors.

PART III

NEED FOR SPECIALISED INSTITUTIONS

CHAPTER 9

EXAMINATION OF THE GENERAL CASE FOR ESTABLISHING SPECIALISED INSTITUTIONS

INTRODUCTION

9.1 In Part II we have discussed the role of selected existing NBFIs and made recommendations. In this part of the Report we shall discuss the need for specialised financial institutions of the following types : Merchant Banking Institutions and Acceptance and Discount Houses, Export-Import Bank, Small Scale Industries Bank, Specialised Savings Banks, Specialised Housing Finance Institutions and Specialised Institutions for Consumer Credit. We have not examined the case for a Specialised Agricultural Bank because we understand that the Banking Commission is itself examining the question.

9.2 Before we discuss the need for specialised institutions for particular sectors, it would be worthwhile to examine the general case for and against establishment of specialised financial institutions in India. It is essential because as the Chairman of the Banking Commission remarked in his inaugural address to the Study Group, "In fact, judging from the number of proposals and suggestions appearing in the daily press, it would appear that any problem can be solved by simply starting a new institution." The purpose of this chapter is to examine the general arguments given in favour of or against the establishment of specialised institutions.

9.3 The arguments in favour of setting up specialised financial institutions can be divided into two categories : (*a*) the existing institutional arrangements are not suitable and adequate for performing certain functions, and (*b*) the development of certain special sectors requires the services of specialised institutions. We shall examine each category of arguments in the following paragraphs and then discuss the arguments generally advanced against the establishment of such institutions.

ARGUMENT FOR CONFINING THE RESERVE BANK TO TRADITIONAL FUNCTIONS

9.4 In advancing the argument that the present institutions are not suitable for catering to the credit needs of particular sectors, it is sometimes contended that the Reserve Bank of India as the central bank of the country

should confine itself to its traditional role of regulating currency and credit and divest itself of its promotional activities like promoting credit for agricultural and export needs. According to this argument, the increasing responsibilities of the Reserve Bank deflect its thinking and energies away from its primary role as the regulator of the financial system of the country. The inference is, therefore, drawn that an Agricultural Bank, a Small Industries Bank, an Export-Import Bank, etc., should be created to cater to the needs of the private sector.

THE CASE AGAINST THE RESERVE BANK CONFINING ITSELF TO TRADITIONAL FUNCTIONS

9.5 We do not agree with this line of argument. Even in developed countries the role of the central bank is not confined to its traditional functions as generally understood. In a country like India, where there are serious institutional gaps, the central bank has to step in actively in certain fields. Apart from leading to the financial and economic development of the country, the Reserve Bank in this way actually succeeds in making its monetary policy more effective. To take an example, in the absence of Reserve Bank's direct involvement in agricultural credit, farmers would be depending entirely on moneylenders for their credit needs. The agricultural co-operative movement was built up with the initiative and active support of the Reserve Bank. Partly as a result of its policy, co-operative credit increased from 3 per cent of the total borrowings of cultivators, in 1951-52, to an estimated 25 per cent in 1968-69, in respect of short and medium-term credit alone.* With the encouragement given by the Reserve Bank to commercial banks and co-operatives in extending finance to agricultural sector, this proportion would be still higher at present. With the expansion of the organised sector, the power of the Reserve Bank to regulate credit has certainly increased.

9.6 If the central bank takes a narrow view of its function, it may find itself almost without any worthwhile function to perform in a developing economy, where there are gaps in the institutional framework†. The expertise to fill up such gaps is usually available with the central bank.

* C. D. Datey, *Co-operative Credit in India—An All-India Perspective* (Talk delivered at the Indian Institute of Management, Ahmedabad), Co-operative News Digest, Reserve Bank of India, April 1971.

† It may be useful to quote the views of Prof. R. S. Sayers in this connection : "In a highly developed financial system it is generally agreed that the business of the central bank is to influence, perhaps to control, the conduct of the commercial banks and other closely related financial institutions. It is, therefore, not surprising that when asked if central banks should be established in countries whose systems were undeveloped, the expert's answer has consisted of the further question, "who is there to be controlled ?", with its implication that a central bank would be out of place. My view is that this negative attitude has been unfortunate, and that it originated in a mistaken identification of central banking with those well-known techniques appropriate in highly developed economies. A young central bank should be able to find banking business to undertake. It should not be disheartened by contemplating a void, it should bestir itself to fill the void and to encourage others to fill it."

R. S. Sayers, *Central Banking After Bagehot,* Oxford Clarenden Press, 1957, p. 115.

It is in order to fill up such gaps that central banks in most developing countries have taken over additional responsibilities of a promotional nature. The central bank can itself take over new functions or can create specialised institutions to fill up an identified credit gap. The essential point is that, *prima facie*, the central bank in a developing country like India, should not take too narrow a view of its functions. The history of the Reserve Bank, in fact, shows that if it had not stepped out of its traditional functions of regulating currency and credit, financial institutions in India would have been less developed than what they are today.

Commercial Banks Should Confine Themselves to Their Traditional Functions — An Argument For Creation of Specialised Institutions

9.7 A somewhat similar argument in favour of the establishment of specialised financial institutions is that commercial banks should confine themselves to their traditional functions of accepting deposits and giving short-term self-liquidating credit. In other words, commercial banks should give credit only for working capital purposes to borrowers who are well established in business and industry and not go in for new fields like term credit or making advances to sectors with which they are not familiar. The essential question is whether commercial banks in India should be multi-purpose financial institutions or should they confine themselves to giving credit mostly to large industries for their working capital purposes.

The Case Against Commercial Banks Confining Themselves to Traditional Functions

9.8 The functions of commercial banks in any country are conditioned by the structure of the economy, policy of the central bank and the Government, the credit requirements of different sectors and the resources available to them. For various reasons, a large portion of the advances of Indian commercial banks has, in recent years, gone to large industries. The development of commercial banking was lop-sided with a definite urban bias. This position is being now rectified by the policy to encourage commercial banks to open a large number of branches, particularly in unbanked places, rural and semi-urban areas.* This policy is in the right direction because commercial banks with a widespread network of branches can cater to the needs of the sectors which, in the strategy of Indian planning, are of crucial importance. The important point is whether it will be more economical to the country if commercial banks take up additional responsibilities or whether specialised institutions should be created for meeting the needs of these sectors.

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* *Vide* paragraph 9.15 of this chapter and paragraph 13.19 of Chapter 13 on Specialised Savings Banks.

9.9 It appears to us that so far as the question of financial resources is concerned, the mere creation of a specialised institution will not enhance the available resources in the economy. An equally important point, however, is the question of shortage of trained manpower resources. It is sometimes said that better training can be given to the staff if there are specialised institutions. We do not see the strength of this argument. To take an example, an employee of a commercial bank who is trained to process the applications for large loans can, with some additional training, also process the applications for small loans. In any case, it appears to us that the solution to the problem of trained manpower lies in an adequate and intensified programme and it has hardly anything to do with the creation of specialised institutions.

The Need for Special Attention to 'Priority' Sectors as a Basis for Creation of Specialised Institutions

9.10 Coming to the second category of arguments in favour of creating specialised institutions, *viz.*, that such institutions are required for catering to the needs of special sectors, it is argued that 'priority' sectors require special attention which can be given only if there are specialised institutions to meet their needs. For instance, the expertise required for giving farm loans is of a different nature from that required for giving industrial loans. Similarly, it is argued, that export credit is of a specialised nature which requires a whole range of services extending from locating export markets, collecting necessary information relating to the financial position of the importing country and of the importer and assessing the creditworthiness of the exporter himself. The conclusion is, therefore, drawn that for sectors like agriculture, small industry and exports, specialised institutions should be set up.

Increase in Commercial Banks' Advances to Priority Sector—Implications for the Need to Have Specialised Institutions

9.11 In examining the arguments, let us analyse the experience gained so far. As a result of the changing emphasis on the direction of credit under social control and more particularly since the nationalisation of major commercial banks, the flow of credit to the hitherto neglected sectors has increased. Table 9.1 shows that advances of scheduled commercial banks to agriculture have more than doubled from about Rs. 188 crores in June 1969 to Rs. 400 crores in December 1970. As a proportion of their total advances, they have gone up from 5.2 per cent to 8.9 per cent during the same period. Similarly, advances made during the same period to small scale sector (including advances made to road transport industry, small scale industries and loans for setting up industrial estates) have gone up by almost 75 per cent. As a proportion of total advances, loans to the small

sector have increased from about 8 per cent to 12 per cent. Taking the export sector, the advances have gone up from Rs. 263 crores in June 1969 to Rs. 363 crores in December 1970, thus increasing by Rs. 100 crores over a period of 18 months.

9.12 The above figures show that within a short period and in spite of the limitations of financial and manpower resources, commercial banks have succeeded in changing the direction of their credit in accordance with the new credit policy. Statistics relating to the cost of banking services are not yet available. The essential point, however, is that even if specialised institutions are created, the problems which are at present being faced by commercial banks will also be faced by the new institutions.

Consideration of the Argument to Establish Specialised Institutions to Ensure Co-ordination of Activities of Various Institutions

9.13 It is also sometimes suggested that at present there are a number of financial institutions meeting the needs of the same sector. This results in duplication and wastage of efforts and resources. According to this argument, if a specialised institution is created, it would be able to co-ordinate the efforts of all the institutions in the field. It is also sometimes argued that if there was only one institution rather than a large number of institutions, a borrower would be able to meet his credit needs with less difficulty. This is an argument which cuts both ways. For instance, assuming that there are specialised institutions for small scale industries and for export credit a small scale industrialist who is also an exporter may have to go at least to two institutions in order to get credit for different purposes. He may have to go to small industries bank to meet his credit needs as a small industrialist. As an exporter, he may have to go to the export bank. If the same small scale industrial unit, in the process of growth becomes a large scale unit, it will have to cut off its connections with its previous bank and go to an entirely new bank. Thus, the creation of specialised financial institutions on this ground will not necessarily result in the avoidance of delays and difficulties to the borrower.

Argument for Specialised Institutions to Give Special Credit Facilities and to Link Savings with Credit

9.14 Another argument in favour of the setting up of specialised institutions is that there are certain sectors the credit needs of which cannot be easily satisfied by commercial banks because of the nature of the facilities required. It is, for instance, argued that in the case of commercial banks there should be some sort of relationship between the structure of deposits and the term period for credit. Hence they should not advance long-term loans, nor enter fields where only long-term credit is required. Also, it is

contended that the creation of specialised institutions, besides filling up an identifiable credit gap will also succeed in mobilising new resources. For instance, in those countries where thrift and savings institutions such as specialised savings agencies have been set up, the savings schemes of the institutions have been almost invariably tied up with the credit policies. If both these conditions are met, no doubt, the setting up of specialised institutions can be an advantage to the economy.

Arguments Against the Creation of Specialised Financial Institutions

9.15 This leads us to an examination of the general arguments put forth against the creation of specialised financial institutions. First, the establishment of a new institution will need resources. If we look at the structure of resources of existing term lending institutions (*viz.*, IDBI, ICICI, IFC and SFCs), we find that at the end of June 1970, the budgetary grants and borrowings from Government and the Reserve Bank of India constituted two-thirds of their total resources excluding foreign credit. This means that, generally speaking, the resources of specialised banks will have to come either from the Government or from the Reserve Bank of India. This would either mean a burden on the Central Exchequer or inflationary methods of financing the new institutions. Secondly, it is argued that in the case of multi-purpose financial agencies, the risk is distributed over a wider field and hence minimised. In the case of a specialised financial institution, on the other hand, the risk will be greater because the credit will be concentrated in one or two sectors. Thirdly, even if specialised institutions are created to cater to the needs of specified sectors, they may have to utilise the services of the wide network of branches of commercial banks as their agents. If they establish their own branches, it would be an additional burden on the scarce resources of the economy. It may be mentioned in this connection that since nationalisation, public sector commercial banks have opened branches on an unprecedented scale. The number of new branch offices opened by public sector banks during the period 19th July 1969 to 30th April 1971, was 2,934; of these, 2,011 were in the hitherto unbanked centres. Taking the commercial banks as a whole, 3,419 new branches were opened in that period. Thus, on an average 5 new branches a day were opened during this period. The total number of bank offices at the end of April 1971, was 11,703. Thus, even if new specialised institutions are created they may have to utilise the services of commercial bank branches in order to spread their activities over large areas. Fourthly, it is contended that if specialised institutions are set up for agriculture, small industry and exports, it would result in a psychological setback to the commercial banks which have succeeded in venturing in new directions.

Conclusions

9.16 Our analysis above shows that on *a priori* or general grounds, a case cannot be built up for establishing specialised financial institutions. This does not mean that in particular cases, specialised institutions will not be desirable or even necessary. There may be certain sectors credit needs of which are not at present adequately served by the financial institutions in the organised sector and which perhaps require a specialised institution to take care of their needs. Also, over a period of time circumstances may change and require the setting up of specialised institutions for particular sectors. Our conclusion is that in present conditions, specialised institutions should be created only if there is a clearly identified credit gap which, for some reason or the other, cannot be filled by the existing financial institutions. In other words, each case should be examined on its merit. This is what we proceed to do in the following chapters.

TABLE 9.1—SCHEDULED COMMERCIAL BANKS' ADVANCES* TO AGRICULTURE, SMALL SCALE SECTOR AND EXPORTS

(Rs. in crores)

Bank Group / Sector	Agriculture				Small scale Sector†				Exports‡			
	June 1969	December 1969	June 1970	December‡ 1970	June 1969	December 1969	June 1970	December‡ 1970	June 1969	December 1969	June 1970	December 1970
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1) *SBI Group*												
(A) Total Advances	1185.2	1057.0	1329.4	1331.8	1185.2	1057.0	1329.4	1331.8	1185.2	1057.0	1329.4	1331.8
(B) Advances for the sector	99.9	116.8	141.9	157.8	103.0	135.7	167.8	195.5	70.7	80.4	92.0	96.2
(C) % of (B) to (A)	*8.4*	*11.1*	*10.7*	*11.8*	*8.7*	*12.8*	*12.6*	*14.7*	*6.0*	*7.6*	*6.9*	*7.2*
(2) *14 Nationalised Banks*												
(A) Total Advances	1831.4	1942.5	2248.2	2411.2	1831.4	1942.5	2248.2	2411.2	1831.4	1942.5	2248.2	2411.2
(B) Advances for the sector	62.4	104.3	159.7	196.5	153.8	188.5	227.0	264.7	124.0	139.0	158.0	169.7
(C) % of (B) to (A)	*3.4*	*5.4*	*7.1*	*8.1*	*8.4*	*9.7*	*10.1*	*11.0*	*6.8*	*7.2*	*7.0*	*7.0*
(3) *Total of Public Sector Banks*												
(A) Total Advances	3016.6	2999.5	3577.6	3743.0	3016.6	2999.5	3577.6	3743.0	3016.6	2999.5	3577.6	3743.0
(B) Advances for the sector	162.3	221.1	301.6	354.3	256.8	324.2	394.8	460.2	194.7	219.4	250.0	265.9
(C) % of (B) to (A)	*5.4*	*7.4*	*8.4*	*9.5*	*8.5*	*10.8*	*11.0*	*12.3*	*6.5*	*7.3*	*7.0*	*7.1*
(4) *Other Scheduled Commercial Banks*												
(A) Total Advances	582.2	616.4	635.2	708.2	582.2	616.4	635.2	708.2	582.2	616.4	635.2	708.2
(B) Advances for the sector	26.1	36.8	40.1	45.8	37.3	40.6	50.8	56.3	68.7	83.4	70.4	97.2
(C) % of (B) to (A)	*4.5*	*6.0*	*6.3*	*6.5*	*6.4*	*6.6*	*8.0*	*7.9*	*11.8*	*13.5*	*11.1*	*13.7*
(5) *All Scheduled Commercial Banks*												
(A) Total Advances	3598.8	3615.9	4212.8	4451.2	3598.8	3615.9	4212.8	4451.2	3598.8	3615.9	4212.8	4451.2
(B) Advances for the sector	188.4	257.9	341.7	400.1	294.1	364.8	445.6	516.6	263.4	302.8	320.4	363.1
(C) % of (B) to (A)	*5.2*	*7.1*	*8.1*	*8.9*	*8.2*	*10.1*	*10.6*	*11.6*	*7.3*	*8.4*	*7.6*	*8.2*

* As on the last Friday.
† Advances for Small scale sector include those made to small scale industries, transport operators and loans for setting up industrial estates.
‡ Provisional.

Source : Reserve Bank of of India Bulletins.

CHAPTER 10

MERCHANT BANKING INSTITUTIONS AND ACCEPTANCE AND DISCOUNT HOUSES

INTRODUCTION

10.1 In this chapter, we shall discuss the need for merchant banking institutions in India. These insitutions in foreign countries are financial intermediaries which offer varied services like promotion and syndication of projects, and investment management and advisory services. In the U.S.A., Investment Banks perform the functions of underwriting of stocks, brokerage and management of companies. Commercial banks are not in a position to offer these services to their clients in the normal course of their business. In the U.K., merchant banking institutions also undertake acceptance business to enable their clients to discount bills at low rates of interest. In this chapter we shall also examine whether the country needs specialised institutions to perform the functions of acceptance and discount houses.

10.2 The chapter is divided into five parts. In Part I, we have discussed the justification for merchant banking institutions in India. The functions of these institutions are discussed in Part II. The question of acceptance credit and discounting function and the institutions which can appropriately perform such functions is examined in Part III. The questions relating to policies, structure and administration are dealt with in Part IV. The conclusions are given in Part V.

I

JUSTIFICATION FOR THE INSTITUTION

10.3 During the three Plan periods, India has built up a wide-based and highly diversified industrial structure capable of producing a variety of consumer goods, basic raw materials, industrial goods and capital goods. In the earlier period of the Plans, the private sector of industry in India was practically a virgin field and when the programme for industrial development in the Second Plan was published, the Indian and foreign business houses avidly seized the investment opportunities and set up new industrial concerns and expanded the capacity of the existing ones. The majority of entrepreneurs who came forward at that time to set up new enterprises were

mostly organised and experienced businessmen. In the segment of small and medium scale industry, there was a rapid growth which was largely stimulated by the growing demand for their products and sheltered domestic market. In respect of large undertakings many turn-key jobs were entrusted to foreign consultancy firms and the industrial undertakings were put into operation with the assistance of technicians deputed by the foreign collaboration firms.

10.4 During this period, it was possible for financial institutions to take certain aspects for granted and to make an overall appraisal of projects. Sometimes loans were granted mainly on the high commercial creditworthiness of the borrowing parties, who were leading industrialists, or businessmen. Even if the information supplied was defective in some respects and appraisal was inadequate, these features never came to light so long as the proposed enterprise was set up and went into production. In 1966, the situation underwent a significant change. On account of the serious deterioration in the agricultural output owing to drought conditions in 1966-67 and 1967-68, there were serious inflationary pressures on the one hand, and industrial recession on the other. For the first time, an appreciable measure of competition emerged in many industries, there were more units in the same industry competing with each other on factors of price and quality with the result that while some units were able to maintain their profitability others worked at a loss; the demand for various products, especially in the sphere of capital goods, intermediate goods and spare parts and components of ancillary industries, showed a downward trend. This made the industrialists for the first time conscious of the need for reducing costs for stepping up efficiency in production so as to improve their competitive ability and for exploring possibilities for exports so as to maintain production at a higher level. The recessionary situation revealed diseconomies of scale in several industries, stagnant technology and serious lack of experience in developing export markets in many others. With two successively good monsoons, the situation both in agriculture and industrial fields has improved considerably. Consequently the scope for industrial expansion has widened. There is a large corporate sector comprising over 27,000 companies of which about 6,500 are public limited, having public participation in their share capital. This sector is bound to grow in the climate of mixed economy in our country.

10.5 With the prospect of rapid industrialization, the demand both for financial and other services required by the industrial sector will grow. In India, the financial community consists largely of commercial banks, long-term lending institutions and industrial investment and development institutions recently set up in some of the States. Commercial banks were engaged primarily in the supply of short-term capital for trade and industry; they were until recently security-oriented and are only now gaining experience on project-lending. The long-term financial institutions are mainly

finance-oriented, being concerned with new projects or expansion of the existing ones, and disposed to make investments for their own account. These institutions, have acquired considerable experience and developed expertise for project appraisal. But they have hardly any personnel or time to spare for assisting or guiding entrepreneurs in preparing their proposals. A study of important branches of industry of medium and large size that were incorporated in the Second Plan period in the private sector revealed that "the main factors responsible for delay in the execution of projects were inadequate project-preparation, defective technical planning, inefficient or indifferent management, financial difficulties of promoters, lack of co-operation from machinery suppliers and foreign collaborators and delay in finalization of financing arrangements."† Companies which went to financial institutions for assistance frequently made their approach at a premature stage and consequently in a number of projects changes and modifications both in technical and financial aspects were introduced later. These delays in their turn caused overrun in the capital costs of the projects and imposed a heavy burden on financial overheads and pre-production costs.

10.6 In this context, there are four important points which should be noted. First, in the Fourth Five-Year Plan, in the sphere of large industries, emphasis is laid on the development of industries like fertilisers, pesticides, petro-chemicals and electronics, which would be highly sophisticated and complex in character. Both the scale of operations and the investment outlay in some of them would be much bigger than hitherto. At the same time, there is a distinct stress on decentralisation and encouragement of small and medium industries. This would imply emergence of new entrepreneurs, having technical or managerial qualifications but lacking adequate business training or experience. There is no doubt that both classes of entrepreneurs require expert advice and assistance in the preparation and implementation of their projects. Secondly, the concept of security in respect of short-term lending is undergoing a significant change. Instead of the commercial credit of the borrower, the creditworthiness of the business itself would now be assessed and taken as the basis for working capital or medium-term loans by commercial banks. The corporate enterprises would, therefore, need services and expert advice of a financial intermediary in respect of financial management for their short or long-term credit requirements. Thirdly, in many business enterprises, the managing agents offered their services to companies under their management, for securing adequate financial resources for commercial banks and other financial institutions. With the elimination of this pattern of management, the Boards of Directors of these corporations, would stand in need of services of objective and impartial agencies, having the necessary experience and expert knowledge of financial management. Also the middle sector industries which do not have the benefit of the advisory services of managing

† Jakhade, V. M., and Bhatt, H. C., "Time-lag in the Implementation of Industrial Projects And in Returns on Investment", *Reserve Bank of India Bulletin*, March 1968, p. 329.

agencies will continue to feel the need for such services. Fourthly, there is a need for industrial rationalisation. This can come about through mergers and integration between the existing public or privately owned companies or through the private companies and new ventures going public. There is also a distinct possibility of Indian enterprises investing in joint ventures abroad thereby getting a foot-hold in the overseas markets. In all these respects, there is need for sophisticated financial planning and management practices. The expanding scope for financial services therefore calls for separate institutions which have a flexible approach and are set up for specialised purposes.

II

Functions of Merchant Banking Institutions

10.7 Having regard to the requirements of business and industry in India it would appear that the functions of merchant banking type of service institutions should for the present be as under :

(*a*) Promotion, financing and syndication of Indian projects ;

(*b*) Investment advisory services ; and

(*c*) Investment management.

(*a*) *Promotion, Financing and Syndication of Indian Projects*

10.8 The merchant banking institutions can function as issue houses by assisting their clients in raising funds they require and formulate the terms and conditions which would be acceptable to lenders. They should ensure that the amount sought is reasonable. In foreign countries they do not themselves provide large resources as their function is mainly to act as sponsors and underwriters rather than as a source of finance. They, however, lend their reputation to the issue which would make it easier to raise the money in the market. They act as intermediaries between the borrowers and lenders and offer their services to both. In India they should cultivate every class of clients particularly the medium and small business enterprises which are today greatly in need of these services. Maintaining close and continuous contact with the clients, they would acquire familiarity with their problems arising out of the activities in which they are engaged and the general economic outlook. They should advise the clients about the best method of raising financial capital and the best time at which to float the issue. Their advice, therefore, will not be merely confined to actual issues but generally help the clients in financial management of their respective enterprises. The merchant banking institutions would also advise a client on the rules and regulations of the stock exchanges and the practices governing new issues. The sponsorship of the issue house would help in

enlisting the confidence of the investor who would have to have the assurance that the issue was scrutinised by financial experts and was made on reasonable terms and under reputable auspices. The issue houses would discuss the form of the issue with the client who wants to raise the money. The issue houses would then consult the underwriters and brokers to the issue and recommend its floatation at the appropriate time so as to ensure the success of the issue. This will include not only the issue of capital by a new enterprise but also assistance to a private company to go public, in reorganisation, acquisitions or mergers and generally negotiating the terms for them. The institution may take a minority position in financing an equity issue but this would be on a temporary basis. Its main role would be as an issue house and sometimes as manager of financial syndicate for specific issues. The institution, on the basis of its scrutiny of each project, would design and negotiate a financing package which would meet the specific type and terms of financing needed by it. It is realised that it is not always possible for medium-sized businesses to float an issue in the market but the issue houses can assist in placing them privately with financial institutions at reasonable terms. The activities of the issue houses can be extended in sponsoring offers for sale by foreign subsidiaries or branches who are now advised by Government to bring down their holding below 50 per cent of the total equity capital.

10.9 In regard to the new enterprises the merchant banking institutions can assist the new entrepreneur in a variety of ways to promote the enterprise. Before a licence is obtained for a client and if the client wishes to have feasibility study made the merchant banking institution can enlist the services of technical and managerial consultancy firms and get a market survey or a feasibility study prepared by them for its client. After the letter of intent has been obtained, the client may wish to have a project report prepared in which case again they can seek the assistance of Indian consultancy firms.

10.10 During the past two or three years, experience has shown that a number of industrial concerns, particularly in the engineering field, were, during the period of recession, forced to work far below their installed capacity. As a consequence, many of them found it difficult to break even and some of them operated at a sizeable loss. With the revival of demand for their products, some of these companies have their order books full but are short of working capital. Many of them are soundly managed and financially viable concerns but owing to the shortage of current finance, their operations are considerably hampered. In such cases what is needed is a quick assessment of their financial requirements to tide over a temporary period so that they can execute the orders on hand and thereby regain profitable working. In such cases the merchant banking institutions can help in obtaining medium-term credit of 3 to 5 years from commercial banks or from financial institutions. Further, there are a number of cases in which

manufacturing concerns require a medium-term loan for minor plant or balancing equipment which would enable it to increase production by 10 to 25 per cent which is permissible without an industrial licence. At present, commercial banks give a medium-term loan with refinance facilities from the Industrial Development Bank of India. The merchant banking institution can assist in obtaining this advance direct from the term lending institution or from its own resources.

10.11 With the termination of the managing agency, the problem of guaranteeing the short-term advances or overdraft accommodation to large and medium concerns has arisen. The merchant banking institution may, after due assessment of the financial soundness and credit standing of a business enterprise, agree to guarantee the loans for a specified commission. This would be a fairly remunerative business and the sponsoring banks should agree to accept the guarantee of their merchant banking institution.

(b) Investment Advisory Services

10.12 The advisory services would include matters regarding the financial condition, performance, prospects and needs of a corporate enterprise. In respect of mergers, acquisitions and reorganisations, the merchant bank would help in handling the actual operations. These services would also include providing information to its clients, of developments affecting their business in India and abroad and establishing foreign contacts, whenever required. It may assist in the formulation and preparation of investment studies and proposals, advising in financial planning and control, on management changes and needs. The projects to be sponsored and financed may include: (a) new projects of new companies; (b) new projects of existing companies; and (c) expansions and modernisation of existing companies. All the three categories offer a promising market for the institution's services.

(c) Investment Management

10.13 With the exception of the firms of brokers registered with the stock exchanges there is practically no investment advisory service in this country. The merchant banks in the United Kingdom maintain accounts of individual clients which now run into several hundred millions and act as investment advisers to their clients. Some of the accounts are small or purely discretionary in the sense that the merchant bank is left with the discretion to invest the money according to its best judgment. For larger amounts exceeding £ 1,00,000, they act according to the instructions received from their clients. In India, there are thousands of persons in small and medium income groups who are unable to manage their funds and who sometimes fall victims to unscrupulous manipulators. It would be an excel-

lent idea if merchant banking institutions would agree to maintain accounts from Rs. 10,000 and above and invest funds on behalf of their individual clients. This is not a highly remunerative operation but would be of great benefit to small and medium savers in the country. It may be remembered that in the olden days, some of the commercial banks used to maintain accounts on behalf of their large clients like ruling princes, *zamindars* and wealthy merchants and made investments in securities and shares on their behalf. Investment management would also include the management of provident funds, pension funds and trusts of various types.

III

Acceptance Credit and Discount Houses

Acceptance Credit in India

10.14 While we are of the view that the merchant banking institutions should perform the abovementioned functions of promotion, financing and syndication of projects, investment advisers and investment managers, a related question is whether like merchant banks in the U.K., they should also act as acceptance houses.

10.15 The need for acceptance credit largely arises where a full-fledged bill market has been developed. The bill of exchange is in law: 'An unconditional order in writing addressed by one person to another signed by the person giving it requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a certain sum in money to or to the order of a specified person or to bearer.' The person to whom it is addressed accepts the order by signing on the face of it. In this way he, in effect, substitutes his own credit for that of the drawer of the bill. Legally, the drawer of the bill continues to be liable on the bill in case of dishonour by the drawee or acceptor thereof. The bills may be drawn either in connection with overseas trade or for internal trade. When the acceptor is a house of established reputation the bill automatically becomes acceptable to people with goods to sell or money to lend even if they themselves have no experience of the creditworthiness of the drawer. The risk that the acceptor undertakes is the insolvency of the drawer, who is required to meet his obligation on the date of maturity of the bill. Generally, acceptance credit is granted in all cases, foreign and domestic, for the financing of current trade and *not* for capital purposes and the transactions financed are self-liquidating, that is, when the bill matures, the goods which it financed should have been sold and the proceeds of them should be available to cover the bill. For its services, an acceptance house charges a commission to its customer which varies according to his standing and the terms of the credit arrangement between the customer and the accepting house. This is partly

a remuneration for the work done but mainly a risk premium because by accepting the bill the Acceptance House gives an unconditional undertaking to pay the bill at maturity whether it receives cover from the customer or not and thus assumes the risk of its customer failing to pay his debts. Normally, the acceptance house has a wide network of credit intelligence service from which it obtains the necessary assessment about the credit-worthiness of the drawer and fixes the monetary limit upto which it would accept the bill on his behalf.

10.16 Recently, a Study Group constituted by the Reserve Bank of India, has made recommendations for the creation of a bill market.* The Reserve Bank of India has taken some measures incorporating the recommendations by the Study Group. With effect from July 1971, borrowings from the Reserve Bank against bills under the new bill market scheme will not only be available at the Bank Rate but also such borrowings will not impair their net liquidity ratios. The Group has observed :

> "From the point of view of the short-term borrower, the advantage would be that in a developed bill market, a high class bill of exchange can be normally discounted at rates lower than those charged by the banks on advances, the difference reflecting the greater security given to the bill by the signature of an *acceptor of high standing* and other parties if any".

The Group has suggested that a system could be devised whereby bills of short maturity should be taken up by the banks and those of the longer maturity by the term lending institutions. The Group has however suggested that it might not be absolutely necessary at the present stage to create separate acceptance house under official auspices. According to the Study Group, the commercial banks can, under the present conditions, function as acceptors.

10.17 We agree with this view. Two factors which are of basic importance for the development of bill market are (*a*) reputation and financial standing of the acceptor and (*b*) the eligibility of the parties concerned to give acceptance upto limits specified by the acceptors. Both these functions can be performed by the commercial banks. The banking system in India with its wide network of branches has a nucleus of credit information and credit-rating. A banker has definite idea of the credit-rating of the person for whom he accepts the bills. In fact, acceptance business is almost like guarantees which the commercial banks in India usually give on behalf of their customers. Also the banker's signature is good enough for acceptance. Hence, under the present conditions, the commercial banks can easily perform the role of acceptance houses. In due course, however, after the

* *Report of the Study Group on Enlarging the Use of the Bill of Exchange as an Instrument of Credit and the Creation of Bill Market*, (Chairman : M. Narasimham).

bill market is sufficiently developed and the proposed merchant banking institutions get the necessary experience, they may also take up acceptance business. These would be useful because credit-rating would be required not only for acceptance business, but also for assisting new projects. Also acceptance business would bring income to the merchant banks.

10.18 The question of acceptance credit leads us to a discussion of the need for discount institutions. Once a commercial bill is accepted by the banker of the purchaser of goods, the seller may like to discount it with his bank. In England, one of the major functions of the discount houses is to endorse commercial bills, thus taking responsibility for the payment of the bills at maturity in the event of default. This requires a detailed and up-to-date knowledge of the creditworthiness of large number of customers in various trades. Once a bill is endorsed by a discount house, it can be discounted in the money market at fine rates. In India, commercial banks would be the main institutions discounting bills ; the proposed merchant banking institutions in due course could also do so in addition to their acceptance business. There does not, therefore, seem any need for specialised discount houses though we would not preclude discount institutions being set up in course of time to offer this facility as well as functioning as a money market intermediary to even out the demand for and supply of short-term funds in the money market.

10.19 While we agree that at present commercial banks can usefully take up acceptance and discounting business, we would like to point out that they face certain problems in this connection. There are legal difficulties in a full and meaningful exchange of information between commercial banks regarding their customers. This means that optimum use is not made of the facilities available. The Crowther Committee has suggested that if credit-rating agencies are to continue in operation, they should be required, if asked, to disclose any information they hold on the person whose creditworthiness is concerned, but they should not be subjected to the law of libel in respect of information they pass on in good faith. We are of the view that in India also, there is need for improving the system of exchange of information between the commercial banks. We understand that the Study Group to Review Legislation Affecting Banking is examining the legal aspects of this question.

10.20 Since credit-rating is of basic importance to the development of acceptance and discounting services, it would be useful if commercial banks pay special attention to evolving objective criteria which should be applied uniformly to all business enterprises whose bills can be accepted with safety. Hitherto, most of the lending operations of the banks were governed by commercial standards in the sense that if the individual borrower or a business house had significant wealth and property he was automatically regarded as eligible for either an overdraft or loan accommodation. On

this criterion, however, most of the new entrepreneurs in the medium and small enterprise category find it extremely difficult to get adequate bank accommodation and are considered least eligible for acceptance of bills. It is, therefore, suggested that the following four criteria should be employed for assessing the creditworthiness of a business enterprise itself:

(*i*) The annual rate of growth of business indicated by increase in sales and fixed or liquid assets ;

(*ii*) Ratio of equity to debt and that of net worth to capital employed ;

(*iii*) The rate of profitability in a period of 5 years with various ratios of profits to sales, net worth and capital employed ; and

(*iv*) The overall performance of the business enterprise including the integrity and efficiency of management of the borrowing concern.

IV

Policies, Structure and Administration of the Merchant Banking Institution

Policies

10.21 The policies of merchant banking institution may adhere to the following principles :

(*a*) The primary function of the merchant bank may be the provision of financial advisory and investment services to commerce and industry. It may enter into commitment for small equity investments and loans whenever it adds to the efficiency in appropriate cases. These services and financing would be confined to companies in India and Indian joint ventures abroad.

(*b*) When it makes investments it will normally take a minority position and may endeavour to hold such investments for a temporary period so that it can revolve its funds by resale to the market as soon as favourable conditions arise. The institution will be continuously in touch with the stock and money markets.

(*c*) Its activities will not be limited to new projects or expansion nor only to capital asset financing but will include all forms of services and financing.

(*d*) Its services will be offered to all types of industries both public and private.

(*e*) In locating finance for projects, the institution will give preference to its shareholders and will provide them with information

on which their investment decision can be made. When the institution renders service direct to its shareholders it will charge appropriate fees.

(*f*) It will not discriminate among regions and/or groups and will actively promote its image as an independent all-India institution.

(*g*) The institution will thus offer a wide range of financial and advisory services and will emphasise the flexibility of operations and cultivate a close bank-client relationship.

Structure and Administration

10.22 In our opinion, initially there could be four merchant banking institutions in the country located at Bombay, Calcutta, Delhi and Madras, set up by specialised financing institutions and commercial banks. Later, branches can be set up in inland centres also by each of the regional institutions. First, the institutional set-up and atmosphere where integrity, investment expertise and high management standards are already available in the largest measure should be selected and then the sponsorship of the merchant banking division be entrusted to it. It should be realised that it is not the label but the qualities mentioned above that will attract business and inspire confidence among the clients.

10.23 It is suggested that these four divisions should be set up in the first instance and in the light of experience gained merchant banking institutions may be allowed to be set up in the private sector. The erstwhile managing agencies which have necessary expertise may be allowed to organise such institutions. While the institution will require its own staff, in the initial period a majority of the officers and men with adequate experience should be sent by the sponsoring institutions on deputation to these institutions. There is no doubt that the management will require, at the top level, high-powered and experienced people who can devote their time to negotiations for complicated and large transactions and at the second level technical staff who can attend to more routine consulting services particularly those relating to financial planning and control, project studies, etc. A small unit specialised solely on money market and stock operations may also be included. The institutions would be free to sub-contract specific parts of its engagements to auditing and legal firms and engineering consultants as already mentioned above. The services of bill brokers may also be utilised, if necessary.

V

Conclusions

10.24 The Group recognises the need for merchant banking and acceptance and discount services in India. We believe, however, that

under present conditions acceptance and discount services can be performed by commercial banks. The merchant banking institutions that we have recommended should, to begin with, devote their attention to the capital market function, syndication and promotion of projects and investment and managerial advisory services. In due course, after the bill market is developed and they get the necessary expertise, they may perform the acceptance and discounting functions. It is necessary to explain in this context that the basic 'resources' for merchant banking institutions are their expertise. In fact, it is said that 'while commercial banks live on their deposits, merchant banks live on their wits'. Hence it is necessary to organize a training programme for the staff of the proposed merchant banking institutions. The National Institute of Bank Management and the Institute of Financial Management can play a supporting role in this programme.

CHAPTER 11

NEED FOR AN EXPORT-IMPORT BANK IN INDIA

INTRODUCTION

11.1 In this chapter, we shall deal with an important aspect of export promotion, namely, the financing of exports and allied matters, primarily with a view to finding out whether there is a need for setting up a specialised Export-Import Bank in India. The term Export-Import Bank lends itself to various interpretations. The Export-Import Banks of the United States and Japan assume wide functions. In the United States, the Bank extends loans directly to overseas buyers of American goods and services, guarantees and ensures short and medium-term export transactions, and purchases export debt obligations held by commercial banks. In Japan, the activities of this bank include the following five functional categories: (*i*) export credit, (*ii*) import credit, (*iii*) overseas investment credit, (*iv*) direct loans, and (*v*) credit for overseas technical services. All these functions are performed by the bank in pursuit of its two major activities, the development of the national economy and "the assistance to capital formation in developing countries so essential for their growth." Sometimes a bank specialising in foreign exchange or an institution which is created to co-ordinate the activities of the foreign branches of commercial banks in the country is also designated as an Export-Import Bank. For instance, a suggestion has been made that an institution should be created in India to manage the foreign branches of Indian banks and that it should perform all the functions usually associated with an Export-Import bank.

11.2 We shall discuss the need for an Export-Import bank in terms of its functions to provide export credit and attend to all related problems such as providing guarantee for export loans as well as covering other risks like exchange rate variations, locating individual exporters, identifying foreign markets and importers, etc. Our enquiry would mainly relate to export finance problems from the point of view of export promotion.

11.3 The need for promoting exports is well recognised as part of the long-term strategy of development in Indian Plans. Besides ensuring the much needed foreign exchange for the country's development requirements, they provide scope for high and sustained internal growth and larger employment opportunities.

11.4 The Fourth Five-Year Plan envisages an expansion in the total export earnings at an average rate of 7 per cent a year. The achievement

of the target involves action on a wide front including the expansion of production base, imposing restrictions on domestic consumption, locating export potential and giving incentives to exporters. Measures have been taken in all these directions and it is not necessary to review them at length for the purpose of this chapter.

Importance of Credit for Export Promotion

11.5 One significant aspect of export promotion measures is to ensure the flow of adequate credit to the exporter/manufacturer at a reasonable rate of interest to enable him to produce and export his goods and services at competitive terms. This aspect has become more important in recent years with the changing emphasis on the structure of our exports. In view of the trends in world trade, it is expected that the growth of traditional exports like jute, tea, cotton textiles, etc., would be relatively slow. Hence one major object of India's policy is to diversify exports in directions such as metals, machinery, equipment and engineering goods for which the world demand is expanding at a rapid rate. Also, the demand for turn-key projects, like the erection of industrial plants or construction of pipe lines and railway tracks and for technical know-how is expected to grow. The market for these goods and services is highly competitive because suppliers in advanced countries are prepared to offer their exports on easy deferred payment basis. An exporter who offers credit to the importer, faces the problem of waiting for a long time for the realisation of proceeds of his exports and has also to bear certain risks including the possible risk of changes in the exchange rates involved in such credit. Estimates made for exports of engineering goods on deferred payment basis show that such exports would increase from Rs. 5.6 crores in 1969-70, to about Rs. 44.4 crores in 1973-74, thus constituting 5.3% and 22% of total exports in the respective years.

TABLE 11.1—EXPORT EARNINGS FROM ENGINEERING GOODS DURING THE FOURTH PLAN

(Rs. in crores)

	1969-70 (*Actuals*)	1970-71	1971-72	1972-73	1973-74
1. Total exports	106.4	133.0	158.0	180.0	200.0
2. Estimated exports on deferred payment basis	5.6	29.0	35.1	40.0	44.4
3. Realisations from non-deferred exports (1—2)	100.8	104.0	122.9	140.0	155.6
4. Realisations from exports on deferred payment basis	0.9	5.8	11.6	18.3	25.7
5. Total Export Earnings (3 + 4) ..	101.7	109.8	134.5	158.3	181.3

Source : "Exports of Engineering Goods : Problems and Prospects"—Article in *Reserve Bank of India Bulletin*, October 1970, p. 1723.

11.6 Thus, the role of credit for promotion of exports which was already important, is now assuming vital significance. A number of measures have been taken by the authorities for accelerating the flow of credit on easy terms to the export sector. These measures are well known and have been widely discussed; we shall review them only in so far as they are relevant to the question of examining the need for creating a specialised bank to cater to the credit needs of exporters.

Suggestions for Establishing an Export-Import Bank

11.7 It has been suggested by some committees and some authors@ that in order to take care of all the export credit problems, a specialised Export Bank (sometimes called Export-Import Bank) should be established. Some of the suggestions made in this regard are as under :

> The Joshi Committee had suggested that "India lacks, at the moment, a specialised credit institution to which exporters could turn for assistance, when they have to transact large business, especially on medium/long term basis, against tough competition, at workable rate of interest. The establishment of some sort of an institution to meet the special credit needs of exporters appears to be essential for increasing the growth rate of our exports".*
>
> The Study Group of NCAER made the following recommendation: "Export credit has become an important instrument of foreign trade the world over. No doubt, commercial banks have played their part in finding short-term finance. But in the context of India's growing export trade, the need for a specialised financing institution such as an Export Bank of India to provide comprehensive export credit and guarantees including risk insurance, and to which the exporting community may turn for their medium and long-term finance, is obvious".**
>
> S. K. Verghese summarised the functions of the proposed Export-Import Bank in the following words: "There exists a gap in the institutional structure of India's export credit system, which can be bridged by

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@ To cite a few instances, the following Committees/Reports have discussed and recommended a number of measures in this field :

(1) The Study Group on 'Credit Facilities for Exporters', (Chairan : T. C. Kapoor), (1961).
(2) The Study Group on 'Export Finance', (Chairman : K. P. Mathrani), (1963).
(3) The Study Group on "Cost of Export Credit', (Chairman : Chablani), (1964).
(4) The Working Group on 'Export Credit & Finance', (Chairman : D. S. Joshi), (1967).
(5) Yoshiaki Toda's Report on 'the Export Credit System of India', (1969).
(6) Report of the Workshop on 'Financing Exports', National Institute of Bank Management (NIBM), (1970).

In addition, these problems have been discussed in non-official literature also, *e.g.*, (1) M. Narasimham, 'Some Aspects of Export Finnacc in India'—Article in *Bankers Magazine*, June 1965 and (2) S. K. Verghese, *Export Credit and Credit Insurance Facilities in India and Abroad*, Institute of Foreign Trade, 1970.

* Joshi Committee Report, p. 12, para 27.

** Report of the Study Group on 'Export Strategy for India' ; (Chairman : Manubhai Shah), appointed by NCAER (1969), para 3.26.

establishing an Export-Import Bank. The proposed bank will supplement the resources and activities of commercial banks in providing (*a*) short-term export credit (*b*) medium and long term export credits (*c*) finance for the export of consultancy services (*d*) finance for joint ventures and (*e*) integrated finance for creating exportable surplus and infrastructure for facilitating exports. It will also handle payments in respect of rupee payment countries".*

T. R. Varadachary advocated the need for an Export-Import Bank mainly on the ground that in future India will have to give buyers' credit in place of suppliers' credit. In his words: "In the buyers' credit arrangements, a far higher degree of co-ordination between the respective agencies would be called for. The long term aim must be to have one specialised bank– perhaps an Export-Import Bank—which can deal with the suppliers directly and assume full responsibility for effecting co-ordination amongst the various agencies. The Export-Import Bank may, if necessary, sell participation loan certificates to commercial banks for raising resources; even LIC may possibly be interested in such certificates."£

Manubhai Shah suggested that "........ in the context of India's growing export trade, the need for a specialised financing institution such as the Export Bank of India for providing comprehensive export credit guarantees, including risk insurance, and to which the export community may turn for medium and long term finance, is patent".†

11.8 The basic argument behind the proposal for establishing an Export-Import Bank is that while there are a number of institutions in India giving export credit, there is no single institution to provide credit facilities on a comprehensive basis extending from locating a potential exporter and giving him necessary advice to assisting him with adequate credit on reasonable terms at all stages and protecting him from the risks involved in export business. It is also suggested that the proposed institution will co-ordinate the efforts and activities of all the institutions in the field of export credit.

Examination of the Suggestion

11.9 We shall consider the need for such an institution by examining the present institutional arrangements with respect to different aspects of export credit. The major relevant aspects are the following : (*i*) Availability and cost of credit; (*ii*) insurance of risks and guaranteeing of export credit; and (*iii*) system of collecting information on foreign markets, importers, etc. In analysing these aspects, we have, among other things, taken into account

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* S. K. Verghese : *op. cit.* p. 12.

£ T. R., Varadachary "Export Finance—Buyer's Credit" *State Bank of India Monthly Review*, September, 1970, p. 323.

† Manubhai, Shah *The Role of Reserve Bank in India's Economic Development*, Vora & Co., 1970, p. 74.

the answers given by commercial banks relating to their export business in response to the questionnaire issued to them by the Banking Commission. The emphasis of our analysis is to examine whether the present institutional arrangements are adequate in respect of the abovementioned aspects of export credit.

Availability and Cost of Credit

11.10 Three institutions which are at present providing export credit are (*a*) commercial banks, (*b*) Industrial Development Bank of India (IDBI) and (*c*) Reserve Bank of India (RBI). The most important among them are the commercial banks which provide credit to exporters both at pre-shipment and post-shipment stages. They provide short-term as well as medium-term credit.

11.11 Pre-shipment credit is generally in the form of packing credit, *i.e.*, credit granted against letters of credit or firm orders, to merchants and manufacturer-exporters for the purpose of purchasing, processing, manufacturing, packing, etc., of goods meant for export. The period for repayment ranges between 60 and 180 days depending upon individual cases but normally it is expected not to exceed 90 days from the date of making advances.

11.12 At the post-shipment stage, banks give credit against Letter of Credit (L/C), Documents on Payment (D/P) and Documents on Acceptance (D/A) as well as on consignment basis. It is estimated that about 55% of India's exports are on L/C basis. Over the years, the procedures for giving post-shipment credit have been liberalised. Terms have been relaxed in many cases; for instance L/Cs are not insisted upon provided the foreign buyers are of good standing. In other cases, policies of Export Credit & Guarantee Corporation (ECGC) are furnished and the exporter receives the value of his goods fairly quickly on presentation of documents. Various guarantees provided by the ECGC have helped commercial banks in granting more liberal credit to the second line exporters. For instance, a loan given by a bank to an exporter for the manufacturing, processing and purchasing of goods meant for export against a firm order is guaranteed by the Corporation under its packing credit guarantee. The post-shipment export credit guarantee is designed to protect the bank against losses arising from purchasing, negotiating or discounting of export bills. Similarly, the export production finance guarantee enables the banks to grant advances against entitlement of exporters to cash incentives and duty drawbacks at the pre-shipment stage itself, along with packing credit.

11.13 Finance is made available by commercial banks even in respect of exports which are made initially at a loss by exporters/manufacturers because such losses are subsequently reimbursed in one form or the other, *e.g.*, through cash subsidy or import entitlements. In such cases the ex-

porter/manufacturer is able to raise loans from the bank upto the full local market value irrespective of the Free On Board (FOB) value of the goods to be exported—the bank taking reasonable precautions to ensure that cash subsidies and/or import entitlements after exports are channelised through the bank. The export finance guarantee of the ECGC enables banks to offer in selected cases discounting facilities to exporters upto 125% of value of shipping documents. ECGC guarantee is limited to 25% of FOB value of export bills.

11.14 As Table 11.2 shows, the quantum of finance provided by scheduled commercial banks has been steadily increasing, particularly since the nationalisation of 14 major commercial banks in July 1969.

TABLE 11.2—EXPORT CREDIT EXTENDED BY SCHEDULED COMMERCIAL BANKS

(Rs. in crores)

	JUNE 1969			JUNE 1970			DECEMBER 1970*		
	Total advances	Advances for exports	% to total	Total advances	Advances for exports	% to total	Total advances	Advances for exports	% to total
	1	2	3	4	5	6	7	8	9
1. SBI & subsidiaries	1185.2	70.7	*6.0*	1329.4	92.0	*6.9*	1331.8	96.2	*7.2*
2. Nationalised banks	1831.4	124.0	*6.8*	2248.2	158.0	*7.0*	2411.2	169.7	*7.0*
3. Foreign banks ..	385.2	67.0	*17.4*	409.3	68.2	*16.7*	454.4	95.0	*20.9*
4. Other Indian Scheduled commercial banks	197.0	1.7	*0.9*	225.9	2.2	*1.0*	253.8	2.2	*0.9*
5. All Scheduled commercial banks ..	3598.8	263.4	*7.3*	4212.8	320.4	*7.6*	4451.2	363.1	*8.2*

* Provisional figures.
Source : Reserve Bank of India.

Table 11.2 shows that the amount of export credit made available by scheduled commercial banks has increased from Rs. 263 crores in June 1969 to Rs. 363 crores in December 1970. As a proportion of total credit, it has gone up from 7.3% to 8.2%.

11.15 Judged by the amount of finance given by commercial banks as export credit as well as by the relaxation of their procedures in respect of such credit, it appears that commercial banks' credit to export sector is making progress. In view of the pressure on banks' resources on account of the competing demand from other sectors, the RBI and the IDBI supplement their resources. The RBI refinances the scheduled commercial banks in respect

of their short-term credit not exceeding 180 days. The history of the RBI's policy in this respect is one of progressively liberalising refinance facilities to commercial banks. The chart given in Annexure sums up briefly the changes in the RBI's policy from time to time.

11.16 The basic object of the RBI's policy which treats exports as a priority sector has been to insulate the export sector from the impact of its general policy of restricting domestic credit or making it more costly. The latest change in the RBI's policy, effective from 26th February 1971, has ensured further liberalisation of refinance facilities from the Reserve Bank to scheduled commercial banks in respect of their export credit. The RBI, in terms of the present policy, provides refinance facilities to commercial banks irrespective of their net liquidity ratio (NLR) at (*i*) 4½% for an amount upto 10 per cent of the annual average of export credit in 1970 (calculated at the average of the outstanding level of export credit during 52 weeks) and (*ii*) at Bank Rate (6 per cent) an additional amount upto 10 per cent of the annual average of export credit calculated as in (*i*). Borrowings under these heads are not taken into account in calculating the NLR. The RBI has also provided other incentives to commercial banks to extend credit to exporters. For instance, export credit given by banks is exempted for the purpose of the 'norm' relating to unsecured advances and guarantees given by banks to exporters. There has been a steady increase in the amount of refinance availed of by scheduled commercial banks from the RBI in respect of export credit granted by them. At the end of June 1970, the outstanding amount of refinance given by the RBI stood at Rs. 53.9 crores in respect of packing credit for exports and Rs. 52.3 crores in respect of post-shipment credit.

11.17 While the RBI provides commercial banks with refinance facilities for short-term export credit extended by them, the IDBI has schemes for supplementing the resources of commercial banks both by way of refinance and participation loans in respect of their medium-term advances. Refinance is provided by the IDBI at an interest rate of 4½ per cent to approved commercial banks upto 100 per cent of the export credit extended by them for periods ranging from 6 months to 10 years for financing exports of engineering and capital goods and services on deferred payment terms by exporters in the private and public sectors who are manufacturers, recognised export houses or other exporters of standing. This facility also covers the overall cost of construction projects executed by Indian concerns, where the bulk of the construction contracts constitutes equipments, materials and services of Indian origin. Pre-shipment credit for a period exceeding 6 months to refinance the processing/manufacturing of goods to be exported can also be given when linked with post-shipment credit.

11.18 In the face of large export contracts and the prospect of a growing demand for term export credit, commercial banks might not be able or willing to carry the whole risk and provide the entire term finance even with the refinance assistance from the IDBI. Therefore, in December 1968, the

IDBI introduced a scheme for providing, in participation with approved commercial banks, direct term finance at a low rate of interest and guarantee facilities to industrial concerns for export of engineering goods or services on deferred payment basis. It enters into participation arrangements with approved commercial banks in export credit both during pre-shipment and post-shipment stages for periods over 6 months and also in performance and financial guarantees on behalf of the exporters. There are no minimum and maximum limits for the assistance. While under the refinance scheme the period of the refinance should not exceed 10 years, there is no ceiling as regards the period of credit that may be extended under the participation scheme. It is also understood that the IDBI takes long maturity loans leaving the shorter ones to the commercial banks. The progress of the schemes introduced by the IDBI in respect of refinance as well as participation is shown in Table 11.3.

TABLE 11.3—EXPORT CREDIT OPERATIONS OF IDBI

(Rs. in crores)

Year (April-March)	Refinance		Direct participation finance		Total	
	Net sanctions*	Disbursements	Sanctions	Disbursements	Sanctions	Disbursements
1963-64	0.07	0.07	—	—	0.07	0.07
1964-65	0.21	—	—	—	0.21	—
1965-66	0.64	0.85	—	—	0.64	0.85
1966-67	0.41	0.41	—	—	0.41	0.41
1967-68	0.29	0.27	—	—	0.29	0.27
1968-69	7.06	1.06	—	—	7.06	1.06
1969-70	1.18	3.64	11.92	1.39	13.10	5.03
1970-71	12.93	2.24	10.42	11.90	23.35	14.14
1971-72 (upto 30-6-71)	1.28	8.16	6.77	1.60	8.05	9.76
	24.07	16.70	29.11	14.89	53.18	31.59
Outstandings as on						
31-3-71	4.31		12.75			
30-6-71	12.07		13.95			

* Gross sanctions *less* cancellations and reductions.

Note : IDBI has also participated to the extent of 50% in the issue of (*a*) bid bond, (*b*) advance payment guarantee, and (*c*) performance guarantee facilities to one exporter, IDBI's share being limited to Rs. 169.14 lakhs.

Source : IDBI.

11.19 While the schemes introduced by the IDBI have made commendable progress, there are two major lacunae. First, under the IDBI Act, direct assistance can be provided only to 'industrial concerns' as defined under the Act. As such, IDBI cannot at present extend participation export credits to export houses. Also, it is felt that the present system of suppliers' credit is disadvantageous from the point of view of the exporter because he has to carry the liability of repayment of loan in his books for a long period and hence his borrowing capacity for other purposes is affected. Thus, the exporter has to suffer in spite of the fact that the credit extended to him is in effect credit extended to the buyer. It has, therefore, been suggested that ultimately India

should extend buyers' credit. For legal and other difficulties the IDBI at present is not in a position to extend buyers' credit. It is understood that both the points are under the active consideration of the IDBI.

11.20 It will be seen from the above paragraphs that credit extended by commercial banks to the export sector has made rapid progress with the assistance provided by the RBI, IDBI and the ECGC. So far as the cost of credit is concerned, at present the maximum rate which scheduled commercial banks can charge on their pre-shipment and post-shipment credits other than credit provided to exporters on deferred payment basis, cannot exceed 7 per cent. This ceiling rate was 6 per cent until recently and has been raised to 7 per cent with effect from 16th April 1971, consequent on a rise in the structure of interest rates. The maximum rate of interest which scheduled commercial banks can charge on their pre-shipment and post-shipment credits on deferred payment basis is 6 per cent per annum. In order to compensate commercial banks for the relatively low rate of interest that they are allowed to charge for their export credit, Government promulgated in 1968, an Export Subsidy Scheme under which banks receive a subsidy of 1.5 per cent per annum on their total advances made for exports. As we have seen above, RBI and the IDBI charge concessional rates for the refinance provided by them. IDBI also charges concessional rates on its portion of the participation loans. The interest rate chargeable on IDBI's portion of the credit under the scheme has been fixed at 4.5 per cent, the same as that applicable to refinance loans, irrespective of the level of IDBI's participation. As the participant banks could charge only upto 6 per cent on their portion of the credit, the average interest rate for the exporters worked out to less than 6 per cent, the actual rate depending on the extent of IDBI's participation. In the light of experience gained in the operations of the scheme, the position was reviewed in December 1970, when a differential interest rate system was adopted. Under this method where IDBI's participation exceeds 33½ per cent, the rate is suitably raised above 4.5 per cent so that, after taking into account the rate charged by the participating bank, the average cost to the exporter is 5.5 per cent. This average rate is still low compared to the rates charged in the competitor countries. Where circumstances so warrant, the old rate of 4.5 per cent is charged.

11.21 According to information collected by the Banking Commission, commercial banks charge a rate of interest even below the maximum of 6 per cent in exceptional cases. For instance, in one case a concessional rate of interest of 5¾ per cent was charged for medium-term export credit to enable the engineering goods manufacturer-exporter to comply with the price stipulation for completing the sale. In yet another case, interest at 5½ per cent was charged for post-shipment loan account, (under IDBI's refinance scheme) because it was found that the 'break even' of the export contract was at 5½ per cent.

11.22 The importance of low rate of interest as a measure for promoting exports, will depend on a number of factors. First, the impact of interest

rate will depend upon the borrowed funds/owned funds ratio; *ceteris paribus* the higher the ratio the higher would be the element of interest and as such the higher its impact on the cost of production. Secondly, the policy for inventories, the gestation period and availability of transport and shipping space which play an important role in determining the extent of the working capital requirements, would in turn affect the interest element of production costs. Thirdly, the period required for realisation of receivables, export proceeds and incentives, etc., would also condition the interest factor. The relative importance of the variables mentioned above as influencing the impact of interest cost on the cost of production would differ from manufacturer to manufacturer and also over time for the same manufacturer. One important point to be noticed is that in the export of capital and engineering goods on deferred payment basis, the rate of interest is of crucial importance on account of the competition faced in this sector.

11.23 It is generally believed that the cost of export credit in India is reasonable and compares favourably with the cost in many foreign countries. Table 11.4 throws some light on the cost of export credit in selected foreign countries.

TABLE 11.4—OVERALL COST OF EXPORT CREDIT TO THE IMPORTER

(Approximate range—Includes bank charges but not insurance premium—Allows for special rates available in different countries).

(Figures as at the end of November 1970)

Exporting Country	Short-term	Medium-term	Long-term
U.K.	Upto 2 years : 7½%	2-5 years : 7.6%-7.9%	Over 5 years : 7½%
U.S.A.	Upto 12 months : 8½%-10½%	1-5 years : 8%-10½%	Over 5 years : 6.8%-8%
Japan	Upto 12 months: 6¼%-6½%	1-5 years : 6½%-7½%	Over 5 years : same but may be specially reduced to 6% or less.
Germany	Upto 3 months : 7¾%-10% 3-12 months : 9¾%-11% (Before December cut in Bank Rate)	1-4 years : 9.3%-9.8%	Over 4 years : 8.5%-8.7%
France	Upto 18 months : linked to Bank Rate	18 months—5 Yrs. EEC : 8.7%-9.2% Others : 6.4%-6.9%	Over 5 Yrs. EEC : 7.7%-8% Others : 6½%-7%*
Italy	Upto 12 months : 9½% or more	1-5 years : 5½%-7½%	Over 5 years : 5½%-7½% (6½% for ships)
India@ (Position as at the end of April 1971)	Upto 6 months : 7%	......5½% to 6%......	....

* If no 'aid' used.

@ Cost of credit to the exporter under various schemes introduced by the RBI and the IDBI.

Sources :(1) Richard Fry, *Finance for Exports*, British National Export Council, 1971.
(2) RBI.
(3) IDBI.

11.24 It will thus be seen that both from the point of view of availability and cost of credit for exports the present institutional arrangements are adequate. This does not mean that the present schemes cannot be improved. For instance, in the Workshop on Financing Exports conducted by the NIBM, it was pointed out that export credit facilities are usually available in the port towns and only in some of the inland centres. The NIBM has suggested 100 inland potential centres for intensification of financing and counselling facilities. The important point is that it is commercial banks with their widespread branches which can ensure the dispersion of credit to exporters even in the inland centres. Hence we do not expect that export credit arrangements will improve from the point of view of cost or availability if a specialised Export Bank is established.

11.25 Besides the argument relating to cost and availability of credit, it is also maintained that an exporter at present has to go to a number of institutions for fulfilling various requirements relating to export finance. For example, he has to go to a commercial bank for obtaining a loan, the ECGC for export credit guarantees, and the IDBI in the case of participation loan arrangements. With the establishment of an Export-Import bank, it is stated, the exporter can have dealings with only one single institution. It is also contended that the proposed bank can take care of the financing of import contents of exports. The problem arises in cases where imports are required to meet an export order. Hence, a manufacturer or the exporter may have to obtain an import permit, apply for foreign exchange and fulfil other formalities to carry out the order. The proposed institution, it is contended, can deal with all these problems.

11.26 It may be mentioned in this context that a Review and Standing Committee was set up in 1967, to ensure, among other things, co-ordination of functions of various bodies in the export financing field ; it consisted of representatives of Government of India, RBI, IDBI and ECGC. It is understood that this Committee has not met since August 1969. The Study Group feels that there is need for such a co-ordination of efforts and the Consultative and Informal Groups constituted by the IDBI (see paragraph 11.35) should be entrusted with this function.

11.27 Another point advanced in favour of establishing an Export-Import Bank is based on the need for meeting the credit requirements to finance import orders of large magnitude like purchase of ships, aeroplanes, etc. The argument implies that the proposed Export-Import bank can borrow in foreign capital markets more easily and more economically. This argument again is not a weighty one. For, if a foreign capital market is open to us, Indian commercial banks which have either foreign branches or correspondents abroad can raise loans in foreign markets for the purpose. Besides, many of these large imports are in the public sector and require special arrangements.

Insurance of Risks and Guaranteeing of Loans

11.28 Another argument advanced in favour of establishing a specialised Export Bank is that it would be able to give better insurance cover and guarantee for loans than are available under the ECGC schemes. At present, ECGC extends guarantee to commercial banks in respect of loans extended by them to exporters. Under its various insurance policies, the Corporation also covers political and commercial risks.

11.29 It is not pertinent to our purpose to analyse all the schemes of the Corporation.* We may, however, note that the Corporation has progressively liberalised and extended the coverage of its schemes. The shipments covered by ECGC as a proportion of India's total exports in 1970, worked out to about 7 per cent. But all the exports of the country do not need credit insurance cover. Over 55 per cent of the total exports are estimated to go against L/C and a substantial portion is exported on house to house basis. Also, exporters who have been dealing for long periods with well established customers abroad do not feel the need for credit insurance. Taking all these factors into account, it seems that ECGC coverage is not unsatisfactory. This is also shown by the fact that the ratio of insured exports to total exports even in some developed countries is not very high as compared to India. It is around 5 per cent in Australia, Belgium, Canada and Denmark and between 5 per cent and 10 per cent in Italy, the Netherlands, Switzerland and W. Germany. In U.K., however, where the oldest credit insurer operates, the percentage of exports covered by insurer is 30 — 35 of the total exports.† It may be pointed out that the principle of insurance requires that good business also should be secured to blend with the bad. It is for this reason that ECGC has recently offered to increase the percentage of cover to 75 and to lower the premium rate substantially, if a bank agrees to cover under ECGC's packing credit guarantee all its pre-shipment credit.

11.30 We may note the views expressed by commercial banks regarding the utility of ECGC policies. A majority of the banks in their replies to the Banking Commission's questionnaire felt that ECGC policies are beneficial both to banks and exporters. They have, however, given some suggestions for enhancing the utility and coverage of the Corporation's policies and guarantees. Some banks have stated that the Corporation should be prompt in settling claims under its various policies and guarantees. At present, it takes about 4 - 6 months to settle a claim. Also, the Corporation should not insist on covering all exports by an exporter. Some other banks have suggested that just as the Corporation's export production finance guarantee covers risks arising from insolvency or protracted default by the

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* For a recent and brief review of the policies offered by the ECGC, please see : T. R. Varadachary, *Export Credit Insurance in India*, Feb. 1971.

† *Ibid*, pp. 7-8.

manufacturer/exporter, the rejection and/or delay in disbursement of cash subsidy to the exporter by the Government on technical grounds should also be covered. ECGC should start, it is also suggested, giving covers for small amounts, say upto Rs. 5,000 without going in for reports on importers, because the policy would benefit the small exporters. It was also felt by some banks that there was considerable scope for reducing the premium charged by the Corporation. In this context, it was suggested that the Group Insurance Scheme which has become popular in Japan should be adopted by the Corporation.

11.31 We would commend the above suggestions for consideration by the ECGC. We strongly feel, however, that there is one risk in deferred payment exports which is not covered at present by the ECGC or by any other institution in India. Where an exporter expects to realise his proceeds after a long period, he runs the risk of exchange rate variation which may involve him in a substantial loss. The risk arises not because of day-to-day variations which are negligible, but because of the fear of large and sudden changes in the value of a foreign currency. Other countries also have no facilities to cover risks of fluctuations in exchange rates over a period longer than 6-12 months, but most of them overcome this problem by invoicing exports in their own currency. The alternatives available to an Indian exporter for covering the exchange risks are extremely limited. Forward cover is expensive, in view of the high premium involved and the short period cover available, namely, 6-12 months. Only two alternatives appear feasible. Exporters should endeavour for incorporating a 'gold clause' in their contracts which, however, may not be acceptable to the importer. Alternatively, the Indian exporter should invoice his goods only in Indian currency. This may also not be acceptable to all foreign importers. There is another point which deserves consideration, if this practice is followed on a large scale. In case the Indian rupee is devalued, the country may lose foreign exchange on account of the goods having been invoiced in Indian rupees, although the individual exporter will not be the loser. For all these reasons, we strongly feel that the authorities should devise a machinery for providing foreign exchange cover on reasonsable terms in respect of long-term deferred payment exports. We are aware of the practical difficulties involved, but the problem of covering the exchange risk in deferred payment exports is so important that it requires urgent attention.

11.32 We note that the absence of covering of such risks is a lacuna in the present export credit insurance schemes operating in India. At the same time, we feel that the establishment of an Export-Import Bank will by itself not solve the problem.

System of Collecting Information

11.33 It is sometimes contended that if an Export-Import Bank is established in India, it could more purposefully utilise the information which

is at present available with different institutions regarding foreign markets, creditworthiness of importers, etc. There is some substance in the point that at present, such information is available to a number of institutions in India but there are no arrangements for pooling it. A manufacturer who is a new entrant to the export business finds it particularly useful to get such information on his own. Commercial banks collect this kind of information through their foreign branches or correspondents. ECGC, it is learnt, has collected useful information relating to a large number of importers abroad. IDBI has its own system of collection of information. The Trade Development Authority, it is understood, will have its own arrangements to collect the required data. Some useful information is also available with the State Trading Corporation, Export Promotion Councils, Commodity Boards and large Export Houses.

11.34 There is at present no system under which the information available can be pooled. The collection of such information is costly and duplication of efforts as well as incurring of expenditure, part of which is in foreign exchange, could be saved if a system could be evolved under which the information could be pooled and made available to any institution which needs it.

11.35 Some steps are already under consideration for meeting this lacuna. The Trade Development Authority is expected to gather, co-ordinate and disseminate findings of market research conducted by various consultancy organisations including the Indian Institute of Foreign Trade. It is also expected to study the prospects for specific products, assess the need for product adaptation to suit demand in various markets, locate the individual buyers and arrange the corresponding exports. The NIBM at its Workshop suggested the creation of an Inter-bank Information Centre. Foreign Exchange Dealers' Association, it is learnt, is sounding its members on the feasibility of starting such a centre for the benefit of its members. IDBI has constituted informal consultative and working groups to utilise the information available within the country. We are of the view that IDBI is in an excellent position to obtain the information available within the country, keep it up-to-date and make it available to commercial banks and others on request and perhaps against a fee. Hence on this ground also, we do not see any reason for establishing an Export-Import Bank.

11.36 It is also sometimes suggested that if an Export-Import Bank is set up, foreign exchange leakage from the country would be plugged. The leakage of foreign exchange due to over-invoicing and under-invoicing of imports and exports respectively is estimated at Rs. 50 crores to Rs. 70 crores per year.† While we recognise the importance of the problem, we do not see the force of the argument because there is already a machinery for

† Minister of Finance gave these figures in his reply to a question in the Rajya Sabha on 8th June 1971.

checking up such leakage and the establishment of a specialised institution will not be helpful from this point of view.

11.37 A suggestion has also been made that a new institution should be set up to manage the business of foreign branches of the public sector banks* and this body can perform the functions of an Export-Import Bank by collecting and disseminating information and taking up other relevant functions. The basic arguments of the proposal of establishing an institution for managing the foreign branches of commercial banks are not relevant to our study. We feel, however, that if the suggestions made in paragraph 11.35 regarding the pooling of information are implemented there would be no need for the proposed body to take up this function.

11.38 It will be clear from the above analysis that it is not necessary to establish a new specialised institution to improve the export credit schemes in the country. Commercial banks, which in India, are multipurpose credit agencies are already extending export credit on reasonable terms. It is less costly for commercial banks to take up this work because they can combine it with their other activities. On the other hand, a centralised institution can confine its activities to financing export-import business. This concentration on one type of business can be a source of risk to the centralised institution. There is also the problem of resources. The proposed institution would not be able to mobilise additional savings because it would not be in a position to offer lucrative terms to savers, since its business will be confined only to exports and imports. Reliance on budgetary resources will be a burden on the exchequer and Reserve Bank finance will be inflationary. IDBI is performing a number of functions which are usually associated with an Export-Import Bank in foreign countries. We would, however, like to point out that the authorities should give more emphasis to the training of personnel in commercial banks. The appraisal of export credit proposals usually requires good understanding of financing foreign trade as well as term financing. Many banks are imparting the necessary training to their officers in their Foreign Exchange and Industrial Finance Departments and also by sending them to their own Staff Training Colleges or to the Bankers Training College of the Reserve Bank of India. We feel that the present arrangement will have to be strengthened in view of the increasing importance being given to exports and the need to ensure integrated finance to an exporter from commercial banks. We endorse the recommendation made by the NIBM that a programme should be prepared with the objective to help the banking industry to build up a cadre of executives for directing the export promotion activities of banks. The NIBM itself can play a leading role in this respect. Also, banks should play a more active role in locating, assisting and developing export potential in different regions of the

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* *Report of the Committee for Examining the Establishment of an Institution to Run Foreign Branches of Public Sector Banks & Allied Matters*, (Chairman : S. B. Kaji), 1970.

country. With their numerous branches they are in a good position to perform this function.

11.39 We may in the end mention another point. It is sometimes stated that in India we need an Export-Import Bank in order to facilitate foreign investments by India just as the Export-Import Banks of the U.S.A. or Japan do. We have not considered the problem from this angle because we feel that the stage has not reached when India can make massive foreign investments.

ANNEXURE

REFINANCE FROM RESERVE BANK OF INDIA TO SCHEDULED COMMERCIAL BANKS IN RESPECT OF EXPORT CREDIT

(Position upto 16.4.1971)

DATE OF CIRCULAR	N.L.R. POSITION	REFINANCE FACILITY		REMARKS
		AT BANK RATE	AT 4½%	
(1)	(2)	(3)	(4)	(5)
October, 1958.		Extension of Bill Market Scheme to Export Bills. All eligible scheduled banks, which were authorised dealers in foreign exchange.	—	Demand loans granted by scheduled banks to their constituents against the security of usance export bills drawn on any country outside India which is a member of the IMF and maturing within 90 days, were to be converted into usance promissory notes and were treated as security for advances under the scheme by the Reserve Bank. The Reserve Bank agreed to bear ½ of the amount of stamp duty. In January 1959 it offered to bear 3/4 of the stamp duty. In October, 1959, it offered to bear the whole stamp duty.
March, 1963.		Export Bills Credit Scheme was introduced. A distinction was made between Rupee Export Bills and Foreign Currency Export Bills. Under the Rupee Export Bills Scheme, loans by the Reserve Bank against rupee usance export bills could be made at the Bank Rate and would be treated as *additional* to the basic quota* of the bank concerned for borrowing at the Bank rate as well as additional to the overall borrowing quota of the bank.	—	Such loans, however, were to be granted on the condition that the borrowing bank among other things agreed to charge commission, interest or discount on the usance export bills at a rate not exceeding 1½% over the Bank Rate.

*At the time scheduled bank borrowing from the Reserve Bank was regulated by a system of quotas ; each bank was allotted a quota on the basis of its reserves and any borrowing over and above the quota was allowed at a higher rate.

ANNEXURE—(*Contd.*)

REFINANCE FROM RESERVE BANK OF INDIA TO SCHEDULED COMMERCIAL BANKS IN RESPECT OF EXPORT CREDIT

(Position upto 16.4.1971)

DATE OF CIRCULAR	N.L.R. POSITION	REFINANCE FACILITY		REMARKS
		AT BANK RATE	AT 4½%	
(1)	(2)	(3)	(4)	(5)
August 9, 1967.	Irrespective of NLR.	Re-introduction of Bill Market Scheme for Packing Credit and Extension of Export Bills Credit Scheme to "Other Currencies." In the case of packing credit advances to exporters of other products and in respect of post-shipment export credit.	In the case of packing credit advances to exporters of engineering and metallurgical products.	In order to ensure that the benefit of the lower cost is passed on to exporters, the Bank directed the banks to charge their exporter—customers rate of interest not more than 6% for their export credit in respect of packing credit advances to exporters of engineering and metallurgical products and not more than 8% for their other export credit, irrespective of whether or not they obtain refinance from the Bank in this regard. In regard to Rupee Export Bills, the rate of interest was not to exceed 1½% above the Bank Rate (*i.e.*, 7½%). For purpose of calculating the N.L.R. the increase in export credit over the base period will be added on to their actual net liquid assets.
February 3, 1968.	—	—	—	Banks agreed to charge not more than 7½% per annum on credit for exports other than engineering and metallurgical products as against the 8% rate charged until then. However, the ceiling rate of 6% in respect of packing credit advances to exporters of engineering and metallurgical products was kept unchanged. A concessional rate of 4½% was to be charged in respect of banks' borrowing equivalent to the increase in advance to three priority sectors taken together over the base period.
March 2, 1968.	—	—	—	The Reserve Bank prescribed ceiling rate of 6% for export credit.

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ANNEXURE—(*Contd.*)

REFINANCE FROM RESERVE BANK OF INDIA TO SCHEDULED COMMERCIAL BANKS IN RESPECT OF EXPORT CREDIT

(Position upto 16.4.1971)

DATE OF CIRCULAR	N.L.R. POSITION	REFINANCE FACILITY		REMARKS
		AT BANK RATE	AT 4½%	
(1)	(2)	(3)	(4)	(5)
June 15, 1968.	—	—	—	*Export Credit (Interest Subsidy) Scheme :* In order to alleviate the burden on account of granting export credits at concessional rate, the interest subsidy scheme was brought into effect from March 3, 1968 the amount of subsidy, so long as the rates on export credit charged by banks do not exceed 6% amounts to 1½% of the total outstandings subject to the provision laid down in the scheme.
October 26, 1968.	—		Refinance in respect of increments in banks' credit to *each* of the priority sectors, while in the past, it was in respect of increments in the *total of advances to the three sectors*. Such increments will continue to be excluded from the computation of the net liquidity ratio.	For the purpose of calculating the increments in respect of these three sectors, the base period is being brought forward by year, *i.e.*, it would be the increase in the average level of credit to each of these sectors in the period November 1968-April 1969 over the average level in the period November 1967-April 1968.
January 20, 1969.	–	..	—	Refinance to banks in respect of their pre-shipment (packing credit) advances which was hitherto provided under the liberalised Bill Market Scheme under 17(4)(c) would be made available under a new scheme (pre-shipment Credit Scheme) under 17(3A) of the R.B.I. Act. Under the revised procedure the banks need not be required to apply to the Reserve Bank for sanction of limits in respect of individual borrowers. The scheme is effective 1st February 1969.

ANNEXURE—(*Contd.*)

REFINANCE FROM RESERVE BANK OF INDIA TO SCHEDULED COMMERCIAL BANKS IN RESPECT OF EXPORT CREDIT

(Position upto 16.4.1971)

DATE OF CIRCULAR	N.L.R. POSITION	REFINANCE FACILITY		REMARKS
		AT BANK RATE	AT 4½%	
(1)	(2)	(3)	(4)	(5)
November 1, 1969.	Irrespective of N. L. R. Relief in computation of N. L. R. in respect of incremental credit to the export sector.	Against packing credit advances to exporters of goods other than metallurgical and engineering and against post-shipment usance export bills (both rupee and foreign currency bills).	(*i*) Against packing credit advances to exporters of metallurgical and engineering goods ; (*ii*) up to an amount equivalent to the increase in export credit over the prescribed base period.	The base period during the busy season 1969 will be November 1968 to April 1969 and during the succeeding slack season May to October 1969.
February 18, 1970 and February 28, 1970.	Irrespective of N. L. R. The relief given by adding the increase in a bank's advances relating to exports over the prescribed base period for computing the net liquidity ratio was withdrawn.	—	Upto an amount equivalent to the *increase* in export credit over the prescribed base period.	The base period for *calculating the increase* will be the *average level* of such credit in the corresponding *calendar quarter* of the previous year, *e.g.*, for the quarter January-March 1970 the base will be the average for the quarter January—March 1969.
November 17, 1970.	—	—	—	The base period for calculating the increase will now be the average level of such credit in the corresponding calendar quarter of the previous year, *e.g.*, for the quarter October-December 1970 the base will be the average for quarter October-December 1969 and similarly for the quarter January-March 1971, the base will be the average for quarter January-March 1970.

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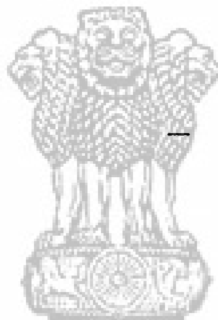
ANNEXURE—(*Contd.*)

REFINANCE FROM RESERVE BANK OF INDIA TO SCHEDULED COMMERCIAL BANKS IN RESPECT OF EXPORT CREDIT

(Position upto 16.4.1971)

DATE OF CIRCULAR	N.L.R. POSITION	REFINANCE FACILITY		REMARKS
		AT BANK RATE	AT 4½%	
(1)	(2)	(3)	(4)	(5)
February 20, 1971.	Irrespective of N. L. R.	An amount upto 10% of the annual average export credit in 1970.	Any additional amount equal to 10% of the annual average of export credit in 1970.	Annual average of export credit is calculated as the average of the outstanding level of export credit during 52 weeks. Effective 26.2.71. Benefits under Cols. (3) & (4) will not be taken into account while computing the net liquidity ratio of a bank and will not, therefore, impair its net liquidity ratio till 31.12.1971.
April 16, 1971.	—	—	—	Ceiling rate for credit for exports other than those on deferred payment terms (in which case the existing ceiling rate of 6% per annum continues) is raised to 7% per annum with immediate effect.



CHAPTER 12

THE NEED FOR A SMALL SCALE INDUSTRIES BANK

THE PURPOSE

12.1 Small scale industrial units, defined as those with fixed capital and equipment worth upto Rs. 7.5 lakhs per unit, have in recent years grown in importance mainly in view of their output and employment generating potential. It is estimated that small scale units registered with directorates of industries in all the States were 1,22,848 in 1967, about 1,78,000 in 1969, and more than 2 lakhs at the end of March 1971. It is believed that the number of unregistered small scale industrial units would be roughly double the number of registered units. In other words, small units, both registered and unregistered, would total about 6 lakhs by the end of March 1971. The national income statistics which cover village and small scale industries as a whole, show that the contribution of small scale manufacturing to net national product is noteworthy ; from Rs. 785 crores in 1960-61, it rose to Rs. 1,456 crores in 1967-68, at current prices. Evidently to produce such a sizeable output (in value terms), each unit would need finances that may not be, and usually cannot be, met out of its own resources. Borrowing funds for fixed capital and/or working capital purposes is therefore common. It is generally agreed that institutional sources should increasingly provide funds to the units which need them, so that the unorganized credit agencies could gradually be eliminated and credit would be relatively less costly. The requisite funds may be either channelised through the existing institutional agencies or through the creation of an apex financial body exclusively for the purpose of meeting small scale units' financial needs. The purpose of this chapter is to examine the need for a Small Scale Industries Bank at the all-India level in the light of the adequacy or otherwise of the existing institutional arrangements, keeping in view the expected credit needs of small scale industries.

ROUGH ESTIMATES OF CREDIT NEEDS

12.2 An accurate assessment of credit needs of small scale industries for fixed or working capital purposes is not easy in view of the enormous gaps in data regarding the total number of units, functioning units, the gross and net outputs produced by different sizes of units and the raw materials used and inventories held by them. The primary sources of information are extremely limited. As a result, estimates of credit needs would necessarily be in the nature of approximations. The Small Scale Industries Develop-

ment Commissioner's Office (SSIDO) estimated fixed investment needs for the Fourth Plan period at Rs. 390 crores **; this estimate, however, may have to be revised upward to about Rs. 425 crores if the government decision to reserve additional 65 industries in the small scale sector is taken into account.† The SSIDO estimated the aggregate working capital requirements for the estimated fixed investment by the end of the Fourth Plan period at about Rs. 1,000 crores.@

SOURCES OF FINANCE FOR LONG AND SHORT-TERM NEEDS

12.3 The institutional agencies that presently finance long-term and medium-term financial requirements of modern small scale industries are : (1) the State Governments giving loans under State Aid to Industries Acts/Rules; (2) State Financial Corporations ; (3) National Small Industries Corporation (NSIC) which supplies machinery on hire-purchase basis ; (4) State Small Industries Corporations (SSICs) and State Industries Development Corporations (SIDCs) ; (5) State Bank of India, its subsidiaries and other commercial banks ; and (6) the State Government which builds factory accommodation to accommodate industrial estate. The sources that usually finance short-term capital needs are : the State Bank of India and other commercial banks. There are in addition two special agencies—State Industrial and Investment Corporation of Maharashtra (SICOM) and Gujarat Industrial Investment Corporation (GIIC). Industrial co-operative banks and urban co-operative banks as well as the State and central co-operative banks have been giving financial accommodation to small scale industries mostly in the 'traditional' sector, small artisans and

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** The methodology of SSIDO in estimating credit requirements for fixed capital purposes may be briefly stated. On the basis of growth trends during the 1960-64 period in the net value added in small scale factories under the purview of the SSIDO, figures of further production for 1968-69, and for 1973-74, were worked out. They were adjusted to a certain extent keeping in view the likely fuller utilisation of capacity (with increased availability of raw materials) and the adoption of improved production techniques, modernization, etc. Thus the fixed capital requirements for the factories in the SSIDO's purview for the Fourth Plan period has amounted to Rs. 180 crores. SSIDO then estimated additional fixed investment in the unorganized sector, by observing the trends in the contribution of the units in the unorganized sector to national income and then making an adjustment for the likely utilisation of capacity and adoption of improved techniques in the unorganized sector. This estimate was Rs. 175 crores. Additional fixed investment by units now falling in the small scale sector in view of the change of definition of small scale industry effected in 1965, was estimated at Rs. 35 crores. In all, thus, additional fixed capital requirements in the entire small scale sector under the purview of the SSIDO during the Fourth Plan period worked out to Rs. 390 crores.

† By the end of March 1971, 73 new items were actually added to the original list of 55 items reserved exclusively for the small scale sector. If 73 industries in the small scale sector are taken into account, credit needs on account of fixed and working capital purposes will go up slightly over the figures mentioned here.

@ The method of estimation used by SSIDO is as follows : The rates of working capital per rupee of fixed investment in the organised sector yielded the working capital needs of Rs. 340 crores in 1968-69, and Rs. 570 crores in 1973-74. As for the unorganised sector, the requirements were Rs. 410 crores in 1968-69, and Rs. 630 crores in 1973-74, based on the assumption that the ratio of working capital to fixed capital is 55:45. If Rs. 50 crores are allowed for working capital needs of units transferred from the medium to small scale sector since 1965, the total working capital requirements by the end of the Fourth Plan, would be Rs. 1,250 crores. But in view of the much better availability of raw materials, lesser needs for the maintenance of inventories at a high level, the total working capital requirements are likely to be somewhat lesser at around Rs. 1,000 crores.

craftsmen. Indigenous bankers have also been advancing loans to small traders and small industrial units to the extent of about one-third of their total advances.

Advances by Commercial Banks

12.4 Judged by the amounts lent and the number of units assisted, commercial banks are the most important agencies financing short-term needs of the small scale sector. Table 12.1 gives details of commercial banks' advances. Outstanding balances to the tune of Rs. 469 crores were given to 99,788 units by the last Friday of December 1970, whereas the limits in force were Rs. 856.2 crores. These figures include advances given by commercial banks to traditional industrial units like flour and rice mills, and oil-crushing units. It may also be noted that the outstanding balances included term loans sanctioned to the units. It may be seen that there was an increase in the total outstandings between March 1969 and March 1970, of the order of Rs. 132 crores, showing a rise of 50 per cent in one year. The number of units assisted during 1969-70, increased by about 64 per cent. Between the end of March and the end of December 1970, outstanding advances increased by Rs. 75 crores, *i.e.*, by 19 per cent. In the same period, limits in force increased by Rs. 107 crores, *i.e.*, by 14 per cent, thus indicating the growing involvement of commercial banks in financing small scale industries.

Term Loans by Banks and SFCs

12.5 With regard to long-term loans, clearcut detailed data are not as yet available. By March 1970, the State Bank of India and its subsidiaries had sanctioned Rs. 30 crores as term loans and instalment credit. The balance outstanding as on that date, however, was Rs. 18 crores for 4,203 units. The SFCs, which usually grant term loans, disbursed to small industries Rs. 16 crores in the three-year period 1966-69, and Rs. 13 crores in one year (1969-70) alone. The data about term loans given by other commercial banks are not available but it is estimated that the outstanding term loans of these banks at the end of March 1970, would be about Rs. 7 crores.

Other Institutional Credit

12.6 We have in Table 12.2 the latest available position regarding assistance rendered to small units by different institutional sources. As far as possible, the outstanding balances, as of March 1970, of the different sources are taken into account. *Net* annual disbursements of the different sources are not available. The table shows that the outstanding advances of SSICs seem to be the lowest of all, at about Rs. 1-2 crores. SIDCs fared only slightly better ; their outstanding advances being Rs. 2.71 crores by

the end of March 1970. SICOM with outstanding advances of Rs. 3.05 crores by March 1970, commercial banks' advances for setting up of industrial estates for small units of Rs. 0.36 crores by the last Friday of March 1970, LIC's loans to State Governments for purposes of building up industrial estates to the tune of Rs. 1.14 crores as at the end of March 1970, and the disbursements of the GIIC and the State Industries' Departments for the periods 'upto 31st December 1969' and 1968-69, respectively, were relatively small contributors to the development of small industries. Advances outstanding with the SFCs and with the commercial banks were by far the largest of all the sources mentioned. The industrial and Urban as well as State and central co-operative banks have also in a limited way helped in the financing of small units in the traditional and village industries' sector. From the replies received from different co-operative institutions to the Banking Commission's questionnaire, it, however, appears that advances to small scale and cottage industries by State and central co-operative banks as well as urban co-operative banks amounted to only about 1.7% of their total advances as on 30th June 1969.† The table clearly shows that commercial banks and SFCs are by far the most important institutional arrangements for financing the short and long-term needs of small industrial units.

ADEQUACY OF CREDIT BY BANKS AND SFCs WITH REFERENCE TO THE FOURTH PLAN'S FIXED CAPITAL NEEDS

12.7 A question that may be pertinently asked is whether the credit needs of the small sector for fixed and working capital purposes during the Fourth Plan period can be met by the commercial banks and the SFCs. It has already been stated that the expected fixed investment requirements during the Fourth Plan period would be about Rs. 425 crores. If it is assumed that about 25 per cent of fixed investments are undertaken by self-financing units, and if a margin of about 35 per cent is placed by borrowers on their borrowings against fixed assets,* the total requirements for borrowing for fixed capital purposes would be around Rs. 210 crores. According to present trends and thinking, SFCs will bear greater responsibility of term lendings. Hence, if they are assumed to bear two-thirds of the term loan requirements, then they would have disbursed by the end of the Fourth Plan period Rs. 140 crores for meeting additional fixed capital needs of small units. It is then obvious that other institutions would have to come forward to meet the uncovered portion of the estimated fixed capital needs. Com-

† As on 30th June 1966, loans given to industrial co-operative societies by State and central co-operative banks together amounted to Rs. 44.5 crores and those given by State and central industrial co-operative banks to Rs. 3.5 crores ; loan outstandings of urban co-operative banks were Rs. 1.2 crores. (*Report of the Working Group on Industrial Financing through Co-operatives*, Reserve Bank of India, 1968, pp. 19-20).

* Informal enquires with selected commercial banks indicated that the margins varied anywhere between 25% and 50%. But many seem to keep margins against plant and machinery at about 35%.

mercial banks will obviously have to play a major role in filling up this gap. Commercial banks had recorded total outstanding loans for fixed capital as at the end of March 1970, at about Rs. 25 crores (consisting of SBI Group's outstanding balances at Rs. 18 crores and other commercial banks' balances estimated at Rs. 7 crores). Assuming that one-half of this quantum was disbursed net of repayments during the year ended March 1970, *i.e.*, about Rs. 13 crores, then it is necessary that banks should increase term advances *each year* by about 20 per cent during 1970-74, in order that net disbursements for fixed capital purposes of the small units would be about Rs. 90-95 crores. Besides, the SFCs and commercial banks, there is the NSIC which is expected to disburse about Rs. 15-20 crores over the Fourth Plan period. In all, therefore, the SFCs, commercial banks and NSIC may be expected to meet the fixed capital requirements of the small scale sector to the extent of Rs. 210 crores.

12.8 The Group believes that apart from the fact that this figure cannot be easily reached, the amount of work involved in the scrutiny and processing of the applications for term loan assistance would be enormous. Commercial banks and SFCs will need to have adequate and trained personnel for the purpose, besides the supervisory staff to check whether these applications are well supported by facts as specified in the forms.

Adequacy of Bank Credit with Reference to the Fourth Plan's Working Capital Needs

12.9 The working capital requirements of the small scale units during the Fourth Plan period are, as we have seen, estimated at about Rs. 1,000 crores. We have also seen from Table 12.1 that the outstanding loans rose from Rs. 189.8 crores as at the end of June 1968 to Rs. 285.6 crores at the end of June 1969, *i.e.*, by about 50 per cent. Similarly, between March 1969 and March 1970, the outstanding advances to small scale units rose by about 50 per cent. These trends give an idea of the increasing importance attached by scheduled banks to the development of small scale units. We are aware that the data pertain to only a short period, and hence no trends can be clearly established on this basis. However, keeping in view the objectives of developing small units and the increasing involvement of commercial banks in extending credit to the small scale sector, net disbursements may be assumed to rise by about Rs. 1,000 crores during the Fourth Plan period. The Group is aware that in the context of overall shortage of resources, additional flows of credit to one sector may affect the availability of credit to other sectors. Also, in order to meet the Plan targets, the commercial banks will require considerable manpower and management resources to scrutinise applications, process the loans and supervise regularly the performance of the borrowing units.

The Question of Creation of an Apex Institution

12.10 Although the commercial banks and SFCs seem to be capable of largely meeting the fixed and working capital requirements of the small sector during the Fourth Plan period, the inference cannot automatically be drawn that there is no room for improvement. In this context, the Group has closely gone into the arguments in favour of as well as those against the creation of an apex institution. These arguments may be classified into: (*A*) those that are based on the adequacy/inadequacy of present financing agencies, and (*B*) those that indicate merits/demerits in establishing altogether a new financial institution. These arguments may now be enumerated.

Arguments in Favour of Creating an Apex Body

12.11 Those who favour the creation of such an apex body place the following arguments, under (*A*) : (1) The apex body will be more suitable than either the commercial banks or the SFCs because, (*a*) banks, which have to cater to the credit needs of many other sectors, do not pay sufficient attention to small units ; (*b*) banks think that servicing of small loans is cumbersome and expensive ; (*c*) banks do not realize that small units often need urgently cash and therefore the units frequently turn to non-institutional sources for ready cash even at high rates of interest ; and (*d*) SFCs, with their limited funds and fewer branches and with no administrative control over them of the IDBI are more suited to finance medium industries. (2) 'Smaller' of the small units do not now receive as much attention as needed, as evidenced by the fact that advances of Rs. 50,000 and less from the SFCs were hardly 16.6 per cent of the total advances to the sector in 1969. They could get the needed credit from the proposed apex institution.

12.12 The arguments falling under (*B*) in favour of the apex institution are the following : (1) The apex body will finance long-term and medium-term needs (for mechanization and modernisation) of small scale sector. This might make the prices of products produced by small units competitive with the prices of products of large and medium scale sectors. (2) The apex body will be able to give purposive direction to the possibilities of raising exports in this sector. (3) The apex body could pay undivided attention to the problems of this sector which is expanding. It will be able to provide working capital requirements of this growing sector better than banks or other financial institutions. (4) The apex body could also evolve a credit policy for promoting balanced regional development and thus even out backwardness of some of the areas in different states. (5) The apex body will co-ordinate activities of and particularly credits granted by different institutions at present financing the small scale sector.

Arguments Against the Creation of an Apex Body

12.13 As against these arguments in favour of creating an apex institution to finance and provide small scale industries, the following arguments may be placed against the establishment of such an apex body under (*A*) : (1) It was noticed that commercial banks, particularly in 1969-70, had increased credit for small scale sector, and had attempted to take some steps to train personnel, delegate powers to bank managers and simplify procedures in the credit applications. In answer to Banking Commission's questionnaire, it was found that 60 per cent of the 60 reporting banks stated that they actively seek out small units on their own.† (2) The technical appraisal of the applications would need professional expertise which banks already possess in some measure and are willing to acquire gradually as facilities of training increase. It may be noted in this connection that the service institutions do not seem to have done an adequate job of training personnel for evaluating the creditworthiness of the units. In fact 10 banks in reply to the Commission's questionnaire had stressed that Small Industries Services Institutes should render their assistance in giving quickly feasibility reports and guidance in preparing projects at reasonable rates. Over time, however, it is reasonable to expect a rise in the trained personnel in the banks, either through their own training colleges or/and service institutes, for making appraisal of the applications speedily and efficiently. The proposed apex body in any case will also have to train its personnel for the purpose. This will take time. There is, therefore, no need for creating a special financing institution in place of the already existing financial agencies. What is really needed is a non-financing multi-services agency like the one suggested recently by Thakkar Committee‡, which will be a co-ordinating/planning/advisory body providing technical assistance and information about the possible sources of credit to the self-employed and small units about the feasibility of their projects and providing guidance about the availability of raw materials, marketing prospects, management of resources, etc. (3) Banks have shown in recent months awareness of the productivity aspect in the loan asked for. They realize that once the units employ credit fruitfully, defaults in returning loans would be rare. They have also managed to reduce the average amount of loan sanctioned per small unit from Rs. 96,400 in June 1968, to Rs. 91,700 in April 1970, thus indicating a preference for financing 'smaller' of the small units. It is, therefore, not correct to say that an apex body could be created in view of the banks neglecting smaller of the small units. (4) Banks have found a profitable outlet in financing of the small scale sector mainly because of the availability of liberal refinance facilities from the Reserve Bank of India and the Industrial Development Bank of India. Moreover, the Credit Guarantee Scheme of

† For questions, please refer to Appendix III.

‡ *Report of the Committee to Review the Special Credit Schemes of Banks with Particular Reference to their Employment Potential*, (Chairman: Shri V. D. Thakkar), Supplement to the Reserve Bank of India Bulletin, February, 1971.

the Government of India minimizes risk on credit advanced by major institutional credit agencies. (5) Banks have tried to encourage technically qualified unemployed persons to establish small units, but they received very few applications from such persons. There is no evidence to suggest that this class of persons will show better response if an apex body is established. (6) Banks are widespread and can cater to the needs of the widely scattered small units all round the country. Even if an apex body is created, it has to operate through banks mainly because it will have no branches at least in the beginning. Agency arrangements, therefore, will have to be made in such a situation. There is no reason why banks should not directly finance units and be *not* merely agents of some other agency. (7) SFCs have so far performed a useful role in financing small scale industries, although they can still liberalise the terms and procedures and grant more of small-sized loans.

12.14 The arguments against the creation of Small Scale Industries Bank at an all-India level falling under (*B*) may be stated thus : (1) There will be little for the proposed body to co-ordinate the activities/operations of different institutions financing the small scale sector. For, the Industrial Finance Department of the Reserve Bank of India has already been watching the developments in this regard. An apex body created for the same purpose will, therefore, mean a mere duplication of the function already performed in the existing arrangement. (2) The Development Commissioner for Small Scale Industries at the Centre pools together the work done by various Directors of State Industries Departments and collects statistical information regarding technical, managerial, marketing and financial aspects of small scale units. Since development of small scale industries is essentially a State subject and since they are widely scattered, a central financing agency will find it extremely difficult to probe into the problems of this sector in depth from any one place. (3) The proposed apex body would naturally require funds to operate. It is not clear whether it should be set up and operated with funds from the Government budget or the Reserve Bank or with the help of deposits drawn from the public. Funds drawn from the budget or the Reserve Bank do not indicate new resources mobilisation. Even if the proposed institution is able to attract deposits from the public, it may only mean a transfer of savings from the existing institutions to the new institution. Hence the problem of resources cannot be solved by creating a new body. (4) If the apex body charges less than what the banks and the SFCs charge on their loans to small units, then it will necessarily have to pay lower rate on the funds borrowed by it, in which case it is doubtful if it could mobilise on its own adequate resources from the public directly. (5) Creation of apex body would leave an adverse pscychological impact on the efforts now being put in by the banks, and other institutional agencies (*e.g.*, the SFCs) in as much as the onus of financing small units would shift from them to the proposed institution. (6) The apex body would have to scrutinize the applications in the same technical manner as the present

financial institutions. There is therefore no special advantage in having an apex body. This will hardly help 'smaller' of the small units.

The Group's Recommendation

12.15 After carefully weighing the arguments advanced in favour of as well as against the creation of an apex institution for promoting and developing small scale units, the Group has come to the conclusion that there is no need to create a separate apex body for the purpose. The Group thinks that the existing institutional agencies have been helping the small scale units to the best extent possible, especially since social control and nationalisation of 14 major banks. The Group believes that with the strengthening of the agricultural base (which provides a large amount of raw materials) and basic industries and technical expertise, both the quantum of loans made by commercial banks to small units as well as the method and procedures of giving loans to them would be better.

Preponderance of Proprietary/Partnership Firms in Small Scale Sector

12.16 It is necessary, however, to note the limitations faced by institutional agencies in financing small scale units. It seems that a large number of units are proprietary firms or partnership concerns. This aspect makes it difficult for banks to finance the units because maintenance of accounts by partnership and proprietary concerns often is found to be haphazard and disorderly. In reply to Banking Commission's questionnaire, many commercial banks reported that most of the small units do not maintain their accounts properly, let alone have their accounts audited. Banks, therefore, find difficulty in judging the functioning and performance of units while processing their applications.

Partnership with Limited Liabilities—A Suggestion

12.17 One of the ways by which small industries' development could be accelerated is to make suitable provisions to effect change in the status of organization. Instances are also seen with technically qualified persons promoting small scale industries without enough funds, and willing to have partnership with those who could provide the needed funds. Since such partnerships are of unlimited liability, the risks in becoming partners in such ventures are high. Therefore, those who have funds do not come forward to help the technically qualified persons who have promoted the concerns. In order to make partnerships attractive enough for those who have funds, it is suggested that limited liability of some of the partnerships in certain circumstances may be made legal as in the United Kingdom. If this idea should be given effect to, an amendment to the Indian Partnership Act, 1932, may become necessary.

The Working of the Credit Guarantee Scheme

12.18 The Group's belief that the existing institutional arrangements—especially banks—would to a large extent meet the financial requirements of small units is to some degree influenced by the changes introduced recently in the Credit Guarantee Scheme. The Credit Guarantee Scheme has 78 approved credit institutions (including all the major commercial banks and SFCs) and has covered 1,52,240 applications that have come up for guarantee from July 1960 to the end of December 1969. Since 1st February 1970, the system of submission of individual application for guarantee by the approved credit institutions in respect of each credit facility has been dispensed with. The guarantee is made available to all eligible advances on an *automatic* basis subject to each approved credit institution entering into an agreement with the Guarantee Organisation. The approved institutions are now required to submit a quarterly statement containing particulars of all eligible loans and advances, which form the basis for charging the guarantee fee. This change in procedure has two objectives : (*a*) it will save labour for the credit institutions, and (*b*) it will in all probability expedite the flow of credit to the small industries sector. Surprise inspections of the approved credit institutions are undertaken by the Credit Guarantee Organisation on a sample basis to make sure that the quarterly statements submitted to it are regular and correct. The scheme covers *all* credit facilities allowed to small units with the exception of performance guarantees issued on behalf of constituents. The guarantee cover which depended on the limits sanctioned, its utilisation and the ultimate amount defaulted by the borrower has *now* been replaced by a fixed percentage of 75 per cent of the amount defaulted or the amount guaranteed whichever is lower. Again the maximum amount recoverable from the Guarantee Organisation is *now* Rs. 7.5 lakhs in respect of working capital advances and a further Rs. 2.5 lakhs in respect of term loans *per borrower*, as against Rs. 2 lakhs allowed *per account* formerly. These major changes in the scheme which incidentally have also been suggested by most of the respondent banks to the Commission's questionnaire are expected to expedite the flow of credit to small industries sector. The Credit Guarantee Scheme has already covered more than 50 per cent of the registered small scale units all over the country looking at the fact that more than 1,52,000 applications were received by the organisation upto the end of 1969, under the scheme. The existing credit institutions approved by the Guarantee Organisation, it is implicit, would have thus given credit to about 70 per cent of the registered units. Now with the introduction of automatic guarantee for the eligible advances from the approved credit institutions, it is obvious that the credit institutions—particularly major commercial banks and SFCs—would have to raise their advances to (*a*) cater to the 25-30 per cent of the registered units which are left out of the purview of loan-making, and (*b*) meet the working and fixed capital requirements of the registered units. Such a wide coverage of units and an extension of additional credit would imply putting a greater pressure on

the organisational and personnel apparatus now available with the commercial banks and SFCs.

The Group's View on Specialisation in Small Industries' Advances by a Few Banks

12.19 The Group has also considered the suggestion of asking one or more banks, especially the nationalised commercial banks to specialise in the financing of small scale sector on the basis of (*a*) its/their absolute level of advances to the small sector over a period of time, and (*b*) the relative importance of such advances in its/their total advances as well as in the total of loans given to the small scale sector as a whole by the banking system. Table 12.3 gives details of advances to the small scale sector by the State Bank of India Group and 14 individual banks which were nationalised in July 1969. It shows that there were two banks—Bank of Maharashtra and Indian Overseas Bank—which gave advances to small scale sector upto about one-fourth of their total advances in June 1969. In December 1970, there was only one bank—Bank of Maharashtra—which lent to small scale industries (SSI) sector upto about 21 per cent of its total advances. Among the banks which lent more than 10 per cent and less than 20 per cent of their total advances to the SSI sector in June 1969, were : Canara Bank, Dena Bank, Syndicate Bank and Indian Bank. In December 1970, the banks which lent more than 10 per cent but less than 20 per cent of their total advances were State Bank of India Group, Canara Bank, Dena Bank, Syndicate Bank, Union Bank of India, Indian Bank and Indian Overseas Bank. It may be observed that the proportions registered by the Indian Bank, Bank of Maharashtra and Indian Overseas Bank in December 1970, were lower than the proportions recorded against them in June 1969. The performance of United Bank of India and Union Bank of India in this regard appears to be very satisfactory. If judged by the yardstick* of the proportion of an individual bank's advances to the SSI sector to their individual aggregate advances as in December 1970, the task of specialisation should go, in the order of importance, ignoring for the present the State Bank of India Group, to Bank of Maharashtra, Indian Overseas Bank, Dena Bank, Union Bank of India, Syndicate Bank, Canara Bank and Indian Bank in case seven banks should be chosen. But it may be observed that the advances of none of these banks considered individually, to the SSI sector in December 1970, as proportion of the total advances to the sector by *all scheduled banks* amounted to even 5 per cent ; they ranged in fact between the lower limit of 1.5 per cent and upper limit of 4.5 per cent. Again, they are largely concentrated in the States of Gujarat, Maharashtra, Mysore and Tamil Nadu with large number of branches in bigger towns. Their spread in other States is very limited. In so far as the State Bank of India is concerned, its branches are widespread. Its loans to the small scale sector formed about 14 per cent of its total advances and about

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* This yardstick is indicative of the fact that these banks have the necessary organisational ability to deal with such a large proportion of advance-making to the SSI Sector.

40 per cent of the commercial bank advances to the SSI sector as a whole in December 1970. This predominant position of the State Bank of India seems to be mainly due to the organisational arrangements it has made to suit the SSI sector. It had set up separate and specialised departments at the Local Head Offices/Head Offices of the Bank (and its subsidiaries as well) to look into the financing of small units. Besides, there were programmes of personnel training and seminars for the purpose. It built up a cadre of technical staff of its own to make technical appraisal of proposals. Despite this enormous involvement in the financing of small scale industries, the State Bank of India has not remained a mere small industries bank. In so far as State Bank subsidiaries and non-nationalised banks are concerned, the limitations in specialisation mentioned in the case of 14 nationalised banks, will be more forcefully applicable. The Group, therefore, does not favour specialisation in small scale industrial financing by any commercial bank.

The Group's View on the Creation of a Non-Financing Multi-Services Agency

12.20 In view of the Group's thinking that the present institutional arrangements *can* accelerate loans to small scale sector provided they have trained personnel to scrutinize and process the applications, supervisory staff to check information and basic economic and technical information about the units in the region concerned, the Group endorses the Thakkar Committee's recommendation for setting up a non-financing multi-services agency. The Thakkar Committee's proposed multi-services agency will be a co-ordinating/planning/advisory body providing technical assistance and information about the possible sources of credit to the self-employed and small units about the feasibility of their projects and providing guidance in regard to the availability of raw materials, marketing prospects, management of resources, labour laws, taxation and accounting problems, etc. According to the Committee, the cost of running the agency will have to be borne by the participating banks at the centre where it is established. The Committee also felt that organisation and administration of the Agency at a particular centre will be entrusted to one of the participating banks, called the 'Convener bank'. The Committee held that the proposed agencies will be self-contained independent units ; they can work with experts on a part-time basis.

Conclusions

12.21 The Group has made its recommendations only with respect to the financing of small scale industries. It may be emphasised that finance is only one of the many 'inputs' which should be assured to the small scale sector for its development. The Group, however, has not gone into this aspect of the question. Our analysis pertained to an examination of the

need for creating a Small Scale Industries Bank at the all-India level. But the Group believes that it is also applicable to all units which do small business but are usually not categorised as 'small scale industries'. The recommendations are summarised as follows :

(1) There is no need to create a separate apex body for financing small scale units.

(2) The estimated requirements, on account of fixed and working capital purposes, of small scale sector during the Fourth Plan period are very large and may not be easily met by the existing institutional agencies, particularly the commercial banks and SFCs. Apart from the difficulty in meeting the credit needs for fixed and working capital purposes of small units, the task requires the existing credit agencies to have adequate and trained personnel to scrutinise applications, process the loans and supervise regularly the performance of the borrowing units.

(3) One of the limitations faced by the existing institutional agencies in lending to small units is the absence of maintenance of proper accounts on the part of most of the units. Most of the units are proprietary firms or partnership concerns. To make partnerships more attractive and viable, limited liability of some of the partnerships in certain circumstances may be made legal.

(4) No commercial bank should confine itself as to financing of small scale industries only.

(5) There is need for establishing non-financing multi-services agencies at different centres.

सत्यमेव जयते

TABLE 12.1—ADVANCES BY SCHEDULED COMMERCIAL BANKS TO SMALL SCALE INDUSTRIES

(As on the last Friday)
(Rs. in crores)

	June 1968			March 1969			June 1969			March 1970			December 1970		
	No. of Units	Limits in force	Balance out-standing	No. of Units	Limits in force	Balance out-standing	No. of Units	Limits in force	Balance out-standing	No. of Units	Limits in force	Balance out-standing	No. of Units	Limits in force	Balance out-standing
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
State Bank of India & its subsidiaries	18715	124.6	66.8	24069	179.2	93.1	25902	212.6	103.0	36935	276.9	152.2	46796	320.1	187.8
14 Nationalised Banks * ..	15652	207.0	100.1	20057	270.0	135.8	24948	312.5	148.1	37072	393.4	198.7	44426	449.0	232.6
Other Scheduled Commercial Banks	4560	43.7	22.9	5605	59.1	32.8	6133	67.4	34.5	7718	79.0	43.0	8566	87.1	48.7
All Scheduled Commercial Banks	38927	375.3	189.8	49731	508.3	261.7	56983	592.5	285.6	81725	749.3	393.9	99788	856.2	469.1

* Nationalised in July 1969.

Source : Reserve Bank of India Bulletins, July 1970 and June 1971.

TABLE 12.2—FINANCIAL ASSISTANCE TO SMALL SCALE INDUSTRIAL UNITS BY INSTITUTIONAL SOURCES

Sr. No.	Institutional sources	Period of reference	Amounts (Rs. crores)	No. of units assisted or No. of accounts/ loans
1.	2	3	4	5
1.	Under State Aid to Industries Acts/ Rules	1967-68	3.05 (disbursed)	13990 (No. of loans)
		1968-69	3.22 („)	11495 („)
2.	State Financial Corporations ..	March 31, 1970	32.13 (Outstanding)	6818 („)
3.	(A) SBI Group	March 1970	152.2 („)	36935 (No of units)
	[Of which term loans and instalment credit	March 1970	18 („)	4203 („)]
		December 1970	187.8 („)	46796 („)
	(B) 14 Nationalised Banks ..	March 1970	198.7 („)	37072 („)
		December 1970	232.6 („)	44426 („)
	(C) Other Scheduled Banks ..	March 1970	43.0 („)	7718 („)
		December 1970	48.7 („)	8566 („)
	Total of (A+B+C) ..	March 1970	393.9 („)	81725 („)
		December 1970	469.1 („)	99788 („)
4.	National Small Industrial Corporation (NSIC)	31st March 1970	16.31 (outstanding)	About 10-12 thousand units
5.	State Small Industries Corporations (SSICs)		(Expected to be Rs. 1-2 crores)	
6.	State Industries Development Corporations (SIDCs)*	End of March 1970	2.71 (outstanding)	Not available
7.	Advances for setting up of Industrial Estates for Small Scale Industries by commercial banks	Last Friday, March 1970	0.36 („)	31 (No. of Accounts)
		Last Friday, December 1970	3.16 („)	28 („)
8.	State Industrial and Investment Corporation of Maharashtra Ltd. (SICOM)	March 1970	3.05 („)	232 (No. of units)
9.	Gujarat Industrial Investment Corporation	31st December 1970	24.10 (Sanctioned)	Not available
10.	Industrial Co-operative Banks ..	30th June 1966	1.89 (outstanding)	793 units
11.	Urban Co-operative Banks ..	„	1.17 („)	444 units
12.	State Co-operative Banks ..	„	26.95 („)	231 units
13.	Central Co-operative Banks ..	„	16.51 („)	4254 units
14.	Life Insurance Corporation of India	As on 31st March 1970	1.14 („)	

* Data of SIDCs of West Bengal, Kerala and Tamil Nadu for both large and small industries.

Sources: Data collected from different annual reports of the Corporations, the Report of the Office of the Development Commissioner (SSI), Reserve Bank of India Monthly Bulletins, 13th Statutory Report of the Life Insurance Corporation of India and Report of the Working Group on Industrial Financing through Co-operative Banks.

TABLE 12·3—ADVANCES TO SMALL SCALE INDUSTRIES BY THE SBI GROUP AND 14 NATIONALISED BANKS

	As on the last Friday of									
	JUNE 1969				DECEMBER 1970				JUNE 1969	DECEMBER 1970
	Advances to SSI (Rs. crores)	% age to total advances to SSI by public sector banks	Total advances to all sectors (Rs. crores)	Col. (1) as percentage of Col. (3)	Advances to SSI (Rs. crores)	% age to total advances to SSI by public sector banks	Total advances to all sectors (Rs. crores)	Col. (5) as percentage of Col. (7)	Proportion of advances to SSI Sector by SBI Group and 14 Nationalised Banks in Total@ advances by all banks to SSI Sector	
	1	2	3	4	5	6	7	8	9	10
A. *SBI Group*	103·0	*41·0*	1185·2	*8·7*	187·8	*44·7*	1331·8	*14·1*	*36·1*	*40·0*
B. *14 Nationalised Banks*										
1. Central Bank of India	25·9	*10·3*	322·6	*8·0*	36·4	*8·7*	393·0	*9·3*	*9·1*	*7·8*
2. Bank of India	12·1	*4·8*	244·9	*4·9*	22·8	*5·4*	318·6	*7·2*	*4·2*	*4·9*
3. Punjab National Bank	9·1	*3·6*	242·8	*3·7*	12·7	*3·0*	293·7	*4·3*	*3·2*	*2·7*
4. Bank of Baroda	11·5	*4·6*	180·5	*6·4*	25·8	*6·1*	283·6	*9·1*	*4·0*	*5·5*
5. United Commercial Bank	8·6	*3·4*	137·2	*6·3*	15·2	*3·6*	200·2	*7·6*	*3·0*	*3·2*
6. Canara Bank	11·4	*4·5*	108·6	*10·5*	21·1	*5·0*	162·9	*12·9*	*4·0*	*4·5*
7. United Bank of India	3·8	*1·5*	107·8	*3·5*	12·1	*2·9*	135·1	*9·0*	*1·3*	*2·6*
8. Dena Bank	10·9	*4·3*	76·1	*14·3*	16·6	*3·9*	109·9	*15·2*	*3·8*	*3·5*
9. Syndicate Bank	10·9	*4·3*	91·0	*12·0*	17·1	*4·1*	119·4	*14·3*	*3·8*	*3·6*
10. Union Bank of India	5·6	*2·2*	73·6	*7·6*	16·9	*4·0*	111·3	*15·1*	*2·0*	*3·6*
11. Allahabad Bank	3·0	*1·2*	87·1	*3·4*	3·9	*0·9*	95·7	*4·1*	*1·1*	*0·8*
12. Indian Bank	10·7	*4·3*	60·0	*17·8*	7·2	*1·7*	61·3	*11·7*	*3·7*	*1·5*
13. Bank of Maharashtra	13·6	*5·4*	54·4	*25·0*	14·8	*3·5*	71·3	*20·7*	*4·8*	*3·2*
14. Indian Overseas Bank	10·7	*4·3*	44·8	*23·9*	9·8	*2·3*	55·2	*17·8*	*3·7*	*2·1*
C. *Total of* (B)£	148·1	*59·0*	1831·4	*8·1*	232·6	*55·3*	2411·2	*9·6*	*51·8*	*49·5*
D. *TOTAL OF* (A + *B*)	251·1	*100·0*	3016·6	*8·3*	420·4	*100·0*	3743·0	*11·2*	*87·8*	*89·6*

@ Total advances to Small Scale Industries Sector by all the scheduled commercial banks were about Rs. 285·6 crores and Rs. 469·1 crores in June 1969 and December 1970 respectively.

£ Constituents may not add up on account of rounding off.

Source : Reserve Bank of India.

CHAPTER 1:

THE NEED FOR SPECIALISED SAVINGS BANKS IN INDIA

INTRODUCTION

13.1 The importance of savings for economic growth needs no emphasis. This is specially so in the case of underdeveloped countries which are caught in the morass of the well-known vicious circle—namely, low income, low rate of savings and of capital formation, and hence low income. It will be useful from the viewpoint of development if there are financial institutions to undertake the task of mobilising savings and investing them, and thereby breaking through the vicious circle of underdevelopment. In this chapter we shall inquire into the need for specialised savings banks in India.

13.2 There are already quite a number of savings mobilising institutions in the country. Hence, our enquiry raises, at the outset, the problem of examining whether there exists any *prima facie* case for considering the need for new savings institutions having in view the existing ones and secondly, whether such institutions should be specialised savings banks. Accordingly, it would be logical and advantageous to proceed with our investigation step-wise by considering the following queries in that order :

(1) Are there any savings in the economy which are now outside the purview of financial agencies, *i.e.*, savings that are there (hoards and alike) but which have yet to be mobilised ?

(2) Is there any possibility of increasing the total savings-income ratio of the community by offering new savings media and other allied facilities ?

(3) Is there any need for a change in the flow pattern of savings ? That is, whether it would be desirable, for example, to divert savings flowing into the unorganised agencies to the institutions in the organised sector ?

(4) In which sectors of the economy and with which classes of savers, the savings yet to be mobilised lie ?

(5) What sort of savings media and what kind of facilities should be offered to raise the total savings-income ratio ?

(6) Whose savings pattern, it would be desirable to alter and in which way should it be changed ?

13.3 If the answers to questions (1), (2) and (3) are all in the negative, then there does not exist any *prima facie* case for probing further into our problem and the latter can be dismissed summarily by stating that there is no need for specialised savings banks in India at present ; when the answer to one of these queries is in the affirmative, it will be considered to be sufficient to establish the *prima facie* case, that is for the purpose of this chapter. The other queries will not be investigated here in detail. If on the other hand the answers are in the affirmative to these questions, or at least to one of them, then further queries which are listed below will have to be investigated, having in view the answers to questions (4), (5) and (6). These queries are :

(7) Will the setting up of specialised savings banks help in mobilising the available savings, raising the total savings-income ratio and/or altering the flow pattern of savings in the desired direction ?

(8) What will be the costs, administrative and other financial problems involved in setting up savings banks ? What will be advantages gained thereby ?

(9) Will not the existing institutions bring about the desired results when geared properly to the task through additional promotional measures ?

13.4 This chapter is divided into three parts. In Part I, it is shown that there is a *prima facie* case for considering the need for setting up specialised financial institutions for mobilising savings in the Indian economy. In Part II, the existing financial agencies for mobilising savings in India are examined in their evolutionary process by adopting a comparative static method of analysis. In Part III, the need for specialised savings banks is considered keeping in mind the matters covered in earlier sections.

I

PRIMA FACIE CASE FOR CONSIDERING THE NEED FOR SETTING UP SPECIALISED FINANCIAL INSTITUTIONS FOR MOBILISING SAVINGS

13.5 Recent economic trends in India suggest that there is scope (*a*) for increasing rural savings flowing into institutional agencies and (*b*) for raising the total savings-income ratio of the community.

13.6 The available evidence indicates that there was a marked improvement in the economic conditions of the rural or agricultural sector as a whole during recent years. This can be shown with reference to income and price data. Table 13.1 shows that the percentage of agricultural income to total national income rose over the period 1965-66 through 1967-68 ; it rose from 45.8 in 1965-66 to 47.4 in 1966-67, and finally to 51.2 in 1967-68. During

the year 1968-69 according to provisional figures agricultural income as a percentage of net domestic product fell in a small degree as compared to the previous year and stood at 48.3. The index numbers of prices of agricultural commodities and the index numbers of prices of non-agricultural commodities shown in Table 13.2 also indicate that the index of agricultural prices which was lagging behind that of prices of non-agricultural commodities during the period 1961-62 through 1963-64, rose thereafter much faster thereby outpacing the latter by a wide margin ; from 126.5 in 1965-66, index of non-agricultural prices rose to 160.0 in 1969-70, whereas index of agricultural prices rose from 141.7 in 1965-66 to 194.4 in 1969-70. These trends show that the terms of trade are shifting in favour of the agricultural sector, thereby suggesting that the agricultural income is registering substantial increase.

13.7 Table 13.3 shows the distribution of estimated aggregate farm business income† among different size groups of cultivators ; the average farm business income per household in different size groups of cultivators is also recorded. It can be seen that the total income as well as the income per household of all size groups grew over the period 1965-66 through 1967-68. Besides, the income per household is very large in the higher strata as compared to the lower strata of farmers, implying thereby that the bulk of surplus of rural income over rural current expenditure is mostly concentrated in the hands of cultivators with large holding. A number of recent field studies have also brought out the fact that the benefits of new technology have flowed unevenly to different classes of landholders thereby accentuating further the disparity in income distribution in rural areas.‡

13.8 In contrast to the income trends witnessed by the agricultural sector, this sector's contribution to total financial savings of the economy had remained strikingly low. It is found that the ratio of savings to income in the rural sector almost remained stagnant around 2.3 per cent throughout the period 1950-51 to 1962-63, while the corresponding ratio for urban households rose from 7.3 per cent to 17.0 per cent during this period.* Accordingly, the proportion of rural savings to total savings of the economy declined by nearly one-half, from 29.3 per cent to 15.2 per cent during this period. There is also no indication that the rural savings-income ratio and the share of the rural savings to total, has improved in recent years. There is, therefore, apparently good scope for various financial institutions in mobilising the available surplus of income with rural households and in raising the rural saving-income ratio, specially of the large farmers. Furthermore, it may also be desirable in the long run from the view point of

† These estimates are those worked out by S. S. Madalgi, *vide* his article 'Estimates of Farm Income in India, 1951-52 to 1967-68 in Review of Agriculture', *Economic and Political Weekly*, 28th March 1970.

‡ *Vide*, V. M. Jakhade, Presidential Address, Twenty-Ninth All-India Agricultural Economics Conference 1969, p. 16.

* These estimates which exclude non-monetized transactions are those reported in the *Report of the All-India Rural Credit Review Committee*, Reserve Bank of India, Bombay, 1969, p. 663.

monetary policy and discipline, and also from the viewpoint of savers' interests to slowly divert savings flowing into unorganised financial agencies and arrangements towards organised financial institutions.

13.9 Besides, an important point to be taken into account is the proportion between savings in the financial form and in the form of physical assets in the rural sector. This ratio is relatively higher in developed countries like U.S.A., as compared to that in developing countries like India. It is important to remember here that in the agricultural sector the process of saving and of investing is, to a great extent, being carried out by the same individual or household without involving in the process any intermediation by financial institutions. However, savers in rural areas can be persuaded to keep their savings with commercial banks, pending their investment in physical assets. There exists, therefore, further scope for financial institutions for mobilising savings in the rural areas.

13.10 It is against the above background that the efforts made by existing savings mobilising institutions should be reviewed and the need for setting up specialised savings banks assessed.

II

Existing Financial Institutions for Mobilising Savings in India

13.11 In order to consider the scope for setting up specialised savings banks, it is necessary to survey briefly all the existing institutions for promoting savings. The financial savings institutions, as they exist today, have evolved and improved over a number of years. Testimonies of the growth process can be found by comparing the institutional machinery in different periods in the past and contrasting it with that of the present. For that purpose, it may be interesting to refer to the observations and recommendations regarding the institutional aspects of promotion of savings as advanced by the Indian Central Banking Enquiry Committee (1931), and the Rural Banking Enquiry Committee (1950). Both these Committees had enquired into the availability of savings in the economy and the adequacy of the existing institutional set-up to mobilise them.

13.12. Having noted that the development of banking depends to a great extent on the growth of the investment habit, the Indian Central Banking Enquiry Committee ascertained the general position regarding the forms of investment preferred by various classes of savers and the availability and attractiveness of existing savings media offered by various institutions. The observations made by the Committee, on the forms of investment preferred by various classes of savers,* which are, to a great

* *The Report of the Indian Central Banking Enquiry Committee*, Volume I, Part I—Majority Report, Goverment of India, 1931, p. 432.

extent, based on the reports of the various Provincial Committees, can be tabulated as given in Statement 13. I.

STATEMENT 13.I—FORMS OF INVESTMENT PREFERRED BY VARIOUS CLASSES OF SAVERS

	Categories of Savers			
	Wealthy Agriculturists	Salaried Class	Commercial Community	Merchants and certain classes of Indigenous Bankers
Preferred form of Investment	Land	Post Office Savings Deposits	Short-term bank deposits	Investment in Purchase of Land and Building
	Jewellery	Postal Cash Certificates	Treasury Bills	
		Government Securities	Shares and Debentures of Joint	
		Gilt-edged Securities	Stock Companies	

13.13 Although the Committee doubted the existence of large hoards of cash, it felt that the slender savings of small men everywhere should be garnered. It pointed out that the labourer, the peasant and the artisan have not yet been drawn to the savings institutions in significant numbers. Besides, it felt that it is possible to reduce investment in jewellery through improved banking facilities thereby making a larger share of the people's surplus available for augmenting resources of banking system. In this connection, the Committee reviewed the activities of commercial and co-operative banking system, the working of the post office savings banks, insurance companies and provident funds, and the availability of other forms of savings certificates, and offered a series of recommendations to improve the institutional set-up for mobilising savings. One of these recommendations which is worthwhile to point out here reads as follows : "The formation of National Savings Association in all provinces is supported in principle."*

13.14 Twenty years later, that is, in 1950, the Rural Banking Enquiry Committee stated that the saving capacity of the rural economy, under normal conditions, cannot be dismissed as non-existent or negligible. On the basis of available evidence, it drew the general conclusion that rural incomes have risen and "a margin has been available for savings."$ It also observed that the bulk of savings, in one form or other, should be found with the bigger landholders and with some non-agriculturists, such as village moneylenders, traders, mill-owners, etc.‡ The savings of the small landholders, tenants

* *Ibid*, p. 517.
$ *Report of the Rural Banking Enquiry Committee*, Government of India, 1950, p. 39.
‡ *Ibid*, p. 40

and labourers were expected to be distributed in small driblets among large numbers or utilised for improving their standard of living, or in some cases, squandered on unnecessary things.

13.15 The Rural Banking Enquiry Committee's final opinion on the issue of availability of rural savings was that "while it would be wrong to assume that large amounts of cash savings are available for collection through the extension of banking facilities to rural areas, it cannot be categorically held that no possibilities of drawing rural savings into channels of investment useful to the public exist at all."* On this basis and from the point of view of bringing the savings within the framework of institutional set-up, the Committee suggested the opening of rural offices by commercial banks to tap the savings of the well-to-do rural classes, and also the expansion and effective ultilisation of machinery, like post office savings banks and co-operative societies, for the benefit of the smaller people in rural areas. To this end, a number of specific recommendations were made by the Committee emphasising the point that the measures to be taken by the Government should be such as can be implemented immediately taking note of the then administrative and financial limitations. Accordingly, it is interesting to note, the Committee felt that the establishment of new organisations or other steps involving considerable additional capital outlay or current expenditure should not be included among these measures.$

13.16 From the foregoing, the following two points may be underlined. First, both the Committees—The Indian Central Banking Enquiry Committee and the Rural Banking Enquiry Committee—were of the view that the availability of savings in the sense of institutional supply of loanable funds could be increased through proper promotional and other institutional measures. Secondly, while the Central Banking Enquiry Committee felt that, besides measures to strengthen the existing institutional structure, the setting up of National Savings Association in all provinces was justifiable in principle, the Rural Banking Enquiry Committee preferred expansion and strengthening of the existing institutional machinery to the establishment of new organisations.

13.17 Table 13.4 shows the various types of financial agencies in 1931, 1950 and 1970, providing for the investment of savings of the community. It can be noted that over the past four decades, the number of broad types of financial institutions has hardly altered with the sole exception of the addition of the Unit Trust of India in the sixties. This should not, however, be construed as implying that the institutional machinery had remained static during the long span of a few decades. A number of these institutions have made noteworthy strides in recent years in terms of added strength through consolidation, increase in the volume of activities, and geographical

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* *Ibid*, p. 146, conclusion No. 22, paragraph 32, Chapter I of Part II.
$ *Ibid*, p. 149, Serial No. 41 and paragraph 43, Chapter IV of Part II.

coverage. This is specially true of the commercial and co-operative banking system as revealed by Tables 13.5, 13.6 and 13.7 and also of the postal savings banking system as shown in Table 13.8 and other small savings schemes of the Government. Similarly, institutions providing media for contractual savings have made notable progress as indicated by the household sector's gross savings in these forms (*vide* Table 13.9) ; this sector's gross savings in the form of insurance policies and provident funds rose from Rs. 21.3 crores and Rs. 19.0 crores respectively, in the year 1950-51, to Rs. 97.6 crores and Rs. 198.2 crores respectively, in 1965-66. Non-banking companies which were known to mobilise deposits from friends and relatives in the past have in recent years been canvassing for deposits openly from the public ; these deposits rose from Rs. 136 crores in 1962, to Rs. 283 crores in 1966, and the average deposits per non-banking company (reporting deposits) grew from Rs. 8.78 lakhs in 1962, to Rs. 12.02 lakhs in 1966. In 1967 and 1968, the amount of total deposits was Rs. 431 crores and Rs. 478 crores respectively. These figures, however, are not comparable with those of earlier years. In 1967, the estimated amount of deposits on a comparable basis was about Rs. 370 crores and the average deposit per non-banking company (reporting deposits) worked out to Rs. 15.48 lakhs. (Table 3.3).

13.18 The growth of the institutional machinery for mobilising savings as briefly described above, has, however, been lopsided in some respects. First, it has been unquestionably urban-biased in its coverage* ; this bias, however, is fast changing as revealed by the percentage of commercial banks' offices in rural areas (population group of below 10,000) which increased from 9.2 in 1952 to 31.6 in 1970 (see Table 13.6). Secondly, the unorganised or semi-organised agencies such as the indigenous bankers, chit funds, etc., have been thriving in spite of the dent made by organised and regulated agencies into their areas of activities.

13.19 There emerges, therefore, the need to (*a*) fill up the gap in the organised institutional set-up in the rural areas especially in the face of rising rural incomes, (*b*) diversify the savings media with a view to making them attractive to the small savers, and (*c*) extend the organised and regulated segment of the market for savings. Accordingly, a series of measures are already being taken up to remedy the situation. Among them may be mentioned the following :

(*i*) A rural-oriented branch licensing policy is being followed by the Reserve Bank of India. Licences are being issued to banks in the ratio of one office in urban centres (including metropolitan and port towns) for every two offices opened after the 31st December 1969, in rural and semi-urban centres in the case of banks which had more than

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* This fact had been brought out in the Report of a Study Group of the National Credit Council entitled *Organizational Framework for the Implementation of Social Objectives*, Reserve Bank of India, October, 1969.

60 per cent of their offices in rural and semi-urban centres ; in the case of other banks the ratio is one office in an urban centre for every three offices opened in rural and semi-urban centres.

(*ii*) The Reserve Bank of India, under the Lead Bank Scheme, is also entrusting the task of developing the underdeveloped and underbanked areas mainly to large banks. These banks have been advised to give particular attention to correcting the wide inter-state and inter-district variations in terms of population coverage, and the necessity for urgent attention being given to backward areas to remove imbalances in banking facilities has been impressed on them. Besides, particular care is taken to ensure that centres identified in underbanked districts, *i.e.*, those where population coverage per office is more than one lakh, are taken up by banks for being covered by offices as early as possible.

(*iii*) The Small Savings Movement of the Government is being intensified. A beginning is being made to organise small saving campaigns on a selective basis in the more prosperous rural areas. The Small Savings Scheme is being made more attractive to the genuine small saver.*

(*iv*) The National Savings Reorganisation Committee$ has recommended various measures and arrangements for the co-ordination of the savings effort between the Central organisation and the State organisations ; one of its recommendations is that there should be greater co-ordination between the Post & Telegraph Department and the National Savings Organisation in regard to day-to-day work, requirements of forms, pass books, etc., and in preparing forecast of programmes of special campaigns. The Committee also made recommendations regarding the collections of small savings that could be made, effort required, as well as the cost of collections.

13.20 It is against the above background that the need for specialised savings bank will be considered in the following section.

III

The Case for Specialised Savings Banks in India

13.21 It may be interesting to investigate why specialised savings institutions (like the Savings and Loan Associations of the U.S.A.@) did not come into existence in India. If the experience of foreign countries is any guide, we should have expected nidhis to have evolved into modern savings

* The various measures to that effect are mentioned in the *Report of the Ministry of Finance*, Government of India, 1969-70, paragraphs 174-185.

$ *Report of the National Savings Re-organisation Committee*, (Chairman: Homi J. H. Taleyarkhan), 1970.

@ For description of these institutions, see Appendix VI.

banks in India, because they are of mutual type financial agencies, having their origin in the distant past. Chit Funds also have some characteristics of mutual help among the members. These financial arrangements, *i.e.*, nidhis and chit funds, have, however, failed to evolve either in the direction of savings and loan associations of the U.S.A. or in the nature of English Building Societies.@ These agencies still suffer from various deficiencies examined elsewhere in the Report.

13.22 Having the aforesaid in view, we may now consider the case for starting a network of specialised savings banks. At the outset, the setting up of an entirely new organisation raises the problem of ownership, which can be settled by stating that private capital will fight shy of such venture and hence it can only be set up through Government initiative and resources. The Government, however, will have to ponder over a number of problems which can be expected to arise in implementing this proposal. First, resources for the initial capital outlays will have to be raised. Second, the problem of trained administrative personnel will have to be solved. Third, note will have to be taken of the stiff and growing competition which the specialised savings banks, when set up, will have to face from commercial banks, postal savings banks and other small savings schemes of the Government. Fourth, since the new organization will be constituted with a view to mobilising small savings, the costs of mobilising and operating small accounts will be relatively high. Fifth, to wean away the small farmers from unorganised agencies, to change their attitude towards investments from jewellery and other real assets to financial assets, to inculcate thrift habit and to inspire confidence in the new savings banks, heavy expenditure will have to be incurred on various promotion campaigns. In view of the above problems and in the face of various steps being already taken to strengthen and gear the existing institutions to the task of mobilising savings in rural areas, there remains little justification for establishing an entirely new organisation of specialised savings banks.

13.23 In brief, it may be concluded that although there exists good scope for mobilising the available surplus of income, specially with rural households, and in raising the saving-income ratio there is very little support in favour of setting up an entirely new organisation of specialised savings banks. The various steps being already taken to strengthen and gear the existing institutions to the task of mobilising savings in rural areas add support to our conclusion. Finally, it may be noted that the need for specialised savings banks in India has been enquired into by us solely from the angle of mobilisation of savings. There may, however, be the need for specialised types of institutions providing special kind of loan facilities. Hence, the issue may be raised whether there exists stronger case for specialised savings and loan institutions rather than specialised savings banks alone. This has been done in other chapters dealing with specialised institutions.

@ For a description of these institutions, see Appendix VI.

TABLE 13·1—AGRICULTURAL INCOME IN RELATION TO TOTAL NATIONAL INCOME

Year	Net Domestic Product (At current prices) (In crores of rupees)	Agricultural Income (At current prices) (In crores of rupees)	Col. (3) as a percentage of Col. (2)
(1)	(2)	(3)	(4)
1960-61	13366	6570	49·2
1961-62	14148	6771	47·9
1962-63	14981	6905	46·0
1963-64	17208	8015	46·6
1964-65	20209	9846	48·7
1965-66	20786	9523	45·8
1966-67	23872	11323	47·4
1967-68	28615	14665	51·2
1968-69*	28841	13916	48·3

* Provisional.

Source : Reserve Bank of India Bulletin, January 1971.

TABLE 13·2—INDEX NUMBERS OF PRICES OF AGRICULTURAL COMMODITIES AND OF NON-AGRICULTURAL COMMODITIES

Year	Index Numbers of prices of Agricultural Commodities (1961-62=100)	Wholesale prices Index Numbers (1961-62=100)	Index Numbers of prices of Non-Agricultural Commodities (1961-62=100)
(1)	(2)	(3)	(4)
1961-62	100·0	100·0	100·0
1962-63	102·3	103·8	104·5
1963-64	108·4	110·2	111·1
1964-65	130·9	122·3	118·0
1965-66	141·7	131·6	126·5
1966-67	166·6	149·9	141·5
1967-68	188·2	167·3	156·8
1968-69	179·4	165·4	158·4
1969-70	194·8	171·6	160·0

Source : Reserve Bank of India Bulletins.

TABLE 13·3.—ESTIMATES OF FARM BUSINESS INCOME ACCORDING TO SIZE GROUP OF OPERATIONAL HOLDINGS

Size group of operational holdings (Acres)	1965-66		1966-67		1967-68	
	Adjusted Income (In crores of Rupees)	Income per House-hold (In Rupees)	Adjusted Income (In crores) of Rupees)	Income per House-hold (In Rupees)	Adjusted Income (In crores of Rupees)	Income per House-hold (In Rupees)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Lower Strata						
(*i*) 0·50 to 4·99	1489 (*19·24*)	481	1758 (*19·18*)	554	2231 (*19·25*)	684
(*ii*) 5·00 to 9·99	1338 (*17·29*)	1208	1586 (*17·31*)	1394	2004 (*17·29*)	1723
Total [(*i*) + (*ii*)]	2827 (*36·53*)	675	3344 (*36·49*)	775	4235 (*36·54*)	955
Upper Strata						
(*iii*) 10·00 to 14·99	1228 (*15·87*)	2772	1457 (*15·90*)	3202	1843 (*15·90*)	3938
(*iv*) 15·00 to 19·99	781 (*10·09*)	3755	927 (*10·12*)	4352	1170 (*10·09*)	5342
(*v*) 20·00 to 29·99	992 (*12·82*)	4935	1175 (*12·82*)	5704	1484 (*12·80*)	7000
(*vi*) 30·00 to 49·99	984 (*12·72*)	7628	1166 (*12·72*)	8833	1471 (*12·69*)	10816
(*vii*) 50·00 and above	926 (*11·97*)	15965	1095 (*11·95*)	18250	1387 (*11·98*)	22738
Total [(*iii*) to (*vii*)]	4911 (*63·47*)	4727	5820 (*63·51*)	5460	7355 (*63·46*)	6711
GRAND TOTAL	7738 (*100·00*)		9164 (*100·00*)		11590 (*100·00*)	

Source : S. S. Madalgi, 'Estimates of Farm Income in India, 1951-52 to 1967-68', in Review of Agriculture, *Economic and Political Weekly*. March 28, 1970, pp. A-23 to A-32, Table 3.
Note : Figures within brackets indicate percentages to total.

TABLE 13·4—FINANCIAL AGENCIES FOR MOBILISING SAVINGS

1931	1950	1970
(At the time of the Indian Central Banking Enquiry Committee)	(At the time of Rural Banking Enquiry Committee).	(Agencies existing today)
1. Commercial Banks.		1. Commercial Banks.
2. Co-operative Banking system.		2. Co-operative Banking system.
3. Government :	(Same types of Institutions as in the year 1931)	3. Government :
(*i*) Postal Savings Bank Deposits.		(*i*) Postal Savings Bank Deposits.
(*ii*) Postal Cash Certificates.		(*ii*) Other Small Savings including various savings and other certificates, and other fixed deposits.
(*iii*) Treasury Bills and other securities.		(*iii*) Treasury Bills and other Securities.
4. Insurance Companies (Life Insurance).		4. Life Insurance Corporation.
5. Indigenous Banking System.@		5. Indigenous Banking System.@
6. Nidhis.		6. Nidhis.
7. Chit Funds.		7. Chit Funds.
8. Provident Funds.		8. Provident Funds.
9. Other Non-Banking Companies.		9. Other Non-Banking Companies.
(*i*) Deposits.		(*i*) Deposits.
(*ii*) Shares.		(*i*) Shares.
(*iii*) Debentures.		(*iii*) Debentures.
10. Co-operative Insurance Societies.		10. Co-operative Insurance Societies.
11. Investment Companies.		11. Investment Companies.
12. Loan Offices (Bengal).		12. Loan and Finance Companies.
		13. Unit Trust of India.

@ Indigenous financial system consists of moneylenders, shroffs and other agencies doing banking business. Most of the moneylenders generally work with their own capital, but some of the urban moneylenders do take deposits.

TABLE 13.5—PROGRESS OF COMMERCIAL BANKING SYSTEM

End of December	1951	1961	1965	1966	1967	1968	1969	1970
1. Number of Banks (Reporting) ..	566	292	109	100	91	86	87	85
(a) Scheduled Banks ..	92	82	76	73	71	70	73	73
(b) Non-scheduled Banks	474	210	33	27	20	16	14	12
2. Number of Offices of Banks in India	4151	5012	6131	6593	6982	7647	9015	11184
(a) Scheduled Banks ..	2647	4390	5902	6380	6779	7444	8867	11040
(b) Non-scheduled Banks	1504	622	229	213	203	203	184	144
3. Population£ per office (in '000)	87	88	79	76	73	69	60	50
4. Total Deposits in India (Rs. crores)	908	2012	3073	3587	3962	4478	4966	5801
5. Average Deposit per office (Rs. lakhs)	22	40	50	54	57	59	55	52
(a) Scheduled Banks ..	32	45	52	56	58	60	55	52
(b) Non-Scheduled Banks	5	6	11	12	13	13	13	N.A.
6. Deposit per capita (Rs.)	25	46	63	72	77	85	91	104

£ Estimated except for 1961.
Sources : 1. Statistical Tables relating to Banks in India, 1968.
2. Trend and Progress of Banking in India, June 1970, Reserve Bank of India.
3. Reserve Bank of India.

TABLE 13.6—DISTRIBUTION OF COMMERCIAL BANKS' OFFICES—POPULATION GROUPWISE

Population	As at the end of					As on	
	1952	1961	1966	1967	1968	19/7/69	30/9/70
1. Upto 10,000	244 *(9.2)*	557 *(12.7)*	1044 *(16.4)*	1197 *(17.6)*	1496 *(20.1)*	1858 *(22.4)*	3325 *(31.6)*
2. 10,000 to 50,000	958 *(36.2)*	1559 *(35.5)*	2164 *(33.9)*	2223 *(32.8)*	2360 *(31.7)*	3323£ *(40.1)*	3742£ *(35.6)*
3. 50,000 to 5,00,000	925 *(35.0)*	1382 *(31.4)*	1820 *(28.5)*	1918 *(28.3)*	2027 *(27.2)*	1446@ *(17.5)*	1620@ *(15.4)*
4. 5,00,000 and above	519 *(19.6)*	895 *(20.4)*	1355 *(21.2)*	1444 *(21.3)*	1564 *(21.0)*	1657* *(20.0)*	1832* *(17.4)*
TOTAL	2646	4393	6383	6782	7447	8284	10519

£ Places with population over 10,000 and upto 1,00,000—Semi-urban centres
@ Places with population over 1,00,000 and upto 10,00,000—urban centres
* Places with population over 10,00,000—Metropolitan centres
Note : Figures in brackets indicate percentages to the total.
Sources : 1 Supplement to Reserve Bank of India Bulletin, November 1970.
2 Statistical Tables relating to Banks in India.

TABLE 13.7—PROGRESS OF CO-OPERATIVE INSTITUTIONS

	1951-52	1960-61	1965-66	1966-67	1967-68	1968-69
	1	2	3	4	5	6
1. AGRICULTURAL CREDIT SOCIETIES						
Number of societies (Lakhs)	1.08	2.12	1.92	1.79	1.72	1.68
Number of villages covered (Lakhs)		4.23	5.03	5.07	5.26	5.35
Percentage of membership to rural households		*23.7*	*32.3*	*32.0*	*34.7*	*34.6*
Share capital (Rs. crores)	9	58	115	129	148	167
(of which Government contribution)	(—)	(6)	(10)	(11)	(12)	(13)
Owned funds (Rs. crores)	18	76	149	165	191	215
Deposits (Rs. crores)	4	15	34	39	47	57
Average per member						
Share capital (Rs.)	19	34	44	48	53	57
Deposits (Rs.)	9	9	13	15	17	19
Average per Society						
Share capital (Rs. thousands)	0.8	3	6	7	9	10
Deposits (Rs. thousands)	0.4	0.7	2	2	3	3
Average deposit per 100 of Rural Population (Rs.)		41	85	94	131	151
2. CENTRAL CO-OPERATIVE BANKS		(Amounts in crores of Rupees)				
Number	509	390	346	346	344	341
Number of offices	779	1445	2475	2648	2849	3124
Share capital	5	39	76	86	101	115
(of which Govt. contribution)	(—)	(10)	(19)	(22)	(27)	(30)
Reserves	5	12	26	30	34	40
Total owned funds	10	51	102	116	135	155
Deposits						
From co-operatives	11	45	105	115	128	148
From others	27	67	132	144	173	203
Total	38	112	237	259	301	351
Average deposit per 100 of Rural Population (Rs.)		317	596	635	836	931
3. STATE CO-OPERATIVE BANKS						
Number	16	21	22	25	25	25
Share capital	2	18	29	31	35	38
(of which Govt. contribution)	(—)	(6)	(10)	(10)	(12)	(12)
Reserves	2	6	16	25	30	38
Total owned funds	4	24	45	56	65	76
Deposits						
From co-operatives	8	44	100	95	122	145
From others	13	28	47	52	58	71
Total	21	72	147	147	180	216
4. CENTRAL LAND DEVELOPMENT BANKS						
Number	6	18	18	19	19	19
Number of primary land development banks	289	463	673	707	731	740
Number of offices of central land development banks			350	397	455	488
Total debentures outstanding	8	37	178	232	299	426
Total debentures sold during the year		10	50	58	70	130

TABLE 13.8—PROGRESS OF POST OFFICE SAVINGS BANKS

End of March	1952	1961	1966	1967	1968	1969	1970
Number of Offices £	11027	17096	14644	15183	15758	16634	17378
Deposits as at the end of period (in lakhs of Rupees)	19981	43142	64430	70163	76012	81202	89040
Average balance per office (in lakhs of Rupees)	1.8	2.5	4.4	4.6	4.8	4.9	5.1
Number of depositors at the end of the year (in '000)	4446	9213	13728	15186	16972	18394	19718
Average balance per depositor (Rupees)	449	468	469	462	448	441	452

£ These figures refer to the number of Head Banks and sub-banks. In addition to these, a number of branch post offices also do savings bank work and the number of such branch offices throughout India was 68,649 at the end of March 1970.

Source : Statistical Tables relating to Banks in India.

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TABLE 13.9—SAVING OF THE HOUSEHOLD SECTOR IN THE FORM OF FINANCIAL ASSETS

(In Crores of Rupees; at current prices)

	1950 -51	1951 -52	1952 -53	1953 -54	1954 -55	1955 -56	1956 -57	1957 -58
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
A. *Gross Saving of the Household Sector in Financial Assets*	82.3	26.8	56.0	124.7	372.1	513.0	427.0	395.8
(*a*)	*0.9*	*0.3*	*0.6*	*1.2*	*3.9*	*5.1*	*3.8*	*3.5*
(*i*) Currency	79.6	—114.6	—22.4	24.5	85.4	190.3	51.9	45.3
(*a*)	*0.8*	*—1.1*	*—0.2*	*0.2*	*0.9*	*1.9*	*0.5*	*0.4*
(*b*)	*96.7*	*—427.6*	*—40.0*	*19.6*	*23.0*	*37.1*	*12.0*	*11.7*
(*ii*) Bank Deposits	9.7	—19.1	19.7	12.2	63.8	84.5	94.4	93.3
(*a*)	*0.1*	*—0.2*	*0.2*	*0.1*	*0.7*	*0.8*	*0.8*	*0.8*
(*b*)	*11.8*	*—71.2*	*35.2*	*9.8*	*17.2*	*16.5*	*21.8*	*24.0*
(*iii*) Insurance Policies ..	21.3	15.5	22.2	26.4	31.3	35.3	15.8	36.5
(*a*)	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	*0.4*	*0.1*	*0.3*
(*b*)	*25·9*	*57·8*	*39·6*	*21·2*	*8·4*	*6.9*	*5·3*	*7·5*
(*iv*) Provident Funds ..	19.0	18.1	22.8	42.4	44.0	50.3	60.5	72.2
(*a*)	*0.2*	*0.2*	*0.2*	*0.4*	*0.5*	*0.5*	*0.5*	*0.7*
(*b*)	*23.1*	*67.5*	*40.7*	*34.0*	*11.8*	*9.8*	*13.9*	*18.6*
(*v*) Claims on Government	—80.2	104.1	0.6	—5.2	109.7	101.7	119.9	94.8
(*a*)	*—0.8*	*1.0*	—	—	*1.1*	*1.0*	*1.1*	*0.8*
(*b*)	*—97.5*	*388.4*	*1.1*	*—4.2*	*29.3*	*19.8*	*27.6*	*24.4*
(*vi*) Corporate & Co-operative Shares and Securities	32.9	22.8	13.1	24.4	38.4	50.9	84.5	53.7
(*a*)	*0.4*	*0.2*	*0.2*	*0.2*	*0.4*	*0.5*	*0.8*	*0.5*
(*b*)	*40.0*	*85.1*	*23.4*	*19.6*	*10.3*	*9.9*	*19.4*	*13.8*
B. *Financial Liabilities of the Household Sector*	65.7	46.2	11.2	40.5	55.9	122.8	109.0	64.3
(*a*)	*0.7*	*0.5*	*0.1*	*0.4*	*0.6*	*1.2*	*1.0*	*0.6*
(*i*) Bank Advances ..	47.4	25.7	—8.4	20.6	31.6	84.3	89.4	38.0
(*a*)	*0.5*	*0.3*	*—0.1*	*0.2*	*0.3*	*0.8*	*0.8*	*0.3*
(*b*)	*72.1*	*55.6*	*—75.0*	*50.8*	*56.5*	*68.6*	*82.0*	*59.1*
(*ii*) Loans from life insurance companies/corporation..	2.8	3.6	4.3	4.2	4.2	2.2	1.1	4.1
(*a*)	—	—	—	—	*0.1*	—	—	*0.1*
(*b*)	*4.3*	*7.8*	*38.4*	*10.4*	*7.5*	*1.8*	*1.0*	*6.4*
(*iii*) Loans and Advances from Government ..	15.5	16.9	15.3	15.7	20.1	36.3	18.5	22.2
(*a*)	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.4*	*0.2*	*0.2*
(*b*)	*23.6*	*36.6*	*136.6*	*38.8*	*36.0*	*29.6*	*17.0*	*34.5*
C. *Net Saving of the Household Sector in Financial Assets* (A-B)	16.6	—19.4	44.8	84.2	316.2	—390.2	318.0	331.5
(*a*)	*0.2*	*—0.2*	*0.5*	*0.8*	*3.3*	*3.9*	*2.8*	*2.9*

(*a*) Proportion (Percent) to national income.
(*b*) Proportion (Per Cent) to financial assets/liabilities.

Notes : (1) Bank deposits include deposits of public with non-banking companies from 1961-62.
(2) In the case of Insurance Policies, State Government Insurance Funds have been included and adjustment has been made for deposits,premiums and supplementary contracts pending payment.
(3) Method of estimation of Provident Funds has been changed. Consequently estimates of household sector's investments in Government Securities are also changed.
(4) Investments in Units of the Unit Trust of India of Rs. 16.6 crores and Rs. 1.0 crore for the years 1964-65 and 1965-66, respectively, are included in item A(*vi*).

TABLE 13.9— SAVING OF THE HOUSEHOLD SECTOR IN THE FORM OF FINANCIAL ASSETS—(Contd.)

(In Crores of Rupees; at current prices)

	1958 -59	1959 -60	1960 -61	1961 -62	1962 -63	1963 -64	1964 -65	1965 -66
	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
A. *Gross Saving of the Household Sector in Financial Assets* ..	433.2	542.9	578.1	635.0	674.3	939.0	939.4	1168.3
(*a*) ..	*3.4*	*4.2*	*4.1*	*4.5*	*4.5*	*5.5*	*4.7*	*5.7*
(*i*) Currency ..	112.4	130.2	160.3	99.2	172.2	218.8	136.0	287.3
(*a*) ..	*0.9*	*1.0*	*1.1*	*0.7*	*1.1*	*1.3*	*0.7*	*1.4*
(*b*) ..	*26.0*	*24.0*	*27.7*	*15.6*	*25.5*	*23.3*	*14.5*	*24.6*
(*ii*) Bank Deposits ..	95.9	183.3	93.2	219.9	189.3	316.3	359.1	439.4
(*a*) ..	*0.8*	*1.4*	*0.7*	*1.6*	*1.3*	*1.9*	*1.8*	*2.1*
(*b*) ..	*22.1*	*33.8*	*16.1*	*34.7*	*28.0*	*33.7*	*38.2*	*37.6*
(*iii*) Insurance Policies ..	30.9	48.2	57.1	73.0	70.2	93.7	97.4	97.6
(*a*) ..	*0.2*	*0.4*	*0.4*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*
(*b*) ..	*7.1*	*8.9*	*9.9*	*11.5*	*10.4*	*10.0*	*10.4*	*8.4*
(*iv*) Provident Funds ..	68.0	79.1	109.3	113.5	128.8	155.4	181.5	198.2
(*a*) ..	*0.5*	*0.6*	*0.8*	*0.8*	*0.9*	*0.9*	*0.9*	*1.0*
(*b*) ..	*15.7*	*14.6*	*18.9*	*17.9*	*19.1*	*16.5*	*19.3*	*17.0*
(*v*) Claims on Government ..	86.7	49.6	98.9	45.7	54.0	108.9	108.1	92.6
(*a*) ..	*0.7*	*0.4*	*0.7*	*0.3*	*0.3*	*0.6*	*0.5*	*0.4*
(*b*) ..	*20.0*	*9.1*	*17.1*	*7.1*	*8.2*	*11.6*	*11.5*	*7.9*
(*vi*) Corporate & Co-operative Shares and Securities ..	39.3	52.5	59.3	83.7	59.8	45.9	57.3	53.2
(*a*) ..	*0.3*	*0.4*	*0.4*	*0.6*	*0.4*	*0.3*	*0.3*	*0.3*
(*b*) ..	*9.1*	*9.6*	*10.3*	*13.2*	*8.8*	*4.9*	*6.1*	*4.5*
B. *Financial liabilities of the Household Sector* ..	102.7	161.9	142.2	131.3	181.0	240.2	190.6	204.9
(*a*) ..	*0.8*	*1.3*	*1.0*	*0.9*	*1.2*	*1.4*	*1.0*	*1.0*
(*i*) Bank Advances ..	67.9	120.5	99.2	87.6	133.2	201.4	129.7	155.5
(*a*) ..	*0.5*	*1.0*	*0.7*	*0.6*	*0.9*	*1.2*	*0.7*	*0.8*
(*b*) ..	*66.1*	*74.4*	*69.8*	*66.7*	*73.5*	*83.9*	*68.0*	*75.9*
(*ii*) Loans from life insurance companies/corporation ..	1.5	2.6	4.2	5.7	0.8	8.2	8.2	14.3
(*a*) ..	—	—	—	—	—	—	—	—
(*b*) ..	*1.5*	*1.6*	*3.0*	*4.3*	*0.5*	*3.4*	*4.3*	*7.0*
(*iii*) Loans and Advances from Government ..	33.3	38.8	38.8	38.0	47.0	30.6	52.7	35.1
(*a*) ..	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.2*	*0.3*	*0.2*
(*b*) ..	*32.4*	*24.0*	*27.2*	*29.0*	*26.0*	*12.7*	*27.7*	*16.1*
C. *Net Saving of the Household Sector in Financial Assets* (A-B)	330.5	381.0	435.9	503.7	493.3	698.8	748.8	963.4
(*a*) ..	*2.6*	*2.9*	*3.1*	*3.6*	*3.3*	*4.1*	*3.7*	*4.7*

(*a*) Proportion (Per cent) to national income.
(*b*) Proportion (Per cent) to financial assets/liabilities.

Notes : (1) Bank deposits include deposits of public with non-banking companies from 1961-62.
(2) In the case of Insurance Policies, State Government Insurance Funds have been included and adjustment has been made for deposits, premiums and supplementary contracts pending payment.
(3) Method of estimation of Provident Funds has been changed. Consequently estimates of household sector's investments in Government Securities are also changed.
(4) Investments in Units of the Unit Trust of India of Rs. 16.6 crores and Rs. 1.0 crore for the years 1964-65 and 1965-66, respectively, are included in item A(*vi*).

Sources : *Report on Currency and Finance, 1968-69.*

TABLE 13.10—ESTIMATES OF (NET) SAVING OF THE GOVERNMENT, HOUSEHOLD AND THE DOMESTIC CORPORATE SECTORS

(Amount in crores of rupees; at current prices)

	1950-51	1951-52	1952-53	1953-54	1954-55	1955-56	1956-57	1957-58
	1	2	3	4	5	6	7	8
NATIONAL INCOME	9530	9970	9820	10480	9610	9980	11310	11390
I. Saving of the Government Sector	95.9	187.0	102.1	92.6	93.4	111.4	176.7	156.7
(a) *Proportion (per cent) to National Income*	*1.0*	*1.9*	*1.1*	*0.9*	*1.0*	*1.1*	*1.6*	*1.4*
(b) *Proportion (per cent) to Total Savings* ..	*17.8*	*35.2*	*24.9*	*16.4*	*12.1*	*11.4*	*16.4*	*19.4*
II. Saving of the Domestic Corporate Sector	35.0	63.6	1.1	25.9	50.3	60.0	58.5	18.0
(a) *Proportion (per cent) to National Income* ..	*0.4*	*0.6*	—	*0.2*	*0.5*	*0.6*	*0.5*	*0.1*
(b) *Proportion (per cent) to Total Savings*	*6.5*	*12.0*	*0.3*	*4.6*	*6.5*	*6.2*	*5.4*	*2.2*
III. Saving of the Household Sector	408.3	281.0	307.3	447.7	628.9	803.7	839.2	631.0
(a) *Proportion (per cent) to National Income*	*0.2*	*—0.2*	*0.5*	*0.8*	*3.3*	*3.9*	*2.8*	*2.9*
(b) *Proportion (per cent) to Total Savings*	*75.7*	*52.8*	*74.8*	*79.0*	*81.4*	*82.4*	*78.2*	*78.4*
(i) Financial Assets ..	16.6	—19.4	44.8	84.2	316.2	390.2	318.0	331.5
Proportion (per cent) to III	*4.0*	*—6.9*	*14.6*	*18.8*	*50.3*	*48.6*	*37.9*	*52.5*
(ii) Physical Assets@ ..	391.7	300.4	262.5	363.5	312.7	413.5	521.2	299.5
Proportion (per cent) to National Income	*4.1*	*3.0*	*2.7*	*3.5*	*3.3*	*4.1*	*4.6*	*2.6*
Proportion (per cent) to III	*96.0*	*106.9*	*85.4*	*81.2*	*49.7*	*51.4*	*62.1*	*47.5*
Total (I+II+III) ..	539.2	531.6	410.5	566.2	772.6	975.1	1074.4	805.7
Proportion (per cent) to National Income	*5.7*	*5.3*	*4.2*	*5.4*	*8.0*	*9.8*	*9.5*	*7.1*

@ Reserve Bank of India Bulletin, March 1965.

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TABLE 13.10—ESTIMATES OF (NET) SAVING OF THE GOVERNMENT, HOUSEHOLD AND THE DOMESTIC CORPORATE SECTORS

(Amount in crores of rupees; at current prices)

	1958-59	1959-60	1960-61	1961-62	1962-63	1963-64	1964-65	1965-66
	9	10	11	12	13	14	15	16
NATIONAL INCOME	12600	12950	13308	14063	14891	17119	20080	20586
I. Saving of the Government Sector	138.0	202.8	239.4	348.4	410.8	538.3	535.6	654.0
(a) *Proportion (per cent) to National Income*	*1.1*	*1.6*	*1.8*	*2.5*	*2.8*	*3.1*	*2.7*	*3.2*
(b) *Proportion (per cent) to Total Savings* ..	*15.0*	*18.5*	*17.5*	*24.7*	*26.8*	*N.A.*	*N.A.*	*N.A.*
II. Saving of the Domestic Corporate Sector	32.4	57.6	106.7	111.6	135.0	141.6	92.9	93.3
(a) *Proportion (per cent) to National Income*	*0.3*	*0.4*	*0.8*	*0.8*	*0.9*	*0.8*	*0.5*	*0.5*
(b) *Proportion (per cent) to Total Savings*	*3.5*	*5.3*	*7.8*	*7.9*	*8.8*	*N.A.*	*N.A.*	*N.A.*
III. Saving of the Household Sector	750.1	834.5	1025.7	949.3	984.6	N.A.	N.A.	N.A.
(a) *Proportion (per cent) to National Income*	*2.6*	*2.9*	*3.1*	*3.6*	*3.3*	*4.1*	*3.7*	*4.7*
(b) *Proportion (per cent) to Total Savings*	*81.5*	*76.2*	*74.7*	*67.4*	*64.4*	*N.A.*	*N.A.*	*N.A.*
(*i*) Financial Assets ..	330.5	381.0	435.9	503.7	493.3	698.8	748.8	963.4
Proportion (per cent) to III	*44.1*	*45.6*	*42.5*	*53.0*	*50.1*	*N.A.*	*N.A.*	*N.A.*
(*ii*) Physical Assets@ ..	419.6	453.5	589.8	445.6	491.3	N.A.	N.A.	N.A.
Proportion (per cent) to National Income	*3.3*	*3.5*	*4.4*	*3.2*	*3.3*	*N.A.*	*N.A.*	*N.A.*
Proportion (per cent) to III	*55.9*	*54.4*	*57.5*	*47.0*	*49.9*	*N.A.*	*N.A.*	*N.A.*
Total (I+II+III)	920.5	1094.9	1371.8	1409.3	1530.4	N.A.	N.A.	N.A.
Proportion (per cent) to National Income	*7.3*	*8.5*	*10.3*	*10.0*	*10.3*	*N.A.*	*N.A.*	*N.A.*

N.A.—Not Available.
@ Reserve Bank of India Bulletin, March 1965.

Source : Report and Currency an Finance, 1968-69.

CHAPTER 14

NEED FOR SPECIALISED INSTITUTIONS FOR HOUSING FINANCE

INTRODUCTION

14.1 The need for specialised institutions for providing housing finance in India can be examined against the background of the present and prospective housing situation and on the basis of the adequacy or otherwise of the institutions which are supplying housing finance at present. In making an assessment of the current institutional facilities available, it is important to analyse the adequacy of institutional facilities in the light of the peculiarities of the housing market. It will also be useful to study the salient features of housing finance institutions in some foreign countries.

14.2 This chapter is, therefore, divided into the following parts : Part I discusses the present and prospective housing situation. Present institutional facilities for housing finance are discussed in Part II. The need for specialised finance institutions for providing housing finance is examined in Part III in the light of the points emerging from a study of the housing situation, financial facilities currently available and the experience of foreign countries in solving their housing finance problem. Our recommendations regarding an appropriate housing finance system are also presented in that part. Salient features of housing finance institutions in some selected foreign countries are discussed in Appendix VI.

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14.3 It may be mentioned at the outset that housing construction depends on many factors. On the demand side, the important factors are the growth of population and of formation of households, development of new townships as a part of creating industrial complexes and an increase in incomes. On the supply side, the significant factors are cost and availability of land and building materials, fiscal and legal provisions affecting building construction and availability of institutional credit at reasonable terms. The importance of institutional finance arises from the long periods for which mortgage loans are required.

I

HOUSING SHORTAGE IN INDIA

14.4 Various indicators are available for assessing the gap between he demand for and supply of housing stock in India. An indicator of housing

shortage is provided by the proportion of *pucca* (permanent) dwellings to total housing stock. According to an estimate, this proportion in India is 23 per cent as compared to 96—99 per cent in some West European countries, U.S.A., Canada and Japan. An idea of the over-crowding in dwellings can be obtained from the fact that about 77 per cent of the total dwellings are of 1-2 room size, whereas in the developed countries only about 5 per cent of the houses are of this size.@

14.5 Another indicator of housing shortage is provided by a comparison between the number of dwellings and the number of households. At the end of 1967, there were an estimated 6.2 million urban *pucca* housing units for an estimated 18 million urban households ; thus, on an average there was one house for three households in the urban areas. In the rural areas the situation was still worse because for an estimated 81.6 million rural households, the number of *pucca* housing units was only 12 million. *Pucca* housing unit shortage on the eve of the Fourth Plan was estimated to be 13 million in the urban areas and around 70 million in the rural areas.@

14.6 According to present trends, the situation is not likely to improve at least in the near future because of increasing population, expected growth in household formation as well as rapid rate of industrialisation and urbanisation. As against the housing shortage reflected in the above statistics, the scale of effort made so far has been at a low level. The estimated rate of housing construction in India is around 2 dwellings per 1,000 population per annum as against 10 per 1,000 population which was recommended by the U.N., while considering the problem of housing shortage in the developing countries during the Development Decade, 1961-1970. The level of gross investment in dwellings in India, is less than 2 per cent of national income as against nearly 5 per cent of Gross National Product (GNP) in the developed countries. This is clear from Table 14.1.

14.7 Another indicator of the efforts made in India for solving the housing problem is provided by the investment in housing as a proportion of total investment in the public and private sectors. Table 14.2 shows that the proportion of investment in housing to total investment has steadily declined from 34 per cent in the First Five-Year Plan to 12 per cent in the Fourth Plan. Investment in housing as a percentage of total investment has been declining both in the public and private sectors. In the public sector, the proportion of investment in housing to total investment which was 16 per cent in the First Plan declined to 8 per cent in the Second, and 7 per cent in the Third Plan and is expected to be only 4 per cent in the Fourth Plan.

@ C. M. Palvia, ***Integration of Housing Policies and Programmes in the Perspective Economic Development Plan***—a paper submitted to the symposium on Role of Housing in National Economy, organised by the National Buildings Organisation and U. N. Regional Housing Centre for ECAFE region, New Delhi (1969).

TABLE 14·1—ESTIMATES OF PROPORTION OF INVESTMENT IN DWELLINGS IN SELECTED COUNTRIES

Country	Period covered	Gross invstment in dwellings as a percentage of GNP
(1)	(2)	(3)
1. Australia	1962	*4·5*
2. Chile	1954	*3·3*
3. China (Taiwan)	1960	*2·3*
4. Finland	1962	*5·7*
5. France	1962	*5·2*
6. Korea, South	1960	*2·3*
7. Netherlands	1962	*4·3*
8. Philippines	1960	*0·9*
9. Sweden	1962	*5·1*
10. Switzerland	1962	*7·0*
11. U. K.	1962	*3·0*
12. United States	1962	*4·5*
13. Venezuela	1957-59	*3·2**
14. West Germany	1962	*5·4*
15. India	First Five-Year Plan (1951-56)	*2·06@*
	Second Five-Year Plan (1956-61)	*1·87@*
	Third Five-Year Plan (1961-66)	*1·53@*
	Fourth Five-Year Plan (1969-74) (Estimated)	*1·60@*

* Based on market prices of 1957.

@ Figures are percentages to national income.

Sources : (1) Palvia, C. M., *Investment in Dwelling Construction*—paper presented at the symposium referred to earlier.
(2) Figures for India are based on the Five-Year Plan reports and NCAER, *Tax Incidence on Housing*, 1967.

The private sector which devoted almost 50 per cent* of total investment to housing in the First Plan, is expected to invest only 24 per cent* in the Fourth Plan.

TABLE 14·2—INVESTMENT IN HOUSING IN INDIA

(Rs. in crores)

	Investment in Housing			Total Investment			Percentage of		
	Public Sector	Private Sector£	Total	Public Sector	Private Sector	Total	Col. (1) to Col. (4)	Col. (2) to Col. (5)	Col. (3) to Col. (6)
	1	2	3	4	5	6	7	8	9
First Plan (1951-56) ..	250	900	1150	1560	1800	3360	*16*	*50*	*34*
Second Plan (1956-61) ..	300	1000	1300	3650	3100	6750	*8*	*32*	*19*
Third Plan (1961-66) ..	425	1125	1550	6300	4100	10400	*7*	*27*	*15*
Fourth Plan (1969-74) (Proposed) ..	535$	2175	2710	13655	8980	22635	*4*	*24*	*12*

£ Inclusive of investment in construction other than housing.
$ Break-downs are :
(*i*) Proposed investment in Social Housing Schemes .... Rs. 235 crores
plus
(*ii*) Estimate of proposed investment in Departmental Housing Schemes .... Rs. 300 crores

Sources : (1) NCAER, *Tax Incidence on Housing*, 1967.
(2) *Fourth Five Year Plan, 1969-74*, Government of India, Planning Commission, July, 1970.

14.8 The relatively low priority given to investment in housing is a feature common to many developing countries. This is attributable to a number of factors. Housing requires large capital resources and the capital-output ratio in this sector is high. Hence, when the objective is to attain a high rate of economic growth in a short period, housing is allotted a low priority. In a capital short economy the demand from other sectors like industry, power, communications and agriculture, therefore, gets a higher priority. But it is now recognised that attaching low priority to housing sector would adversely affect the long-term rate of growth of the country. The Regional Seminar on the Development of Housing Co-operatives in South East Asia@ held that the major reason for slow progress in housing construction in the South East Asian countries was the erroneous assumption

* These figures include investment in construction other than housing.

@ Organised in Kuala Lumpur/Penang (Malaysia) in October-November 1970 by the International Co-operative Alliance, Regional Office and Education Centre for South East Asia, and Co-operative Union of Malaysia.

that social progress would follow economic development automatically. Investment in housing is, in fact, an investment in social capital, and the effect on productivity as a result of improved housing situation is quite marked. In addition, it has enormous employment creating potential. Also, investment in housing has a multiplier effect on the economy through the concurrent development of allied industries.

14.9 Statistics given in the above paragraphs have shown the need for more investment in the housing sector. The magnitude of investment required is staggering. Various estimates have been made of the amount of investment which will have to be made in order to wipe out the present housing shortage. These estimates differ according to the estimates of shortage of houses and the assumption of cost of constructing a house. According to one estimate, the investment required would be more than Rs. 30,000 crores on the assumption of a modest outlay of Rs. 4,000 per dwelling and an estimated housing shortage of 83 million in 1969. This figure surpasses even the total investment of Rs. 22,635 crores proposed to be made in all sectors in the entire Fourth Plan period.

14.10 The importance of finance as a factor in housing construction may also be examined from the point of view of the individual who wants to own a house. Houses cannot usually be built out of the current income of an individual. Table 14.3 which gives figures for selected Asian countries shows that the ratio of housing cost to income varies from country to country but is generally quite high when judged from the point of view of the number of years of income required to own a house. It has been estimated that in India 4.9 years' income of an unskilled worker is required to get a 30 square metre house. Thus, even if an unskilled worker saves 10 per cent of his income it would take him 49 years to finance the construction of his house with his own savings ! It is also expected that in an economy, about 75 per cent of house-buying involves loan finance and over 50 per cent of all new and old houses are encumbered with debt. Another feature of the housing market is that the rate of interest plays an important part as an element in the cost of housing contruction. Hence, while the desire to own a house is strong in almost every individual, it is necessary for him to have long-term credit on reasonable terms. Thus, we see that whereas there is a large unsatisfied demand for housing credit, the supply of institutional credit is likely to be inadequate unless special steps are taken to encourage the flow of savings to this sector.

II

Existing Housing Finance Institutions

14.11 In this section, we shall examine the role of the existing institutions providing housing finance. The emphasis is not on the details of the

schemes introduced by different institutions but on the sources of their funds and the way in which financial facilities have been provided by them to prospective house owners.

14.12 The major institutions providing housing finance in India are : (*a*) Government agencies, (*b*) Life Insurance Corporation, (*c*) Co-operatives, (*d*) Other lending institutions, and (*e*) Private sector.

Government Agencies

14.13 The Central Government has introduced several social housing schemes for different classes of people and for specific income groups. The different schemes initiated by the Government and the years of introduction are shown below :

S. No.	*Name of the Scheme*	*Year of commencement*
1.	Subsidised industrial housing scheme	1952
2.	Low income group housing scheme	1954
3.	Plantation labour housing scheme	1956
4.	Slum clearance and improvement scheme	1956
5.	Village housing project scheme	1957
6.	Middle income group housing scheme	1959
7.	Land development and acquisition scheme	1959
8.	Rental housing scheme for State Government employees	1959
9.	*Jhuggie* & *Jhopri* removal scheme (in Delhi)	1960

The sources of finance for the schemes are normally the budgetary provisions made for housing from year to year and funds from the LIC. Central and State Governments also provide loans at low rates of interest to their employees.

14.14 Under these schemes, the bulk of the funds is provided by the Government of India and the LIC in the form of loans and subsidies. The Central Government keeps a watch over the working of the schemes but the actual implementation is done by the State Governments or their approved agencies and by the local administration and local bodies in the Union Ter-

ritories. These schemes have inevitably social welfare objectives because they are meant for people belonging to scheduled castes/tribes or to specified categories of employees and income groups. The amount and terms of loan as well as the period of repayment vary according to the schemes. The extent of finance made available is usually 80 per cent of the cost of construction with a maximum which varies from scheme to scheme. In the case of land acquisition and development scheme, however, 100 per cent financial assistance in the shape of loan is advanced to local bodies/urban estate departments for the acquisition of land.

14.15 The Government of India have established in April 1970 a Housing and Urban Development Corporation in accordance with the recommendations made at the conference of Housing and Urban Development Ministers at Bangalore in June 1969. The conference unanimously recommended that a Revolving Fund of the order of Rs. 200 crores should be built up through Government allocations, mobilisation of private savings and supported by assistance from the international agencies. Accordingly, the Corporation was incorporated as a Government company with effect from 25th April 1970, with an authorised capital of Rs. 10 crores. A provision of Rs. 2 crores on this account was included in the budgetary grant for the year 1970-71. According to revised estimate for 1970-71, the allocation remained unchanged at Rs. 2 crores. A provision of further Rs. 2 crores has been made in the budget for 1971-72, so that at the end of 1971-72, the capital of the Corporation would be Rs. 4 crores. Broadly speaking, the Revolving Fund is intended to be utilised in order of priority, for the following projects :

(*i*) Acquisition and development of land for sale for commercial-cum-housing purposes ;

(*ii*) Development of land for the construction of houses for sale ;

(*iii*) Construction and sale of houses.

The main criterion for accepting the project of housing finance from the Revolving Fund would be that investment should be capable of regenerating resources at a fast rate since the main object of the Fund would be to promote housing. Projects involving the construction exclusively of shops and commercial centres will not qualify for assistance unless they are part of a composite housing programme. The intention is to utilise the Fund to finance projects located in areas where there is a keen demand not only for houses and house sites but also for commercial and industrial sites so as to render the projects adequately remunerative. Commercial or industrial sites will be sold by auction. The disposal of houses or house sites to high and middle income groups will ordinarily be based on the system of outright payment. The profits made by the Corporation through its operations would be utilised partly to generate additional resources by reinvestment

and partly to reduce the price of houses/house sites meant for the low income groups and the economically weaker sections of the community. Since the purpose of the Fund is to fulfil a social objective, the Government of India is expected to subsidise the loans given by the Corporation to the extent necessary. Details regarding the resources that can be mobilised progressively (by way of equity and borrowings) and the terms of borrowing and lending have not yet been worked out.

Housing Boards

14.16 Various State Governments have established Housing Boards whose sphere of activities is expanding. These Boards acquire land and construct houses on a fairly large scale. These houses are either rented out or given on hire-purchase basis. The sources of finance for the Boards are customarily the budgetary allocations by the State Governments. They have, however, started issuing debentures on State Government guarantee to which institutions like nationalised banks are contributing.

14.17 Housing Boards are essentially construction agencies and not financing agencies. Their function hitherto was limited to creation and management of housing stock and not its financing. It is true that the hire-purchase scheme involves financing but the scheme is limited to the houses built by the Housing Boards themselves and not by others.

Life Insurance Corporation of India

14.18 LIC has emerged as one of the most important suppliers of long-term credit for housing in India. It advanced a total amount of Rs. 123 crores during the 9 years upto the end of March 1966. The average annual lending during that period amounted to nearly Rs. 14 crores. Since the average annual investment in housing during the first three five-year Plans was about Rs. 267 crores, broadly speaking, about 5 per cent* of the total average annual investment in housing was accounted for by the lending of LIC to this sector. During 1969-70, LIC granted loans of Rs. 36 crores for housing. This works out to about 7 per cent of the average annual investment (estimated) in housing during the Fourth Plan period, showing the increasing importance of LIC in housing finance. According to press reports LIC sanctioned assistance amounting to Rs. 75 crores for housing during 1970-71. Table 14.3 also shows the increasing share of housing loans in the total investment of LIC.

14.19 LIC makes available every year to the Central Government a certain amount for financing specified housing schemes of the various State Governments. The Government of India makes allocations to different

*This contains an element of over-estimation as the advances under 'Property Mortgage Scheme' which have been taken into account are not all for housing.

TABLE 14·3—LIC'S OUTSTANDING LOANS FOR FINANCING HOUSING AS PERCENTAGE OF TOTAL INVESTMENT

(Rs. in crores)

As on	Housing loans outstanding	Total Investment	Col. (1) as % of Col. (2)
	(1)	(2)	(3)
31-12-59	15·78	455·98	*3·5*
31-12-60	22·97	526·96	*4·4*
31-12-61	29·67	581·37	*5·1*
31-3-63@	49·92	677·28	*7·4*
31-3-64	66·70	763·45	*8·7*
31-3-65	85·47	839·96	*10·2*
31-3-66	111·44	961·04	*11·6*
31-3-67	133·78	1078·39	*12·4*
31-3-68	157·63	1202·45	*13·1*
31-3-69	182·58	1348·87	*13·5*
31-3-70	207·67	1514·26	*13·7*

@ After 1961, there was change in the Accounting Year from January-December to April-March.

Source : Annual Reports of LIC.

States out of the said amount. LIC also makes advances to apex co-operative housing finance societies on the guarantee of State Governments and these societies in turn make advances to primary co-operative housing finance societies for construction of houses. In addition, the LIC also extends loans under its 'Own Your Home' (OYH) scheme to its policyholders against mortgage of immovable property to approved parties for construction of residential, office/commercial accommodation, to public limited companies for the purpose of housing schemes for their employees and to co-operative housing societies formed by the employees of public limited companies.

14.20 The interest rates on loans vary from 6½ to 8½ per cent per annum depeding on the scheme. The period of repayment varies from 15 to 20 years and in some cases may extend to even longer periods.

14.21 One scheme of the LIC — 'Own Your Home' — is particularly worth mentioning because under this, the LIC extends loans at reasonable rates to policyholders with stable incomes. The scheme also has elements of compulsory savings. Under this scheme, LIC advances loans to its policyholders for construction of houses, extension of existing houses or for

purchase of recently constructed houses in good condition. The minimum amount of loan for construction of houses under this scheme is Rs. 10,000 and the maximum Rs. 1 lakh. For the purpose of extension, the minimum loan is Rs. 7,500. Rate of interest is 7½ per cent per annum. The loan is granted on the first mortgage of the property. An interesting feature of the scheme is that the repayment of the loan may be made out of the proceeds of the endowment insurance policy/policies on the life of the borrower. The policy or policies should have a maturity date not later than the date of expiry of the repayment programme. As an alternative method of repayment, the loan may be repaid in full with interest due thereon by equated monthly instalments spread over the repayment programme.

14.22 While the LIC is playing a significant part in housing finance, the magnitude of housing finance that it can make available is subject to the total amount which, under its investment policy, the Corporation can devote for the purpose. Also, ordinarily only persons residing at places specified by the LIC for the purpose of the scheme can take advantage of it. According to available information the number and total amount of loans sanctioned during the last 3 years under the OYH Scheme has tended to decline. It is understood that the LIC has recently streamlined the operations of the scheme and extended it to all its offices and sub-offices in the country as well as to certain specified centres.

Co-operative Housing Sector

14.23 The co-operatives represent an important part of the organised sector providing housing finance. Co-operative housing finance units can be classified into State level societies and primary societies. The State level societies have the entire State as their area of operation and their membership consists of all the primary housing societies within the State. They (State level societies) channel their advances to the primaries. In some cases they have undertaken construction also. Table 14.4 gives an idea of the increase in number, membership and total assets of the co-operative housing societies in the country.

TABLE 14·4—PROGRESS OF THE STATE LEVEL CO-OPERATIVE HOUSING SOCIETIES AND PRIMARY CO-OPERATIVE HOUSING SOCIETIES IN INDIA DURING THE PERIOD 1958 TO 1968

Particulars	State level societies			Primary societies		
	As on		Increase in 10 yrs.	As on		Increase in 10 yrs.
	30-6-58	30-6-68		30-6-58	30-6-68	
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. No. of societies	5	17	12	4172	13817	9645
2. No. of members	1419	8618	7199	247883	893718	645835
3. Total assets (Rs. crores) ..	2·72	53·61	50·89	40·86	241·09	200·23

Source : Statistical Statements relating to the Co-operative Movement in India, 1957-58 and 1967-68.

14.24 During the ten year period 1958-68 the average annual increase in the total assets of the primary housing societies was of the order of about Rs. 20 crores. Approximately 7.5 per cent of the average annual investment in housing in the country during the first 3 Plan periods was represented by this sector, although it should be added that a major portion of the loans made by the co-operatives to its members came from the LIC in the form of loans to co-operatives.

14.25 The major source of finance for the co-operative societies is borrowing from the Government or from other agencies (mainly the LIC). The importance of borrowings in the working capital of the societies has been increasing over years. For instance, the owned funds of the State level societies which formed 33 per cent of the working capital at the end of June 1958, came down to 11 per cent at the end of June 1968. Correspondingly, total borrowings as a proportion of the working capital increased from 67 per cent to 89 per cent. The same trend was visible in the case of primary level societies too.

14.26 The financing schemes of the co-operative housing societies necessarily involve an element of self-help mechanism. They represent an organised sector and a well known institutional mechanism for the dispensation of finance for housing. However, the progress of co-operative societies has been uneven in the country. While it has been pronounced in Gujarat, Maharashtra and Tamil Nadu, the movement has not been so successful in other parts of the country. Also, some co-operative housing societies are reported to be suffering from many unhealthy practices. The Mirdha Committee appointed by the Government of India had mentioned in 1965 that they had seen a series of luxurious flats in posh localities built with the assistance of co-operative housing finance in Gujarat and Maharashtra where co-operative housing activity was relatively more developed.[£] Many co-operative societies have fixed ceilings on the amount of loan that can be given to a member. Also, persons with incomes beyond a certain level are not eligible to obtain loans. However, there are profit motivated promoters who purchase land at a low cost and, after forming societies, sell the same to the society at exorbitant price. They enrol members for a number of societies simultaneously and spend funds only on one society, or obtain contracts

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£ The Committee also observed: "Thus, the schemes in which crores of rupees have been sunk have generally gone to tarnish the image of co-operation." (*Report of the Committee on Co-operation* (Chairman: R. N. Mirdha), Ministry of Food, Agriculture, Community Development and Co-operation, Govt. of India, New Delhi, 1965, paragraph 15.

Shri I. K. Gujral, Minister for Housing also stated at the Sixth Co-operative Congress held in New Delhi from 6th to 8th April, 1971 that "Colonisers have, in some cases, found their way into co-operative housing societies. In fact it is difficult to register a complaint against them, much less to take adequate action. The consequences are that they make quick money and become rich overnight. There are cases of housing co-operatives whose members have been agitating to liquidate the societies with a view to weeding out the undesirables." (*Housing Times*, April 1971).

on various bogus names thereby misappropriating funds.† Moreover, an individual who, for some reason or the other, cannot become a member of a co-operative housing society is not in a position to borrow at concessional rates from the co-operative institutions.

Other Institutions — Commercial and Urban Co-operative Banks and Nidhis

14.27 Except the State Bank of India, commercial banks are not legally prevented from advancing loans for housing finance. The State Bank of India Act precludes it from extending credit for housing purposes, except, to the members of staff of the bank. A number of commercial banks extend loans to their own employees. Some of them also make loans to builders but statistics for the same are not available However, very few commercial banks extend housing finance to borrowers other than their own employees. Recently, a few banks have introduced some schemes. For instance, Bank of Baroda, under its personal loan scheme, extends credit upto Rs. 25,000 repayable in 10 years in equal monthly instalments. The margin is 40 per cent and the interest rate is 5 per cent over the Bank Rate with a minimum of 11 per cent. The security is equitable mortgage of land together with construction thereon and assignment of a life policy for an equivalent amount of the loan. In addition, a demand pronote is also insisted upon. The Benaras State Bank has introduced a similar scheme under which loans are given for construction of houses to persons who have assured monthly income of at least Rs. 1,000. The maximum amount of the loan is Rs. 25,000 repayable in 10 years in monthly instalments. As in the Bank of Baroda scheme, an endowment policy on the life of the borrower is to be assigned to the bank as a collateral security. The rate of interest is 10 per cent per annum. In the case of persons having a monthly income of Rs. 500—1,000, the maximum amount of loan will be Rs. 15,000.

14.28 It will be seen that under the schemes of both the banks, monthly payments of a borrower will be quite considerable, particularly if the premium on the insurance policy is also taken into account. For instance, under the scheme of the Bank of Baroda, the monthly repayment would come to about Rs. 500 for a person, aged 35, who takes a loan of Rs. 24,000 for constructing a house costing Rs. 40,000. The amount of monthly repayment includes interest, repayment of principal and premium on insurance policy. However, he would save on rent which he would otherwise have paid for his accommodation. A person, in the above example, should have Rs. 16,000 before he can obtain a loan from the bank. It may be pointed out that at the end of the transaction he would have a highly desired terminal asset.

† Recently, the Maharashtra Co-operative Housing Finance Society issued a warning to prospective members of co-operative housing societies against misleading advertisements issued by builders and professional promoters of co-operative housing societies in which apartments are offered in proposed co-operative housing societies with loan facilities. Such advertisements are likely to mislead the people because they do not spell out the conditions under which loans are given. "As a result some people may fall a prey to unscrupulous builders and promoters". (Times of India, 9th July, 1971.)

14.29 The Indian Bank has recently introduced a different kind of scheme which combines the savings of the acccount holder with advance commitment on the part of the bank to grant a loan for owning a house. Under this scheme, the deposits can be made in monthly instalments of Rs. 50 or over in multiples of Rs. 10 and savers can opt for deposits over periods of 3, 4, 5, 6 or 7 years. The deposits will carry rate of interest of 4 per cent per annum. At the end of the agreed period an amount equivalent to the deposit will be granted as a loan for constructing or purchasing a house. The loan will be repayable in monthly instalments for similar periods agreed to for the relevant deposits. The maximum amount of the loan will be Rs. 30,000 and the interest will be at 8 per cent per annum on the reducing balance basis. A similar scheme with some variations was introduced by the United Commercial Bank in December 1969, and recently by the Syndicate Bank.

14.30 No information is available on the progress of these schemes. The principle behind the schemes, namely, encouragement of saving for the purpose of acquiring a house, is commendable. It is doubtful, however, whether in their present form the schemes would be popular because a person who wants to own a house has to save at least an amount equal to half of the total cost before he can expect to get a loan from the bank. Also the repayment period is not long enough to suit the convenience of a prospective house-owner, belonging to lower and middle income groups.

14.31 Statistics of housing loans made by urban co-operative banks are not available. However, these banks do not play a significant role in housing finance because they are reluctant to give long-term loans. Also, with the passing of the Banking Laws (Application to Co-operative Societies) Act, a primary co-operative bank is not permitted to have other co-operative societies as its members. Thus urban co-operative banks cannot advance loans to housing societies. Under special conditions, however, an urban co-operative bank can be permitted to give loans to housing co-operative societies.*

14.32 Urban co-operative banks which give housing loans to their members confine themselves to relatively small amounts (usually a maximum of Rs. 10,000 to an individual) and the duration of the loan is 7—10 years.

14.33 Nidhis, as we have seen in Chapter 7, also provide loans for housing construction but their operations are limited to certain localities and to their own members only.

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* For instance, the Registrar of Co-operative Societies, Maharashtra State, permitted urban co-operative banks in 1966, under special conditions and within the prescribed limits, to finance housing and industrial co-operatives. The Reserve Bank also agreed to this proposal. G. S. Kamat, *The Janata Sahakari Bank Poona—A case study*, printed in *A Bunch of Field Studies*, Vaikunth Mehta National Institute of Co-operative Management, 1969.

Private Sector

14.34 There are also a few housing finance companies in India. Some of them accept deposits and make loans mostly on mortgage of plots and buildings. The extent of the loan is 50-60 per cent of the value of the mortgaged property. The duration of the loan is usually 8 to 10 years and in addition to the mortgage of the property, surety and LIC policy are also required.

14.35 Table 14.2 given earlier, shows that out of the total investment in housing of Rs. 4,000 crores in the 15 years of the first three Plans, Rs. 3,025 crores or nearly 75 per cent was made by the private sector. Finance is raised in this sector generally in the following ways : (*a*) individuals utilising their own savings and (*b*) professional builders utilising their capital and by borrowing from available sources.

14.36 Most of the individuals do not have enough savings to construct their houses. Provident Fund facilities and loan facilities are available only to a section of the employees of the Government and private institutions. Also the rules for withdrawal from the Provident Fund are not always easy, nor is the amount of loan always sufficient to enable the borrower to build or purchase a house.

14.37 The professional builder also finds it difficult to get interim finance during the period between the investment of his funds and the final sale of flats. The Builders Association of India in the course of discussions with the Banking Commission, stated that financial facilities available to construction industry are inadequate. They pointed out that in getting loan from commercial banks, they depend on their personal standing or on their relationship with the banks. Majority of builders generally have to make their financial arrangements either from private sources or from shroffs or multanis on a hundi basis. If they borrow from the indigenous bankers, they have to pay a very high rate of interest. They also get trade credit from the sellers of building materials. In addition, they attract funds from the prospective purchasers of flats. Their difficulties are enhanced because they have to tender for a number of jobs at a time before they get the work order for the job. They have to give earnest money varying from 1.— 4 per cent of the cost involved. The Association has suggested that if financial assistance was made available to them by commercial banks, the cost of construction of houses could be brought down. The Association has also suggested the establishment of a 'Construction Industry Development and Finance Corporation' for giving financial assistance to civil engineers and contractors for construction purposes.

14.38 Builders have also represented that they face certain difficulties in borrowing from commercial banks. It is well-known that large amounts

of concealed income are involved in construction industry and trade. It is said that in big cities, with a view to avoiding taxation, the vendors show a part of the value of document while the other part is received in cash without receipt. The commercial banks may charge a relatively low rate of interest but they grant loans to the extent of 70 per cent of the *document price* of a property. Thus, for a property worth Rs. 1,00,000 a builder may get Rs. 35,000 from the bank because the document price will be only Rs. 50,000. It should be recognised that the problem arises because the borrowers do not reveal their correct financial accounts to commercial banks. The indigenous bankers and the private moneylenders grant loans upto 70 per cent of the *actual worth* of the property. Thus, they offer financial facilities which in effect encourage irregular and illegal operations in the sale and purchase of land. Further, they charge rates of interest between 24 per cent and 36 per cent per annum although the document rate of interest is not more than 12 per cent per annum. The indigenous banker keeps the title deeds in his custody until the loan is repaid and also takes in advance a post-dated cheque as extra security from the borrowing builder. Thus, the credit granted by the moneylender or indigenous banker is facile, but costly. This inevitably affects the cost of construction. The operations of unscrupulous builders are also prone to land a large number of prospective buyers of houses in difficulties. The overall operations provide a fertile ground for several malpractices.

Brief Assessment of Institutional Credit Facilities Available

14.39 An examination of different institutions providing housing finance in India leaves the impression that there is no organised housing finance system serving the entire country and meeting the requirements of borrowers who want to own a house. There are some schemes with commendable features but they are either limited to certain persons or groups or to certain localities. The most important lacuna in the existing state of affairs is that there are no countrywide institutions which combine regular savings schemes with provision of housing finance in adequate amounts and on reasonable terms. This conclusion is strengthened if we examine the salient features of housing finance in some foreign countries. A brief study of housing finance institutions in selected foreign countries is given in Appendix VI.

Conclusions and Recommendations

14.40 It will be seen that a solution to housing problem will require a multi-pronged action. Land and building material should be available at reasonable prices. The State Governments can play a useful role by making land for housing purpose available at reasonable prices. Building research institutions can also contribute to the successful implementation of housing programme by developing cheap housing materials. The above

discussion also shows that to attain the objective of providing a house to every household in India, would require an enormous amount of investment. This can be achieved by reallocating the available savings in favour of the housing sector and/or promoting new savings for the purpose of investment in housing. There is probably some justification for allocating to housing a larger proportion of the total investments than has been done up till now, particularly because it is held that an improvement in the housing conditions will increase the efficiency of human capital. In the main, however, it will be more beneficial if the savings of the community can be increased by directly linking such additional savings with housing construction.

14.41 A study of housing finance systems in selected foreign countries (Appendix VI) shows that an essential feature of the system in most countries is a link between saving facilities provided by specialised institutions with the provision of finance by them for housing construction or purchase of houses. We believe that the desire to own a house can have a substantial impact on the mobilisation of national savings in India also. Moreover, Governments in foreign countries have taken active steps to encourage mortgage lending through the provision of mortgage insurance system and creating conditions for the development of a secondary mortgage market. Both these are necessary to meet the peculiarities of the housing market where the credit required is of a long-term nature with the attendant problem of illiquidity.

14.42 Hence, we may evaluate the credit facilities provided by the housing finance institutions in India on the basis of the following criteria : (*a*) do these institutions promote savings? (*b*) do they provide long-term credit on reasonable terms? and (*c*) do they generally create an atmosphere where housing construction/ownership is encouraged? Since the problem of finance arises mainly for persons belonging to low and middle income groups, we have to bear the needs of these categories of borrowers particularly in mind.

14.43 As pointed out in the previous Part, we do not have in India a well organised housing finance system. Housing co-operatives have certain advantages particularly because the beneficiaries of co-operative societies can make substantial savings in cost through group action. The movement has not, however, made much headway except in a few States. Moreover, in some cases, the co-operative housing societies have become largely dependent on the profit-motivated 'promoter' who in return for his fee/house, undertakes the task of developing the co-operative housing project. The most serious lacuna in the working of co-operative housing societies is that they are dependent on, and in fact increasingly so, outside sources. Also, an individual is not always in a position to become a member of a co-operative housing society. While the co-operative form of housing societies may continue to be encouraged particularly with an emphasis on mobili-

sation of savings from members, the co-operative movement alone will not be able to take care of the housing finance problem in India.* In connection with the objective of strengthening the co-operative structure we endorse the suggestion of the Working Group on Housing Co-operatives, that there should be a two-tier federal structure for co-operative housing organization in each State, with an apex society at the State level and primary affiliated societies all over the State.

14.44 Nidhis and mutual benefit funds have performed useful services but generally they have not expanded their activities. So far as commercial banks are concerned, the long periods for which housing loans are required and the demands being made on them from various sectors as well as the absence of a secondary mortgage market preclude their participation in housing finance on a large scale. Employers do give loans to their employees for construction of houses and the Government finances a number of social housing schemes, but the benefit of such schemes is not available to all persons desiring to own a house. Moreover, since social housing schemes are financed from budgetary sources, the amount of money that can be allotted to them is inadequate. It is thus only the LIC which offers nationwide urban mortgage lending on long maturities at reasonable rate of interest to its policyholders. The private sector is dependent mostly on the unorganised sector like the indigenous bankers and the moneylenders.

14.45 Thus we see that we do not have in India an institutional framework to meet the objective of encouraging savings for the purpose of investment in housing nor is our system responsive to the characteristics of housing market. In particular, no steps have so far been taken in India to develop a mortgage market or create a simple mortgage instrument to overcome the reluctance of potential investors in extending long-term and relatively illiquid loans in the mortgage market.

14.46 It would appear from the above analysis and discussion that the basic requirements of an appropriate housing finance system would be the following : (*i*) specialised institutions may be created, the main functions of which may be to encourage savings and give housing loans on reasonable terms ; (*ii*) since conditions in the housing market vary greatly from place to place, it would be desirable to have local institutions. This will have the advantage of using local savings for local development. As in the U.S.A., such institutions may be knit into a system through a central institution which may help them and supervise their functions ; (*iii*) there should

* That a co-operative housing society can succeed in mobilising deposits is shown by the example of the Vidharbha Premier Co-operative Housing Society Ltd., Nagpur. This Society, whose operations are confined only to Nagpur, has been able to procure sizeable deposits. Its deposits have increased from Rs. 1.14 lakhs as on 30-6-1936 to Rs. 125·71 lakhs as on 30-6-1970, and its outstanding loans from Rs. 2·38 lakhs as on 30-6-1936 to Rs. 141·90 lakhs as on 30-6-1970. Deposits as a percentage of working capital have increased during the same period from 65.9% to 80·9%. It financed 154 houses during 1969-60. It is also interesting to mention in this connection that the society has not taken any loan or assistance from the Government, LIC or commercial banks.

be a machinery to offer suitable guarantee and insurance to cover the risks involved in providing house finance ; (*iv*) conditions may be created to develop a secondary mortgage market ; (*v*) steps may also be taken to ensure the availability of short-term construction credit to builders of houses to undertake new construction, pending sales to the ultimate purchasers.

14.47 The type of institutions which we have in mind will be like the Savings and Loan Associations of the U.S.A. There will be a two-tier system. At the bottom, that is, at the district or the regional level, there will be local housing finance institutions sponsored by the local community with the active encouragement of an apex central housing finance institution. The nidhis which are already providing housing finance in the localities where they operate can be encouraged to develop into local housing finance institutions. The functions of the central housing finance institution will be to charter, encourage and supervise the local housing finance institutions and serve as a source of temporary liquidity to them as and when required. The central institution will also lay down the policies and standards of operations of local housing finance institutions. We have already a nucleus of a central housing finance institution in the Housing and Urban Development Corporation. However, the proposed central institution will be vested with the responsibility and authority for serving the housing needs of the country in its different aspects and not merely concern itself with financing special building projects. The source of funds for the central housing finance institution will initially have to come from the Government, but ultimately the institution will rely on market borrowings, if necessary, backed by Government guarantee. The LIC may also give loans out of its funds, earmarked for housing, to the proposed central institution. The central institution should also have powers to borrow from the Government and/or the Reserve Bank of India. For this purpose, the Reserve Bank may consider the creation of a fund specially for such loans.

14.48 The prime function of a local housing finance institution will be to provide easy and attractive instruments of savings linked to provision of credit for construction or purchase of houses. They will be local in character, although depending upon the conditions of the housing market, some institutions can be regional. The deposits with local housing finance institutions may be insured by the Deposit Insurance Corporation subject, of course, to their meeting the requirements laid down by the Corporation in this behalf.

14.49 The Government will have to play an active role in encouraging the proposed specialised institutions. It has to be recognised that initially these institutions will not be able to finance housing construction or house purchases on a large scale from their own resources. Hence, Government will have to keep funds at their disposal in the initial stages. The object, however, should clearly be to mobilise additional savings and ultimately eliminate reliance on Government funds.

14.50 An important element of the proposed housing finance system would be to create conditions for the development of a mortgage market. For this purpose, a scheme of insurance of mortgage loans should be devised. LIC, which has some expertise in mortgage lending, or general insurance companies can devise such a scheme, and the housing loans made by the proposed housing finance institutions as well as by other financial institutions can be guaranteed. Guarantee of the repayment of mortgage loans will, however, indemnify an investor only against the risk of default on the part of the borrower. There will still be the problem of imparting the characteristics of liquidity and attractiveness to mortgage paper. This will essentially involve a proper legal framework which would cover such matters as land title, mortgage instrument and procedures for their enforcement. The object should be to develop a uniform countrywide, simple and familiar mortgage paper. The law relating to Transfer of Property will have to be reviewed and, if necessary, suitably modified to facilitate the creation of mortgage paper. In due course the central housing authority should be ready to purchase and sell mortgage paper in the market. Such operations should, however, be conducted in consultation with the monetary authority of the country. Fiscal concessions including relief from State and municipal taxes, may also be considered to increase the attractiveness of mortgage paper as an investment instrument.*

14.51 It will also be useful to ensure co-ordination of functions between commmercial banks and the proposed housing finance institutions. The Group suggests that commercial banks may consider the following arrangements. They may give construction loans to the builders, particularly those builders who have well maintained accounts and have the necessary expertise for their profession. If the ultimate purchasers of houses are assured of adequate and reasonable credit facilities from the proposed housing finance institutions, there will be a ready market for houses and commercial banks would be assured of repayment of credit extended by them to the builders. Commercial banks should also entertain applications even from individuals for the purpose of construction of houses. These applications may be sent by commercial banks to the proposed housing finance institutions. Once the housing finance institution accepts the project, it should assure the commercial banks that a long-term loan would be given to the borrower. On getting this assurance, commercial banks may finance the construction of the house and after the house is completed, the loan may be repaid to commercial banks by the housing finance institution. Thus, the house-owner will get a long-term loan from the proposed institution. In order to co-

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* Taxes add to the cost of housing construction. It may, however, be pointed out that a study on tax incidence on housing published by NCAER revealed that the incidence of tax which adds to the cost of construction and to total investment in housing varies on an average from 7·62 per cent of total investment in Delhi to 5·12 per cent in Patna. The incidence varies on the average from 9·61 per cent of the construction cost in Ahmedabad to 6·14 per cent in Patna. The study was confined to Ahmedabad, Delhi, Hyderabad, Madras and Patna.

Source : Tax Incidence on Housing, NCAER, 1967.

ordinate the activities of commercial banks with those of proposed finance institutions in the interest of encouraging the flow of finance to the housing sector, the State Bank of India Act may be amended to enable it to grant housing loans.

14.52 An important point to consider in this connection is the competition which the proposed specialised institutions may offer to commercial banks, LIC, UTI, Provident Fund, etc., in mobilising savings particularly if they offer savings schemes which are more lucrative than those offered by the existing financial institutions. It should be stressed that the purpose should be to increase the savings in the economy for the purpose of housing construction, rather than trasfer them from one institution to another. The first point to be noted in this connection is that competition for available savings will be restricted because the motivation behind savings would be different. A policyholder of the LIC would primarily be interested in having his risk covered. A unit holder would be interested in regular return on his savings and appreciation of his assets. A saver in the proposed financial institution, however, will be attracted both by the return on savings and the desire to own a house, although, it should be added, the schemes in the proposed institution should not be limited only to those who would like to own a house. Some measures can be considered to restrict competition for deposits between the proposed institutions and the other financial institutions. For instance, in their role of mobilising deposits from their members,deposits may be accepted by the proposed institutions only for long-term periods, as is done by housing finance institutions in certain foreign countries. Also, restrictions can be placed on the frequency of withdrawal of amounts to minimise the risk of competition with commercial banks. These restrictions, however, will not wholly eliminate competition. Nevertheless, it is possible that increasing the number of savings media would induce a larger savings flow.

14.53 The Study Group has offered only broad guidelines for creating specialised housing finance institutions for meeting the housing finance needs of the country. Once the principle is accepted, details can be worked out. In working out the details, it would be necessary to ensure that duplication of efforts is avoided as far as possible. For instance, wherever desirable and feasible, the existing Housing Boards can be invested with the functions of housing finance institutions proposed by us. Also, the social housing schemes of the Government, co-operative housing finance schemes and the schemes involving loans from employers to their employees may continue to operate. It may be noted that an element of subsidy will be required for providing loans to the weaker sections of the community.

14.54 We may in conclusion re-emphasise that the focus of our attention has been on the problem of creating an appropriate system of housing finance. Provision of finance alone, however, is not sufficient. Legislative

and other action will have to be taken in ensuring that the price of land is reasonable and essential building materials are available at reasonable prices. No housing finance scheme would succeed if the unit cost of construction continues to be high. It is also necessary to collect statistics in an organised way about the different aspects of the housing market. Such statistics would greatly facilitate the work of the finance institutions and help the Government in evolving a proper housing policy. It is also important to point out that the establishment of new specialised institutions will require considerable technical personnel resources. In this connection assistance of international institutions like the World Bank and the Economic and Social Council can be of great help.

Note : One of our members, M. Narasimham, is unable to agree with the recommendations of the other members of the Group in regard to the setting up of a separate system of housing finance institutions. His note on the subject is appended to the chapter. There are undoubtedly many difficulties that will have to be faced in establishing a whole chain of new institutions. If we were able to feel certain that commercial banks would be able to undertake the huge task in addition to the wide and expanding range of functions they will be expected to perform, we would not have recommended a new system. We have also taken into account the high degree of likelihood that savings will increase substantially, if they are linked up directly with the acquisition of one of the most highly desired personal assets. However, commercial banks, in our view, are not to be precluded from expanding their activity in the field of housing finance. Besides, the setting up of a new system will require time and, during the transitional period, commercial banks may be encouraged to do all they can in this field.

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A NOTE ON HOUSING FINANCE BY M. NARASIMHAM

N.1 I have serious reservations in accepting the recommendations of the majority of the members of the Study Group with regard to the creation of what I consider to be a parallel banking system in the country for the purpose of providing housing finance.

N.2 The Study Group, in examining the general question of the need for specialised institutions, has taken the view—rightly in my opinion—that specialised institutions to cater to the needs of specific sectors are not, in general, desirable or necessary though it recognises that there may be particular cases which may be exceptions to this general rule. The Group's conclusion is that specialised institutions should be created only if there is a clearly identified credit gap which, for some reason or the other, cannot be filled by the existing financial institutions. The proposal for setting up system of housing finance institutions to be federated at the apex level with a central housing finance institution would, therefore, be justified only if the existing credit gap cannot be financed by the financial institutions now in the field.

N.3 I certainly do not minimise the importance of accelerating investment in the housing sector and promoting new savings for the purpose of financing such investment. I would also agree that it would be useful to forge links between savings facilities with this specific object in view and provision of finance for housing construction or purchase. I am, however, not convinced that it is beyond the ability of the existing financial institutions to undertake this task or that it is desirable or even feasible given the constraint of organisational resources and overall paucity of savings in the economy that a mere replication of the commercial banking system will achieve this result.

N.4 The Study Group lays emphasis on the creation of local institutions the main functions of which would be to encourage savings and give housing loans on reasonable terms. If these institutions are to be local or regional, they would have to operate in the various districts of the country. This would be necessary if the impact of the facilities has to be widespread. The rapid expansion of branch banking system in the last few years has, it would be admitted, placed considerable strain on the organizational resources of the commercial banks. If this is the situation in respect of commercial banks which already have a base to build on, the immensity of the task of floating new institutions to operate at the local level throughout the country could well be imagined. The demand on both financial and organizational resources of the community that this would place would be so onerous as to cast doubts on its practicability and efficiency.

N.5 I believe the better way would be for the commercial banks themselves to have specialised departments—may be with separate accounting,

if necessary—to undertake this function so that the advantages of the commercial banks' organization and regional coverage would be secured at once. I have suggested the setting up of separate departments with separate accounting so that the deposits which commercial banks accept for this purpose could be segregated as a form of long-term or recurrent deposits with a special rate of interest and loans for housing could be made out of such deposits supplemented by suitable refinances or even borrowing from the general banking departments of the banks. Thus, there is no reason why the Housing and Urban Development Corporation or the State Housing-Boards could not themselves place their funds either by way of loans or refinance to the commercial banks for this purpose. There need be no objection to commercial banks obtaining refinance from this source. Just as for certain types of industrial term loans or agricultural term loans they get refinance from the Industrial Development Bank of India and Agricultural Refinance Corporation respectively, they could obtain refinance for housing loans from the Housing and Urban Development Corporation. Housing loans are likely to be fully secured loans ; safety is not likely to be a problem. The liquidity of the assets—its ready realisability—is. If liquidity were to be equated with shiftability we could provide for the Housing Corporation not only guaranteeing housing loans as do the Federal Housing Administration and Veterans Administration in the U.S.A. but also being ready to take over the loans, when banks need liquid funds. Refinance would thus have this advantage. Incidentally, the problem of liquidity is not peculiar to commercial banks. It would apply equally to the local housing finance institutions as recommended by the majority of members of the Study Group.

N.6 The commercial banks could also enter into arrangements with the LIC which could then provide the necessary financial support to the commercial banks for this purpose. Alternatively, the commercial banks could undertake to act as agents of the LIC which is now emerging as a major lending institution for this important sector. In fact, I am not clear in my mind as to what is expected to be the role of the LIC in the set-up proposed by the majority of the members of the Study Group. Should it continue to deal in housing at all if an elaborate system of local housing finance institutions and a central financing agency were created? Should it provide financial support to the central body or should it operate *via* the proposed local housing finance institutions? Again, should its loans be in the form of refinancing these bodies or should it subscribe to their market borrowings? It is necessary to co-ordinate the functions of the LIC, the Central Housing Corporation and the housing finance institutions for this purpose. The problem of co-ordination is important because even under the system proposed by the majority of members, it will be necessary for there to be a proper *inter se* relationship between various agencies providing finance for housing.

N.7 For the last analysis, the problem is not one of creating new institutions but of mobilising more savings in the community for this purpose.

There is no reason to suppose that commercial banks cannot do so while new institutions can. In fact, the commercial banks in India have to be regarded as multi-purpose agencies acting as what may be termed as a financial supermarket where a variety of diverse services could be provided. This would make sense in a situation like ours where there is need to conserve our financial and organisational overheads. Lending to housing need not be regarded as being outside the purview of commercial banks' functions. There are enough examples from foreign countries to support this. It might be felt that asking commercial banks to undertake housing finance may not succeed as the banks might not give this business adequate priority in their lending. We do not need a new set of institutions to accord priority to a particular field. Commercial banks are already taking up new lines of activity and revising their established order of priorities. There is no reason to think that they will not give housing the priority it needs if the policy decision of the authorities is that they should do so. The separation of the housing finance departments from the general accounts of the bank would in fact focus attention on their involvement in this field with at the same time indicating the extent to which they can go in for such business consistent with safety and profitability.

N.8 I would, therefore, plead that rather than propose the establishment of an elaborate system of local housing finance institutions federated with a central housing agency, we may ask the commercial banks themselves to undertake the task in specialised departments set up for this purpose and supported by appropriate guarantee/refinance arrangements.

M. NARASIMHAM.

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CHAPTER 15

NEED FOR SPECIALISED INSTITUTIONS FOR CONSUMER CREDIT

INTRODUCTION

15.1 Credit in the organised sector in India is given generally for financing fixed and working capital requirements of business and industry. The quantum of credit for consumption purposes forms at present a small fraction of the total credit of the organised sector. This state of affairs, however, may not suit the requirements of the economy for ever. For, with rapid economic development, and full utilisation of industrial production capacity, the potential supply of consumer goods will increase. While increased incomes would tend to push up demand for consumption goods and services, such an autonomous demand may not be sufficient to match the potential supplies ; it may, therefore, have to be supplemented by demand induced partly by credit. But before actually reaching this stage of development, it is necessary that the financial system achieves enough resilience and flexibility to encourage credit for consumption purposes in a gradual and an orderly fashion, without adversely affecting the price situation and the pattern of economic growth. It has also to be recognised that at present there are no institutional arrangements for satisfying the occasional acute demand for consumption credit, *e.g.*, for meeting the medical bills. In this chapter, we shall study first the present level of consumer credit and then examine whether consumer credit in future should best be extended within the given institutional framework or by specialised institutions. In this analysis, we shall take into account the present economic policy and situation as well as the likely economic and institutional changes by the next decade.

THE BASIC FEATURES OF CONSUMER CREDIT

15.2 Consumer credit is not as common a feature in India as in the West. Its essential features, therefore, can be derived primarily from what the Western experience reveals. It is short and intermediate term credit granted to consumers for personal consumption purposes or for refinancing debts incurred for such purposes, in not too large sums and preferably within certain limits of minimum and maximum.† It may be given either directly to consumers (be they individuals, firms or retail traders) or indirectly through

† The purposes are, *e.g.*, purchase of durable goods like automobiles, refrigerators, electric fans, radios, etc., meeting unavoidable expenses like the loss of property due to fire, or other expenses like medical bills, payment of taxes or settling small bills/debts.

the dealer of the product for any durable commodity specified by the customer. Whether consumer credit is direct or indirect, it will be in the nature of demand loans, liquidated in instalments (usually monthly) that are agreed upon between the borrower and the lender. Consumer credit is generally provided without lodging any securities ; it is largely based upon calculations of borrowers' character, integrity and net potential earning capacity. It is usually not granted for purchase of lands or houses (which are no doubt items of consumption) mainly because in the first instance, purchase of a house forms a large item in an individual's budget and secondly, housing finance is treated in the West as a special area of loan business of most of the organised financial institutions or alternatively is given by specialised institutions.

Consumer Credit Distinguished from Hire-Purchase Credit

15.3 Consumer credit forms an important part of what is broadly termed as instalment credit,* the other part being hire-purchase credit. Consumer credit is, therefore, not the same as hire-purchase credit. Strictly speaking, the commodity that is bought by the consumer-borrower with the help of consumer credit becomes his own, whereas in hire-purchase system, the hirer of the good cannot claim its ownership. Again, the good that is hired would usually, though not always, be a productive asset and a source of earning while consumer loans are not for productive purposes or for purchasing assets that give rise to flow of income. Moreover, consumer credit may be given to meet an emergency or an expense like a medical bill and thus may not necessarily be for purchasing any physical goods.

Suppliers of Consumer Credit in India

15.4 The institutions that have been giving consumer credit in India are many. Traditionally, urban moneylenders and to some extent indigenous bankers have been the main lenders of credit for consumption purposes.@ Scheduled commercial banks, employees' co-operative credit societies and urban co-operative banks also give personal loans. Organisations in both the public and private sectors often allow their employees to draw on their accumulated provident fund balances and recover them subsequently in instalments. Employees do make use of this facility for meeting their consumption needs. Financial intermediaries such as some hire-purchase finance companies, chit funds, loan and finance companies and mutual benefit companies also seem to cater to the credit needs of consumers. Some dealers of durable goods (*e.g.*, refrigerators, sewing machines and ceiling fans) also sell their goods at prices (that include interest) payable in instalments with an initial down payment. It is believed that a high sales

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* Consumer credit can also be a part of non-instalment credit which may for instance be classified into (a) single-payment loans, and (b) charge accounts. But consumer credit is more popularly known as credit given for consumption purposes and recovered in periodic instalments.

@ Beckhart, B. H., (ed.), *Banking Systems*, Times of India Press, Bombay, 1967. p. 406.

turnover would make the business of dealers economically self-supporting and viable, without any need to resort to accommodation from banks or any other financial institutions.

The Quantum of Consumer Credit by Agencies Other than the Commercial and Co-operative Banking Agencies

15.5 The amount of consumer credit provided by moneylenders is not known and cannot be safely guessed with any degree of accuracy. Similarly, paucity of data regarding the advances given out of provident fund balances and the instalment credit involved in the sales of some of the business firms would come in the way of any reliable estimate of consumer credit in the country. NBFIs, however, were estimated to have extended hire-purchase credit for durable consumer goods (including cars and scooters but excluding trucks), upto about Rs. 1.8 crores at the end of 1967, out of which credit for purchasing cars and scooters alone was said to be about Rs. 1.7 crores. In other words, credit for durable consumer goods other than vehicles would work out to a negligible figure of only Rs. 10—15 lakhs. The main contribution to the hire-purchase credit of Rs. 1.8 crores came from hire-purchase finance companies. The proportions of total outstandings deemed as hire-purchase consumer credit (Rs. 10—15 lakhs) are estimated to be 10 per cent in respect of hire-purchase finance companies, about 75 per cent in respect of loan and finance companies and foremen running chit funds and about 90 per cent in respect of mutual benefit financial companies.

Recent Personal Loan Schemes of Commercial Banks

15.6 Commercial banks have recently, particularly since early 1969, devised personal loan schemes with a view to enabling some of the borrowers to purchase consumer durables. The essential features of these schemes are more or less the same. A person with regular income, including the self-employed, is eligible for personal loans. The borrower, however, has to maintain an account (current or savings) with the bank and the loan has to be utilised for the purchase of new articles. Usually the minimum and maximum amounts are specified; they vary from bank to bank. According to the partial data made available to us, the amount of individual consumer loan varies from Rs. 100 to Rs. 15,000. The prescribed margins also vary from bank to bank—normally 10 per cent on durables other than cars and scooters and 30 per cent on cars and scooters. The rate of interest charged is 9 per cent to 9½ per cent per annum, with a provision for penal rate of interest of 1 per cent per month for instalment in default.* Most banks take service charges of 2 per cent on the amount. Ordinarily, these loans are given for a period of 24 months. In some cases, the period of the

* The rate on consumer credit charged by institutions other than those in commercial and co-operative banking sectors was said to range from 18-30 per cent per annum.

loans was extended to 36 months. The loans are repayable in monthly instalments and the first instalment becomes due one month (or three months in certain cases) after the date of disbursement of the loan. Goods purchased are usually hypothecated to the bank. In certain cases, the bank asks for guarantee of a third party as well.

THE QUANTUM OF SCHEDULED BANK CREDIT FOR CONSUMPTION PURPOSES

15.7 The amount of credit disbursed on the basis of these recent schemes is not as yet available. The data about consumer credit given by commercial banks are, however, partly discernible from 'personal loans' reported by scheduled commercial banks in the Survey of Purpose-wise Distribution of Advances, conducted by the Reserve Bank of India. Figures of personal loans cannot be equated with consumer credit because it is understood that some personal loans are professional loans, though they are not categorised as such. However, they may perhaps throw some light on the trend of consumer loans made by commercial banks. Table 15.1 shows that personal loans of scheduled commercial banks have increased from about Rs. 40 crores at the end of March 1951, to more than Rs. 113 crores at the end of March 1968. However, as a proportion of total credit, they have shown a declining trend ; thus the proportion has steadily declined from 7.4 per cent in 1956, to 3.7 per cent in 1968. The number of personal loan accounts increased by 2.8 times between 1951 and 1968, and as a proportion of the total number of accounts, constituted about 66 per cent in 1966.

TABLE 15·1—PERSONAL LOANS OF SCHEDULED COMMERCIAL BANKS 1951 TO 1968

As at the end of March	Personal Loans (Rs. in lakhs)	Total Bank Credit (Rs. in lakhs)	Personal Loans as percentage of total Bank Credit	Number of Personal Loan Accounts	Total No. of Accounts	No. of Personal Loan Accounts as percentage of Total No. of Accounts	Average size of	
							Personal Loan (Rs.)	Other Loans (*i.e.*, loans other than personal loans (Rs.))
1.	2.	3.	4.	5.	6.	7.	8.	9.
1951 ..	3969	58455	*6·8*	212622	347211	*61·2*	1866	40483
1956 ..	5768	77023	*7·4*	388347	625147	*62·1*	1485	30091
1961 ..	8790	130617	*6·7*	701345	1077932	*65·1*	1253	32350
1963 ..	9922	161070	*6·1*	633830	1028852	*61·6*	1565	38263
1964 ..	10177	186475	*5·5*	595742	1053529	*56·5*	1708	38511
1965 ..	10922	209474	*5·2*	728206	1126397	*64·6*	1500	49864
1966 ..	10779	234680	*4·6*	671485	1018883	*65·9*	1605	64451
1967 ..	11450	271725	*4·2*	599252	1056015	*56·7*	1910	56983
1968 ..	11337	306436	*3·7*	605348	1126888	*53·7*	1872	56582

Source : Statistical Tables relating to Banks in India.

Since then, however, they have tended to decline and formed 54 per cent of the total number of accounts at the end of March 1968. It may also be noticed that the average size of personal loans is relatively small; it was less than Rs. 2,000 at the end of March 1968 as against an average of about Rs. 57,000 for all loans other than personal loans taken together.

15.8 The reduced proportions of personal loans in total credit, especially over the period 1961 to 1968, indicate, among other things, growth of bank credit at a speedier rate than the rate at which the quantum of personal loans has grown and the low priority that has come to be attached to them by banks in the management of their loan portfolios. The low priority to consumer lending which can be seen from the fact that personal loans as a proportion of total bank credit forms hardly 4 per cent, may be explained by two important factors. First, the risks in consumer credit are expected to be high. Secondly, consumer credit is considered contrary to the philosophy of rapid economic growth in an economy where there is a shortage of savings relative to the need for capital formation.†

Co-operative Institutions Catering to Consumers' Credit Needs

15.9 Employees' co-operative credit societies and urban co-operative banks also grant loans to their members for meeting their personal needs and for purchasing consumer goods, but statistics on the actual quantum of such credit are not available. In 1968-69, the short-term and medium-term loans of the employees' societies amounted to Rs. 78.8 crores and Rs. 76.6 crores respectively, while urban banks granted short-term loans to the extent of Rs. 67.8 crores and medium-term loans worth Rs. 36.5 crores. The proportion of consumer loans to the total, however, is not known. The loans of employees' credit societies are normally 5 to 6 times the substantive salary of the member-employees who apply for loans. These loans are recovered generally in 24 or 36 monthly instalments. But it may be noted that their coverage was very low; in 1968-69, there were all over India only 7,840 active employees' credit societies and 1,019 active urban banks. According to an estimate made by a Study Group of the National Credit Council, only 28 per cent of the employed persons were members of employees' co-operative credit societies in 1967.* Their development was not even and orderly in all the States ; they were found to be active in relatively developed States like Gujarat, Haryana, Maharashtra, Mysore, Tamil Nadu and West Bengal.

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† These factors represent only the supply side of consumer credit. There are no definite data about the number of applications for personal loans received and rejected by scheduled commercial banks.

* *Organizational Framework for the Implementation of Social Objectives*, Report of the Study Group of the National Credit Council (1969), pp. 21-22.

An Estimate of Total Consumer Credit in India

15.10 The above discussion shows that because of paucity of detailed data, the actual quantum of consumer credit given by different institutions cannot be derived. If, however, it is assumed that all short and medium-term loans of the employees' credit societies and urban co-operative banks are personal loans, then the actual personal loans outstanding in the scheduled commercial banking and co-operative sectors, in 1968-69, would roughly be Rs. 375 crores, which works out to about 1.3 per cent of national income. In case, medium-term loans of the co-operative agencies are treated as those not given for consumption purposes, the aggregate personal loans in both these sectors will turn out to be only about Rs. 260 crores, *i.e.*, about 0.9 per cent of national income. As pointed out above, not all the personal loans given by commercial banks nor short-term loans given by urban co-operative banks are consumer loans. This coupled with the fact that consumer loans are known to be given by moneylenders and indigenous bankers at very high interest rates shows that the credit institutions are not meeting the demand for consumer credit at present.

Factors Determining the Role of Consumption in a Developing Economy

15.11 The low quantum of institutional consumer credit in the Indian economy may be viewed with reference to the mechanics of growth. Given the target rate of growth and the commodity composition of national output, growth rate in the economy depends upon the rate of saving and the productivity of investment. The two propositions in a growth-exercise that are related to consumption, may be noted here. In the first place, growth of consumption has to be kept in check in a low-saving economy. Secondly, any increase in the demand for consumption goods (other than necessities) at a time when there exists a continuous inflationary pressure would only aggravate the inflationary situation further. These propositions, basic as they are no doubt, need not be true at all times. The existence of unutilized capacity in consumption goods industries, the forward and backward linkage effects in the expansion of consumption goods industries, and the need to provide incentives to work and to 'trade-off' their products (usually primary products) in the market are no less important considerations in determining the role of consumption in a developing economy.

The Case for Consumer Credit for Durables of Low Income Group

15.12 Consumer credit for durables may be classified into credit for durables of relatively low income groups (*e.g.*, bicycles, transistors, furniture, etc.) and that for durables of the relatively high income groups (*e.g.*, motor cars, air conditioners, refrigerators, etc.). The former type of con-

sumer credit would raise consumers' welfare, and help to indirectly force people to save over time in small sums in order to pay for the changed profile of future consumption brought forward by it. Moreover, it may lead to a high sales turnover and an extension of the size of the market which influences specialization and technical progress. In the case of credit for durables of the relatively high income groups, the increment in welfare will be limited to a few, although it may lead to a gradual rise in savings and an extension of the size of the market.

15.13 The most powerful argument against general consumer credit is that it will raise aggregate expenditures and raise prices of most essential commodities *via* excess demand. However, once the new equipment goods industries are built, there will be a large manufacture of consumption goods for domestic market, with the result that the phenomenon of excess demand will slowly recede into background. There may even arise a need then to match consumer demand especially for goods of low income groups with the amount of such goods reproducible by the production capacities, with the help of consumer credit.

Possible Rise in Consumer Credit in the Long-run

15.14 The perspective of development as envisaged by the Planning Commission* indicates that national income would double by 1980-81 from Rs. 29,000 crores in 1968-69. Net investment is expected to go up from Rs. 3,200 crores in 1968-69 to Rs. 10,200 crores in 1980-81. Private consumption is estimated to rise from Rs. 25,700 crores in 1968-69 to Rs. 47,700 crores in 1980-81. And Government consumption is expected to go up by Rs. 3,100 crores to Rs. 6,200 crores in 1980-81. Thus, net investment is expected to be about 17-18 per cent of the target national income in 1980-81, as against 11 per cent in the national income of 1968-69. The increase in incomes is likely to be all round with the introduction of new technology (as, for instance, evidenced by the introduction of high-yielding seeds) and consequently the pattern of private consumption would tend to be diversified. There may arise a gap between what individuals would like to purchase and what they could afford to possess the durables. Consumer credit in such a situation would become imperative.

Consumer Credit in the Next 10-15 Years and the Institutional Framework

15.15 If we accept the argument that consumer credit will be required on a large scale in the next one or two decades, two questions relevant to institutional framework may be raised. In the first instance, there is the question of adequacy of the existing institutional framework for providing the requisite consumer credit in future as well as the need, if any, for creating

* *Fourth Five Year Plan 1969-74*, Govt. of India, Planning Commission, July 1970.

specialised institutions for the purpose. There is, secondly, the need to specify the direction in which consumer credit would probably develop. These questions, in other words, relate to the resilience and flexibility of the financial system to face new tasks in consumer credit.

15.16 The kind of consumer credit with which we shall be concerned is the one given for purchase of durable consumer goods, as loans for purposes of meeting medical, educational and other urgent expenses could more appropriately be met by health and educational insurance schemes and other welfare schemes of the Government as part of its social welfare function. We have already seen that at present the most important single institution, judged by the magnitude of consumer credit extended, are the commercial banks. They have large resources and they have a widespread network of branches. Both these factors put them in an advantageous position for extending consumer credit. The number of personal loan accounts of the scheduled commercial banks is more than half of their total number of loan accounts and hence they can be considered to have a certain expertise for giving consumer loans. In course of time they will probably, in response to the emerging need, extend more consumer credit. However, the demand on their material and personnel resources from the competing sectors is likely to be so large that they would not find it easy to meet the entire or even a large part of the emerging demand for consumer credit. So far as the hire-purchase finance companies are concerned, it is possible that in due course the number of well-organised companies will increase and their coverage of the country will become more even. As explained in Chapter 4, most of the hire-purchase finance companies are at present financing the purchase of automobiles. They may, in course of time, also extend credit for producers' durables like pump-sets, tractors, etc. The demand from these sectors is likely to be quite large in future. Hire-purchase finance companies may not, therefore, find it possible to venture into consumer credit on a large scale. Co-operative credit societies and the urban co-operative banks are also likely to expand their operations in future. However, as pointed out earlier, the facilities that they offer would be limited only to their members.

15.17 Thus, we visualise a situation where the major institutions which are extending consumer credit at present may not find it possible to meet the demand for consumer credit in future. This will especially be so because consumer credit is a complex function which in foreign countries has assumed certain special characteristics. That is why in foreign countries, particularly in the U.S.A. and some western countries, specialised institutions have evolved over time to cater to the requirements of consumer credit. On the other hand, demand for consumer credit will increase and it is possible that, as a result, certain institutions may come up to meet such demand. As we saw in Chapter 8, the number of finance corporations has been on the increase recently. The growth in the number of such institutions as well

as the popularity of chit funds is an indication of the emerging need for consumer credit. However, these institutions in their present form will create problems both for the safety of deposits of the savers who keep their savings with them as well as the monetary authority.

SPECIALISED INSTITUTIONS FOR CONSUMER CREDIT IN INDIA

15.18 We, therefore, feel that the need is likely to emerge in the near future for an organizational innovation to satisfy the credit needs of consumers. It is not possible at this stage to visualise in exact terms the pattern of the need and the form in which the financial structure will have evolved by that time. We can, therefore, at best offer some suggestions for the consideration of the Banking Commission.

15.19 The first important point is that there should be a uniform legislation for the country as a whole with allowances for regional characteristics in so far as the terms and conditions of business are concerned. Here the experience of the United States may be worth pursuing.* The small loan laws in the U.S.A. stipulate maximum rate, loan-size, maximum security, the manner of charging the rate, default charges, credit insurance, etc.

15.20 Secondly, in the interest of orderly development of such institutions it will be desirable to encourage public limited companies to give consumer credit. Regulation of such companies is easier as compared to the regulation over a very large number of firms and private limited companies. It may, however, be added that the evolution of financial structure may demand in future the establishment of subsidiary companies or institutions by the commercial banks or by other financial intermediaries like insurance companies. Such subsidiaries need not be discouraged, although what form they should take is a matter of judgment depending upon the circumstances obtaining at the time when the situation would arise.

15.21 The new specialised institutions in India may be set up on private initiative with basic capital structure provided by private shareholders or in the public sector. It will be useful to entrust them with consumer consultancy services. Their main resources would consist of paid-up capital and short and long-term credit from commercial banks, other financial institutions and private investors. Obviously, however, their business would mainly depend upon the rate of inflow of instalment funds, since their loans would be of relatively small size for relatively short periods. They may be encouraged to offer high-risk loans and discouraged from giving credit for those consumer durables which are mainly consumed by high income groups.

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* Of the many good books on consumer credit, *The Consumer Industry* (1962), published by the Commission on Money and Credit and *The Consumer Finance Industry : Its Cost and Regulations* (1967), edited by J. M. Chapman and R.D. Shay may be referred to.

To enable them to be economically viable, their loans may be covered by suitable insurance schemes. From the point of view of regulation, it will probably be useful to bring them under the control of the Reserve Bank of India or any other agency set up in this behalf, because as the experience in foreign countries suggests, consumer credit can at times be a destabilising influence in the credit market.

15.22 We may re-emphasise in conclusion that our remarks are in the nature of suggestions which should be considered at the appropriate time in the light of the situation as it emerges.

CHAPTER 16

SUMMARY OF MAJOR CONCLUSIONS AND RECOMMENDATIONS

16.1 The analysis and the arguments on which our conclusions and recommendations are based, have been fully explained in the preceding chapters and it is felt that any attempt to summarise all this may mean some distortion of emphasis. The following paragraphs only bring together our major conclusions and recommendations. (Figures within brackets refer to the relevant paragraphs containing conclusion/recommendation.)

SCOPE AND METHOD OF STUDY

16.2 The current definition of 'banking' (accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise) does not help in making an unambiguous distinction between banks and NBFIs. The Study Group to Review Legislation Affecting Banking is examining various definitions relating to banking. Hence, the Group selected for its study, NBFIs which are recognised to be important, *viz.*, (*i*) Hire-Purchase Finance Institutions, (*ii*) Investment Trust Companies, (*iii*) Chit Funds, (*iv*) Nidhis, and (*v*) Finance Corporations. (2.7 and 2.8)

16.3 In accordance with its terms of reference, the Group also enquired into the need for the following types of specialised financial institutions: (1) Merchant Banking Institutions and Acceptance and Discount Houses, (2) Export-Import Bank, (3) Small Scale Industries Bank, (4) Specialised Savings Banks, (5) Specialised Institutions for Housing Finance and (6) Specialised Institutions for Consumer Credit. (2.9)

16.4 The major constraints on the work of the Study Group were the non-availability of adequate data on the subjects relevant to its study and limited time within which the Report had to be prepared. (2.10)

APPROACH OF THE STUDY GROUP

16.5 NBFIs supplement the activities of banks. Their functioning in deposit mobilisation is somewhat akin to the role of the small local non-scheduled or urban banks. In many cases, they perform a gap-filling function insofar as they cater for purposes and to customers who may not be getting required amounts of finance at the required time from the organised banking system. (3.10 and 3.11)

16.6 The operations of the NBFIs have not yet assumed such dimensions as to modify the effectiveness of monetary policy. It is, however, possible that in the absence of regulation, their impact may grow to substantial proportions. (3.19)

16.7 NBFIs should be regulated not only to safeguard the depositors' interests but also to ensure the implementation of credit policy objectives of providing credit to neglected sectors at reasonable rates and restricting its availability for less essential purposes. The present system and methods of regulation do not serve these purposes. There is also need for encouraging the growth of NBFIs which are capable of playing a dynamic role in the economy. (3.23)

16.8 The administrative difficulty of regulating a large number of NBFIs can partly be solved by enacting legislation so that only corporate bodies can accept deposits from the public for the purpose of lending. For purposes of regulation, NBFIs in general may be classified into two categories : 'approved' and 'non-approved'. While a specified minimum degree of control may be exercised on all NBFIs, those units—to be designated as 'approved' NBFIs—which satisfy certain additional requirements to be laid down by the regulating authority, may be accorded a special and favourable treatment. 'Approved' institutions which will be only corporate bodies would be eligible for refinance facilities from the banking system and their own lending operations could also be covered under the Credit Guarantee Scheme. Eventually, the Deposit Insurance Scheme can also be extended to those of the approved NBFIs whose manner of conducting business meets the requirements of the Deposit Insurance Corporation. The basic factor to identify 'approved' institutions will have to be the judgment of the regulating authority regarding the quality of their operations. (3.24)

16.9 The Reserve Bank of India or any other regulating authority which may be set up in this behalf will have to strengthen or build up its inspecting machinery so that these institutions can be inspected at least on a sample basis. (3.24)

16.10 In dealing with the question of regulation, the approach may have to be tailored to the special characteristics of the different types of NBFIs. Some types of NBFIs would obviously need a greater degree of surveillance than others. (3.25)

16.11 Each of the NBFIs falling within the scope of our study as identified earlier (*vide* paragraph 16.2) is studied with the following objectives in mind : (*a*) reviewing its operations, (*b*) examining its role in the economy by reference, wherever necessary and feasible, to foreign experience; (*c*) studying the weaknesses, if any, emerging from the above review ; and (*d*) making suitable recommendations about the action to be taken.

Hire-Purchase Finance Institutions

16.12 In order to bring down the level of finance charges, strengthen the financial position of financing agencies and facilitate regulation, the policy objective should be to institutionalise hire-purchase credit. (4.17)

16.13 In view of the fact that the amount of borrowing is of crucial importance for a hire-purchase financing unit for its profitability, the permissible debt-equity ratio may increase directly with the size of the capital of the unit. (4.17)

16.14 The liquidity ratio as at present applicable against deposits of hire-purchase finance companies, mobilised from the public, may be made higher for the smaller companies and lower for the bigger companies, with a minimum of 10 per cent in each case. (4.18)

16.15 Wherever necessary, commercial banks may start subsidiaries for hire-purchase finance. The authorities may consider whether Section 19 of the Banking Regulation Act, 1949, can appropriately be amended so as to enable banks to promote subsidiary hire-purchase finance companies in which any single banking company may own shares to the extent of 51 per cent. (4.21)

16.16 Small non-nationalised Indian banks may enter more vigorously into hire-purchase finance business. (4.22)

16.17 The benefit of Credit Guarantee Scheme recently introduced for small borrowers, including transport operators, and SFCs, may be extended to other financial institutions (like non-scheduled commercial banks and approved hire-purchase finance companies) in appropriate cases. (4.22)

16.18 All hire-purchase finance companies may be regulated by the Reserve Bank of India or such other agency as may be set up in this behalf in the following way. They may be classified into 'approved' and 'non-approved' institutions. While regulation may extend to all hire-purchase financing units, the approved ones which will be only corporate bodies, may have special advantages of the following types : (*a*) commercial banks may extend them credit on more favourable terms ; (*b*) they may be allowed to get more credit in relation to their capital ; (*c*) liquidity ratio may be lower in their case than in the case of non-approved institutions ; (*d*) the Credit Guarantee Corporation may consider extending the benefit of guaranteeing small loans made by them; and (*e*) ultimately insurance cover of Deposit Insurance Corporation may also be made available to their depositors. The criterion for approval would generally be the working of a hire-purchase finance company determined on the basis of inspections. (4.23)

16.19 All hire-purchase finance units may compulsorily be licensed and the licensing authority may be given powers to revoke the licence in case it is satisfied that the operations of a particular unit are unsatisfactory. (4.23)

16.20 In advertisements as well as in agreements, hire-purchase financiers should clearly indicate the true rate of interest along with flat rate. With the present structure of hire-purchase finance companies and the existing structure of interest rates ceilings on hire-purchase charges at flat rate of 10 per cent per annum for new vehicles and of 12 per cent for old vehicles are considered to be reasonable. (4.15 and 4.16)

Investment Trust Companies and Unit Trusts

16.21 There is no need for more unit trusts and investment trusts in the economy because (*a*) UTI has introduced a new financial asset which combines the advantages of liquidity, yield and growth ; it is also considering the introduction of new schemes with different mix and (*b*) the capital market in India is not broad enough to be able to serve the requirements of the existing institutions as well as new unit trusts or investment trusts. The new industrial securities which may come into the market as a result of growth of industrial development can be absorbed by the existing institutions and private investors. (5.19 and 5.20)

16.22 Existing genuine investment companies may be encouraged and the Government may consider offering them relief from inter-corporate tax provided that they are prepared to have the same obligations (*i.e.*, diversification of investments, distribution of a specified minimum portion of income and regulation by authorities) as the UTI. (5.23)

16.23 The following criteria may be adopted for identifying a genuine investment company : (*a*) it should have an independent management and investment policy ; (*b*) it should have a diversified investment portfolio both in terms of companies and groups of companies ; (*c*) it should have adequate public participation in its share capital and it should ensure listing of its shares on stock exchange ; (*d*) a major portion of its funds should be invested in shares, stocks, bonds and other securities ; and (*e*) it should regularly distribute not less than a specified proportion of its income to its members. (5.24)

16.24 Although the number of genuine investment companies at present is small and hence no separate machinery is required to regulate them, it would be useful to enact a separate legislation with the object of protecting the interests of the members of these companies. The legislation may be applied as and when number of investment holding companies convert themselves into genuine investment companies. (5.25 and 5.27)

16.25 The proposed legislation may be framed on the lines of Investment Companies Act of the U.S.A. and also should incorporate provisions forbidding investment companies from entering certain fields. No industrial or trading company should be permitted in any event to hold any shares in investment companies. In order to ensure an independent management and policy, a Government nominee should be appointed on the Board of Directors of each genuine investment company. (5.25 and 5.26)

16.26 One of the members does not agree with the main conclusions and recommendations of the Group on the subject of Investment Companies and Unit Trusts. His note of dissent is appended to Chapter 5. (D.1 to D.21)

Chit Funds

16.27 Chit fund is an indigenous institution which combines saving (through subscription of members) and lending (through distribution of 'prizes'). There is discrimination in the distribution of profits and losses to the members of chit funds. The more needy a person the higher the rate of interest which he has to pay. Also, the unscrupulous among the foremen resort to unfair methods which are not in the interests of members. At the same time it is popular as an indigenous institution. Ultimately the solution to the problem is that commercial banks should introduce schemes similar to chit funds but without the disadvantages associated with them. (6.23, 6.30, 6.32 and 6.50)

16.28 Meanwhile, elimination of chit funds will leave a credit gap. Hence they should be regulated. There are three lines of action. (*a*) State Governments may, wherever they think it appropriate, consider starting chit funds at strategic places as model foremen. (*b*) Commercial banks may run chit funds subject to proper safeguards as formulated by the Reserve Bank of India. (*c*) Depending upon the constitutional position, whether chit funds come under the Union List, Concurrent List or State List, either an all-India chit fund law may be enacted by the Central Government or a model law may be framed which may be adopted by State Governments. The Tamil Nadu Chit Funds Act contains the essential features of legislation regulating chit funds. This may be strengthened with a view to safeguarding the interests of members and ensuring that the foreman works only as a manager and ceases to enjoy the wide powers that he has at present. Since a large number of chit funds working in States having no chit fund legislation are branches of chit funds registered in States which have such legislation, it will be useful to apply the provisions of chit fund laws in these latter States to their branches operating in the former States. Regulation will be easy if only public limited companies are allowed to run chit funds. Also, the offence under Section 294-A of the Indian Penal Code relating to lotteries may be made a cognisable one so that 'prize chits' could be prohibited. (6.33, 6.34, 6.36, 6.50, 6.55 to 6.58 and 6.60)

NIDHIS

16.29 Nidhis are performing useful functions through their operations in the localities where they are operating. It would be useful to encourage the growth of these institutions. Although they deal with their members, it is very easy for any person to become a member of a nidhi. Hence, they are working like commercial banks and should, therefore, be subject to regulation. In the case of nidhis which accept demand deposits the regulation may be similar to that applicable in the case of commercial banks. All other nidhis may be subject to the following regulations :

(*a*) They may be licensed by the Reserve Bank of India.

(*b*) A minimum level of liquidity ratio may be fixed which may, however, be lower than that of commercial banks.

(*c*) Periodical inspections may be conducted.

(*d*) A minimum amount of paid-up capital and reserves may be prescribed. (7.34, 7.35 and 7.43)

16.30 While these regulations may be applicable to all the nidhis, incentives may be offered to those among them which satisfy certain requirements. For this purpose, nidhis may be classified into two categories, *i.e.*, 'approved' and 'non-approved'. Approved nidhis will be those companies which are run on sound lines and whose affairs are conducted in a manner not detrimental to the interests of their depositors. (7.44)

16.31 The benefit of availability of refinance, guarantee of loans as well as, ultimately, insurance of their deposits may be extended to approved nidhis. Government may also consider extending to the depositors of approved nidhis the same tax concessions which are available to the depositors of commercial banks. (7.44)

FINANCE CORPORATIONS

16.32 Since the Bangalore type finance corporations are para banking institutions, it is necessary to regulate their activities on the following lines in the interests of their depositors : (*a*) No finance corporation may be allowed to work without a licence from monetary authorities ; (*b*) A ratio may be prescribed between the owned funds of corporations and their deposit liabilities ; (*c*) Liquidity ratios may be prescribed for them ; (*d*) Periodical inspection of the corporations on a sample basis may be undertaken ; (*e*) Maximum interest rates on deposits may be prescribed which may, however, be higher than those prescribed for commercial banks. (8.24 & 8.26)

16.33 Finance corporations may be classified into two categories — 'approved' and 'non-approved'. Approved corporations should be only

corporate bodies and be eligible to get the benefit of refinance facilities from commercial banks or the Reserve Bank of India. The benefits of guarantee for their loans and ultimately of deposit insurance may also be extended to them. The criteria for according the status of 'approved' to a corporation will have to be based on the judgment of the regulating authority as to whether its affairs are being conducted in a manner not detrimental to the interests of its depositors. (8.27 and 8.28)

16.34 Ultimately the solution to the problems created by the emergence of a large number of Bangalore type finance corporations lies in the commercial banks competing with them effectively in the localities where such corporations are operating. (8.17 and 8.29)

Examination of the Case for Establishing Specialised Institutions

16.35 New specialised institutions should not be set up merely on general grounds. Each case should be studied on merits and a new institution may be created only if there is a clearly identified credit gap which, for some reason or the other, cannot be filled by the existing financial institutions. (9.16)

Merchant Banking Institutions and Acceptance and Discount Houses

16.36 Institutions of the merchant banking type are required in India to perform the following services : (*a*) syndication, financing and promotion of Indian projects ; (*b*) investment advisory service ; and (*c*) investment management. (10.6 and 10.7)

16.37 Under present circumstances, they may not take up acceptance and discounting functions because these services can well be performed by commercial banks which have a wide network of branches and an intimate knowledge of the creditworthiness of their borrowers. In due course, however, after the bill market is well developed and the merchant banking institutions get the necessary expertise they could enter the acceptance and discount business. Although, at present there is no need to set up specialised discount houses, in course of time, such institutions could be set up to offer discounting facility as well as a money market intermediary to even out the demand for and supply of short-term funds in the money market. (10.17 to 10.19)

16.38 Initially, there could be four merchant banking institutions located in Bombay, Calcutta, Madras and New Delhi set up by the specialised financial institutions and commercial banks. Later branches can be set up in important centres also by each of the regional institutions. (10.22)

16.39 In the light of experience gained and depending on the integrity, investment expertise and management standards, the erstwhile managing agencies may be allowed to set up merchant banking institutions in the private sector. (10.23)

16.40 It will be necessary for the successful working of the proposed merchant banking institutions to organise a training programme for their staff. (10.23)

Need for an Export-Import Bank in India

16.41 There is no need for a specialised Export-Import Bank in India because the existing institutions, *viz.*, commercial banks, Industrial Development Bank of India and the Reserve Bank of India are providing adequate credit on reasonable terms. (11.24)

16.42 The functions of insurance of risks and guaranteeing of loans are performed by the Export Credit and Guarantee Corporation which has progressively liberalised and extended the coverage of its schemes. There are, however, no facilities available for covering risks of exchange rate variation involved in long-term deferred payment exports. The authorities should devise a machinery for providing such exchange cover. The creation of a new institution will not, however, be necessary for performing this function. (11.29 to 11.32)

16.43 There is at present no systematic collection of information regarding exports. A number of institutions like the Trade Development Authority, State Trading Corporation, Export Promotion Councils, Commodity Boards, ECGC and IDBI collect useful information and it will be beneficial from the point of view of promoting exports if such information is pooled. (11.34 and 11.35)

16.44 The IDBI has constituted informal and consultative working groups to utilise the information available within the country. Such groups should co-ordinate the functions of all the export financing institutions so that an exporter is prevented from the necessity of going from one institution to another for meeting his needs. (11.26 and 11.35)

16.45 In course of time buyers' credit will be required. It is understood that the IDBI is examining this problem. A separate institution will not be necessary for the purpose. In fact, the IDBI is already performing many functions expected from Export-Import Bank. (11.19)

16.46 If a new institution is created, its operations would be more costly because it will have to establish branches all over the country and perhaps abroad. It is less costly for commercial banks to take up this work because they can combine it with their other activities. (11.38)

16.47 The need for an Export-Import Bank is sometimes advocated on the grounds that it will be able to borrow more economically in the foreign markets for financing the imports of goods like ships and aeroplanes. In the view of the Group, commercial banks with their branches and contacts abroad are in a position to perform the same function efficiently. (11.27)

16.48 Banks should play a more active role in locating, assisting and developing export potential. More emphasis should be given on the training of personnel of commercial banks in the field of export credit. (11.38)

Need for Small Scale Industries Bank

16.49 There is no need to create a separate financing institution for small scale industrial units and/or small business units because (*a*) the existing financial institutions are adequate for the purpose and (*b*) the creation of a centralised agency has no special advantages to offer. (12.15)

16.50 Commercial banks, through a wide network of branches, are meeting the working capital needs of widely scattered units to a considerable extent. Their professional expertise and trained personnel are helpful in making technical appraisal of loan applications. Other institutions, such as the SFCs, are also playing a useful role in giving term loans to small units. (12.19)

16.51 If a specialised Small Industries Bank is set up, it would have to find sufficient resources to operate, without depending on funds drawn from the budget or Reserve Bank or other existing institutions. It would only duplicate the functions presently being performed by the Industrial Finance Department of the Reserve Bank of India, of co-ordinating the activities of different financial institutions in the field. Since its costs of borrowing are likely to be as high as for other institutions, it may not be able to provide credit to small units more cheaply than the existing institutions. (12.21)

Need for Specialised Savings Banks

16.52 There exists enough scope for mobilising and institutionalising savings, especially in rural areas. (13.19 and 13.23)

16.53 On the basis of a review of the growth and structural changes of financial institutions over the past few decades, and having in view the various measures which are being taken to strengthen and gear the existing financial institutions to the task of mobilising savings, and the general problems associated with the establishment of new savings institutions, there is little support in favour of establishing an entirely new organisation of specialised savings banks. (13.22 and 13.23)

NEED FOR SPECIALISED INSTITUTIONS FOR HOUSING FINANCE

16.54 Existing financial institutions are not in a position to solve the problem of housing finance because of its large magnitude, the peculiarities of the housing market and (as in the case of commercial banks) the burden of wide and expanding range of functions. Also, as the experience in foreign countries shows, savings can increase substantially if they are linked up directly with the acquisition of houses. (14.39 and 14.41)

16.55 Specialised housing finance insiitutions are required in India in order to mobilise additional savings for the purpose of giving loans for house construction or ownership. The proposed organisation will have two tiers. The Housing and Urban Development Corporation may work as an apex institution and local and regional institutions may be set up with the active support of the Government. (14.46 and 14.47)

16.56 The local and regional institutions will have the primary function of attracting savings linked to the provision of credit for construction or purchase of houses. The functions of the apex body will be to encourage, supervise and provide temporary finance to the local or regional institutions. This body will also be vested with the responsibility of serving the housing needs in the country in its different aspects. The source of funds for the central housing finance institution will initially have to come from the Government but ultimately the institution should rely on market borrowings. The LIC and the Reserve Bank of India may also give loans to this body. (14.47 to 14.49)

16.57 There should be a machinery to offer suitable guarantee and insurance facilities to cover the risks involved in providing housing finance. (14.50)

16.58 Steps should be taken to create and develop a secondary mortgage market to impart liquidity to housing loans. (14.50)

16.59 Co-ordination may be ensured between the proposed institutions and the existing financial agencies in the following ways: Wherever feasible, Housing Boards and nidhis may be vested with the functions of the proposed housing finance institutions. Social housing schemes which involve an element of subsidy, may be continued. Co-operative housing societies should be strengthened particularly with a view to mobilising resources from members and eliminating malpractices. An apex co-operative society should be set up in each State with primary affiliated societies all over the State. However, as individuals cannot borrow from the co-operative housing finance societies, they would not be a substitute for specialised housing finance institutions. Commercial banks may give short and medium-term credit to the builders in order to enable them to undertake mass housing construction programmes. Prospective purchasers of houses may borrow from the specialised institutions to purchase houses from the builders who,

in turn, can repay their loans to commercial banks. To the extent their administrative and personnel resources permit them, commercial banks may also give credit to individuals desiring to own or construct houses. (14.51)

16.60 One of the members is of the view that commercial banks with their wide network of branches will be able to provide housing finance and there is no need for setting up specialised housing finance institutions. Commercial banks may set up specialised departments for receiving housing deposits and making housing loans. The Housing and Urban Development Corporation may guarantee such loans and impart liquidity by taking over the loans when banks are in need of funds. (N.1 to N.8)

NEED FOR SPECIALISED INSTITUTIONS FOR CONSUMER CREDIT

16.61 Consumer credit for durable goods on a large scale in the present circumstances is likely to raise aggregate expenditures and thus raise prices of essential commodities. (15.13)

16.62 Loans for the purposes of meeting medical, education and other contingent expenses would have to be provided, preferably, by health and educational insurance schemes and other welfare schemes of the Government. (15.16)

16.63 With the likely increase in incomes in the next decade, there is likely to emerge in the long run an increase in the demand for low income or middle income consumer durables and consequently there will be need for an organisational innovation to satisfy the consequent credit needs of consumers. In this connection, it is suggested that there should be a uniform legislation in the country as a whole, with allowances for regional characteristics insofar as the terms and conditions of consumer business are concerned. Again, in the interest of orderly development of financial institutions it will be desirable to encourage the formation of public limited companies for extending consumer credit. Moreover, from the point of regulation, it will be useful to bring the specialised institutions for consumer credit under the control of the Reserve Bank of India, or any other agency set up in this behalf. (15.14 to 15.21)

Bhabatosh Datta
Chairman

R. S. Bhatt — A. B. Bilimoria

Jawaharlal A. Darda — D. N. Kaveeshwar

M. Narasimham — S. D. Pardiwalla

T. S. Santhanam — A. Hasib
Convener

Bombay,

August 9, 1971.

APPENDIX I

EXTRACTS FROM THE OFFICE ORDERS CONSTITUTING THE STUDY GROUP

BANKING COMMISSION
(Government of India)

Telegrams : BANKINGCOM

Telephone : 3 6 3 3 1 1

"White House",
91, Walkeshwar Road,
Post Bag No. 6155,
BOMBAY-6.

June 4, 1970.

OFFICE ORDER NO. BC./S/NBFI—1

Subject : Constitution of a Study Group on Non-Banking Financial Intermediaries

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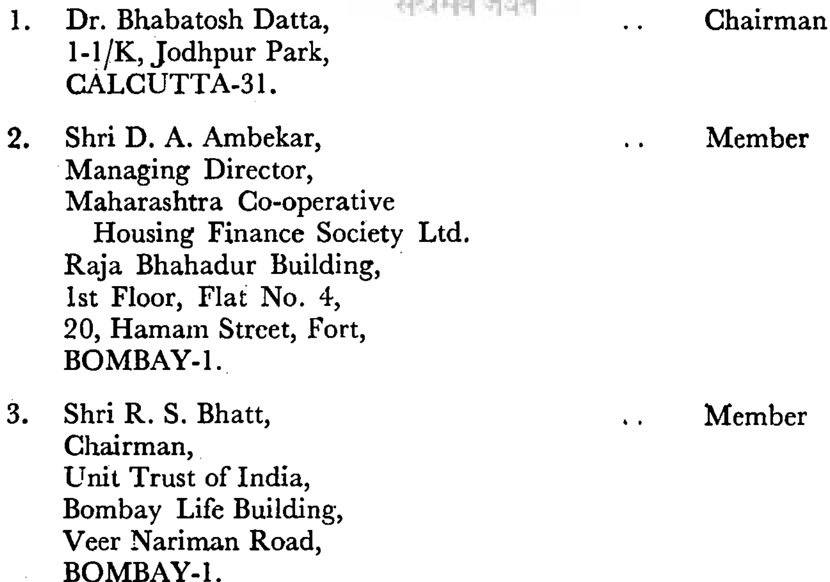
The Banking Commission appoints the following persons to constitute the Study Group on Non-Banking Financial Intermediaries.



1. Dr. Bhabatosh Datta, .. Chairman
   1-1/K, Jodhpur Park,
   CALCUTTA-31.

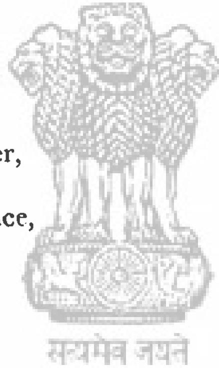
2. Shri D. A. Ambekar, .. Member
   Managing Director,
   Maharashtra Co-operative
   Housing Finance Society Ltd.
   Raja Bhahadur Building,
   1st Floor, Flat No. 4,
   20, Hamam Street, Fort,
   BOMBAY-1.

3. Shri R. S. Bhatt, .. Member
   Chairman,
   Unit Trust of India,
   Bombay Life Building,
   Veer Nariman Road,
   BOMBAY-1.

4. Shri A. B. Bilimoria, .. Member
Managing Director,
Investment Corporation of India Ltd.,
Ewart House, Bruce Street, Fort,
BOMBAY-1.

5. Shri D. N. Kaveeshwar, .. Member
Deputy Superintendent of Police,
Research Division,
Central Bureau of Investigation,
Ministry of Home Affairs,
Government of India,
Ramkrishnapuram, East Block No. VII,
NEW DELHI-22.

6. Shri M. Narasimham, .. Member
Secretary,
Reserve Bank of India,
BOMBAY-1.



7. Shri S. D. Pardiwalla, .. Member
Deputy General Manager,
Union Bank of India,
15, India Exchange Place,
P. B. No. 754,
CALCUTTA-1.

8. Shri T. S. Santhanam, .. Member
Chairman,
Sundaram Finance Ltd.,
52, Peters Road,
MADRAS-14.

9. Shri A. Hasib, .. Convener
Director of Research,
Banking Commission,
White House,
91, Walkeshwar Road,
BOMBAY-6.

2. The Terms of Reference of the Study Group will be as follows :

I) To review the role of various classes of non-banking financial intermediaries at present existing in the country such as Unit and Investment Trusts, Chit Funds, Nidhis and loan companies, and other finance companies ;

II) To enquire into the structure and methods of operations of these non-banking financial intermediaries and to recommend measures for their orderly growth (Insurance companies and Development banks such as the I.D.B.I., I.C.I.C.I., S.F.Cs, would be excluded from the purview of the Group) ;

III) To consider what other types of non-banking financial intermediaries such as specialised savings banks, building societies, consumer finance companies, Export-Import Bank, Small Scale Industries Bank, etc., are needed for the proper development of the economy ;

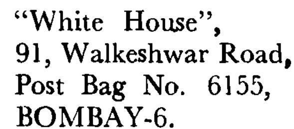
IV) To recommend appropriate measures therefor ; and

V) To make any recommendations on any other related subject matter as the Study Group may consider germane to the subject of enquiry or any related matter which may specifically be referred to the Group by the Commission.

BANKING COMMISSION
(Government of India)

Telegrams : BANKINGCOM

Telephone : 3 6 3 3 1 1



"White House",
91, Walkeshwar Road,
Post Bag No. 6155,
BOMBAY-6.

August 18, 1970.

OFFICE ORDER NO. BC./S/NBFI—2

Subject : Constitution of a Study Group on Non-Banking Financial Intermediaries

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In continuation of the Office Order No. BC./S/NBFI—1 dated June 4, 1970 constituting the Study Group on Non-Banking Financial Intermediaries, the Banking Commission appoints Shri Jawaharlal A. Darda, (Chairman, Maharashtra Co-operative Housing Finance Society Ltd.), Prithvi Vandan Yeotmal, as a Member of the Study Group on Non-Banking Financial Intermediaries, in the place of Shri D. A. Ambekar.

APPENDIX II

LIST OF INDIVIDUALS/COMPANIES/ASSOCIATIONS/INSTITUTIONS, ETC., WHO SUBMITTED MEMORANDA AND/OR WITH WHOM THE MEMBERS OF THE STUDY GROUP HAD DISCUSSIONS ON SUBJECTS RELEVANT TO THE WORK OF THE STUDY GROUP

A) MEMORANDA ON

I) *Non-Banking Financial Intermediaries :*

1) Shri L. C. Gupta

II) *Hire-Purchase Finance :*

1) ANCO Investments Pvt. Ltd., Bombay.
2) Hindustan Motor Corporation Ltd., Calcutta.
3) Karolbagh Financiers Private Ltd., New Delhi.
4) Khanna Financiers Private Ltd., Jammu Tavi.
5) Sundaram Finance Ltd., Madras.
6) Shri Anand N. Amin of Industrial Hire Purchase Corp. (P) Ltd., Ahmedabad.
7) Shri Vasant Murdeshwar of Commercial Credit Corporation (1943) Private Ltd., Bombay.

III) *Investment Companies :*

1) Industrial Investment Trust Ltd., Bombay.
2) Kettlewell Bullen & Co. Ltd., Calcutta.
3) MacNeil Barry & Co. Ltd., Calcutta.
4) Pilani Investment Corporation Ltd., Birlanagar (M.P.).
5) Platinum Jubilee Investments Ltd., Bombay.
6) The Premier Construction Co. Ltd., Bombay.
7) Dr. M. Y. Khan, University of Delhi, New Delhi.
8) Shri D. C. Kothari, Madras.
9) Dr. T. V. Sethuraman, Indian Institute of Technology, Bombay.
10) Shri Lakshmipat Singhania, J. K. Organization, Calcutta.

IV) *Chit Funds :*

1) Government of Tamil Nadu.
2) Incorporated Chit Fund Companies Association, Coimbatore.
3) Bhaskara Financial & Chit Funds Private Limited, Vijayawada.
4) Bright Funds Private Limited, Calicut.
5) Competitive Trading Concern Limited, Calcutta.
6) Jupiter Chit Fund Limited, Kanpur.
7) The Navjivan Chit Fund Private Limited, Bombay.
8) The Palghat Chit Funds Private Limited, Madras.
9) Uma Investments Private Limited, Bangalore.
10) Shri K. P. Hormis, Chairman, Federal Bank Ltd.
11) Shri K. P. J. Prabhu, Custodian, Canara Bank.
12) Shri N. R. Srinivasa Iyer, Chairman, Dhanalakshmi Bank Ltd.

V) *Nidhis :*

1) Associated Body of Nidhis, Madras.
2) The Abhiramapuram Fund Ltd., Madras.
3) The Amritsar Radhasoami Finance Co. (P) Ltd., Dayalbagh, Agra.
4) The Egmore Benefit Society Ltd., Madras.
5) The Harpanahalli Sri Venkataramana Swami Permanent Bhandar Ltd., Harpanahalli (Mysore State).
6) The Kumbakonam Mutual Benefit Fund Ltd., Kumbakonam.
7) The Mylapore Hindu Permanent Fund Ltd., Mylapore, Madras.
8) The Pudupakkam Permanent Fund Ltd., Pudupakkam, Madras.
9) The Sriman Madhwa Sidhanta Onnahini Permanent Nidhi Ltd., Triplicane, Madras.
10) The Thiruvateeswarar Hindu Janopakara Nidhi Ltd., Triplicane, Madras.
11) The Triplicane Permanent Fund Ltd., Triplicane, Madras.

VI) *Finance Corporations :*

1) Federation of Finance Corporations (Regd.), Bangalore.
2) The Mysore Finance Corporation.
3) Shri K. P. J. Prabhu, Custodian, Canara Bank.

VII) *Housing Finance :*

1) Life Insurance Corporation of India.
2) Hind Finance, Industries and Investment Ltd., Nagpur.
3) Vidarbha Premier Co-operative Housing Society Ltd., Nagpur.

B) DISCUSSIONS WITH

ON

I) *Hire-Purchase Finance :*

1) Shri P. M. Shah of PAL Hire Purchase Ltd., Bombay.

II) *Investment Companies :*

a) COMPANIES AT BOMBAY :

1) Devkaran Nanjee Investment Co. Ltd.
2) Digvijay Cement Co. Ltd.
3) Gandhi Parekh Investment Corporation Ltd.
4) Industrial Investment Trust Ltd.
5) J. K. (Bombay) Pvt. Ltd.
6) J. K. Investors Ltd.
7) Mafatlal Gagalbhai & Co.
8) M. G. Investment Co. Ltd.
9) Oriental Industrial Investment Corporation.
10) Platinum Jubilee Investments Ltd.
11) The Premier Construction Co. Ltd.
12) Provident Investment Co. Ltd.
13) Western India Shares Corporation.

b) COMPANIES AT CALCUTTA :

1) Andrew Yule & Co. Ltd.
2) Bhagwati Trading Co.
3) Birds Investments Ltd.
4) Calcutta Discount Co. Ltd.
5) Calcutta Investment Co. Ltd.
6) Calcutta Sales Agency.
7) Clive Row Investment Holding Co. Ltd.
8) Duncan Bros. Ltd.
9) Eastern Ganges Corporation.
10) Jaipur Investment & Finance Co.
11) Jayant Investment Corporation Pvt. Ltd.
12) Karam Chand Thapar & Bros. Pvt. Ltd.
13) Karnani Investments Pvt. Ltd.
14) Kettlewell Bullen & Co. Ltd.
15) MacNeil Barry & Co. Ltd.
16) Mc Leod & Co. Ltd.
17) New India Investments Co.
18) Octavious Steel.
19) Pearl Investment Co.
20) Sahu Jain & Co. Ltd.
21) Shekhavatti Investment Corporation.
22) Usha Investment Corporation Pvt. Ltd.

c) INDIVIDUALS :

1) Shri Bhatter of Bangur Group.
2) Shri R. C. Maheshwari of Birla Group.

III) *Finance Corporations :*

1) Mysore Government Representatives.

a) Representatives of Finance Corporations at Bangalore:

1) Federation of Finance Corporations.
2) Avenue Finance Corporation.
3) Bangalore Finance Corporation.
4) Bharat Finance Corporation.
5) Hindustan Finance Corporation.
6) Indian Finance Corporation.
7) Janatha Finance Corporation.
8) Jayanagar Finance Corporation.
9) Malleswaram Finance Corporation.
10) Mysore Industrial and Finance Corporation.
11) Oriental Finance.
12) South India Finance Corporation.
13) Sri Venkateswara Finance Corporation.
14) United Finance Corporation.

(b) Representatives of Commercial Banks :

1) Shri K. P. J. Prabhu, Custodian, Canara Bank.
2) Shri K. Gopal Rao, Chairman, Andhra Bank Ltd.
3) Shri A. Krishnamurthy, Ex-General Manager, State Bank of Mysore.
4) Shri G. M. Natarajan, Dy. General Manager, State Bank of Mysore.
5) Shri T. N. Nagarajan, Area Manager, United Commercial Bank, Bangalore.

APPENDIX III

QUESTIONS IN THE QUESTIONNAIRE ISSUED BY THE BANKING COMMISSION TO COMMERCIAL BANKS

Relating to :

(I) CREDIT EXTENSION BY COMMERCIAL BANKS TO HIRE-PURCHASE FINANCIERS :

Q. 10.20.1 Has your bank extended credit to hire-purchase financiers? If so, please state the number of such financiers and the products involved; also describe the terms and conditions on which credit is extended.

Q. 10.20.2 What is the rate of interest charged on advances to hire-purchase financiers? Do you stipulate that they do not charge more than a certain finance charge? If so, what is the maximum and what steps are taken to ensure compliance with your stipulation?

Q. 10.20.3 What difficulties are encountered in extending credit to hire-purchase financiers?

Q. 10.20.4 What, in your view, should be the scope and content of legislation covering hire-purchase transactions?

(II) CHIT FUND OR KURI BUSINESS OF COMMERCIAL BANKS :

Q. 8.10.1 (*a*) Please furnish the number and amount of chits and kuris operated by you as at the end of 1966, 67 and 68.

(*b*) What are the terms and conditions on which these are operated? Please describe the procedure followed.

(*c*) What in your view are the advantages in banks conducting this business?

(*d*) How would you estimate the profitability of this business?

(III) Financing of Small Scale Industries :

12 Questions relating to the financing of small scale industries were asked by the Banking Commission in the questionnaire circulated to all the commercial banks. The questions relevant are :

Q.10.13.4 Do your branches actively seek out small scale units established in their areas of operation ? If so, how is this achieved ?

Q.10.13.8 What difficulties are encountered in processing credit proposals from small scale units and in following up the advances after sanction ? What suggestions have you to remove these difficulties ?

Q.10.13.10 Please furnish your suggestions, if any, for improving the facilities provided under the Credit Guarantee Scheme.

APPENDIX IV

STRUCTURE AND GROWTH OF INVESTMENT COMPANIES IN INDIA, 1956-57 TO 1968-69

M. Y. Khan,
University of Delhi.

This paper examines the structure and growth of investment trust companies in the private sector in India. It also suggests, on this background, measures for their orderly growth so that Investment Trusts, as financial intermediaries, become an efficient instrument of economic and social development. In order to elucidate the subject matter, the paper is divided into two parts. In Part I, I have analysed the structure and growth of private investment companies in India. Part II outlines a scheme for the promotion of such institutions. The official policy in this sphere is also scrutinized to evolve a pattern suited to Indian conditions.

PART I

Growth and Structure of Investment Trust Companies in India, 1956-57 to 1968-69

2. Unlike foreign countries, there is at present no clearly differentiated category of investment companies in India. The available estimates show marked divergence. A study published by the Reserve Bank of India in 1960, (*Reserve Bank of India Bulletin*, October, 1960, pp. 1445-68) revealed that there were as many as 595 investment companies with a paid-up capital of Rs. 37.70 crores in 1958-59, as compared to 619 companies having a paid-up capital of Rs. 37.19 crores in 1957-58. The study attempted to survey the working of investment companies on the basis of information from the annual reports of 32 public limited companies. This study brought forth hardly any significant data on the subject about selected companies except citing a few examples.

3. The Research and Statistics Division of the Department of Company Affairs (the then Department of Company Law Administration) compiled in August, 1963, for the first time a complete list of all the companies which could be called investment companies, in an unpublished brochure "Investment Trust Companies at work in India as on 31st March 1963". The results were published in the form of a study in the *Company News and Notes*, October 1963, (pp. 125-28).

4. According to this study 542 companies having a paid-up capital of Rs. 42.28 crores in 1960-61, could be classified as investment companies.

They included, besides some of the State Finance and Industrial Development Corporations, a mass of heterogeneous companies engaged in such diverse financial business as hire-purchase, general financing, mortgage and other lending, share dealing and speculation, acting as Secretary and Treasurer, Managing Agents and so on. Obviously, all these companies cannot be classified under the category of investment companies.

5. The author has undertaken a study of companies which can be called genuine investment companies on the basis of their main objects. Of the 542 companies listed by the Department of Company Affairs, a scrutiny was undertaken of all the public limited companies, numbering 178 ; the remaining 364 companies in this list were left out as they were private limited companies in which the general public was not allowed to invest.

6. This investigation revealed that 103 companies with paid-up capital of Rs. 26.73 crores in 1964-65, could be said to be companies whose main object seemed to be holding of investment in securities. A further scrutiny identified 56 companies, out of 103, with a paid-up capital of Rs. 20.20 crores and investments at book value of Rs. 33.32 crores in 1964-65, as genuine investment companies on the basis of income derived from investment. For this purpose a genuine investment company was defined as one whose income to the extent of at least 75 per cent was from investment ; the remaining 25 per cent may be derived from any source. Out of these 56 companies, 19 are quoted companies, having a paid-up capital of Rs. 14.35 crores and investments at book value of Rs. 23.19 crores in 1964-65. Data regarding all the investment companies for the year 1956-57 to 1968-69 are presented in Annexure 'A'. Similar data pertaining to the quoted companies are available separately in Annexure 'B'.

7. A characteristic feature of investment companies in India is that they have close association with leading industrial houses. Out of 56 investment companies, as many as 38 have such link. Only 18 companies having a paid-up capital of Rs. 3.23 crores do not have any "group association". But even some of these companies have subsidiary companies. Almost all the prominent industrial groups, maintain a string of investment companies. Thus, Birlas have 2 investment companies with paid-up capital of Rs. 3.53 crores and investments of Rs. 4.30 crores in 1968-69. Tatas have 2 companies having a paid-up capital of Rs. 3.37 crores and investments of Rs. 7.20 crores. Bangur group is associated with the largest number of investment companies. The eight companies belonging to this group had paid-up capital of Rs. 0.75 crore and investments of the order of Rs. 2.60 crores. Dalmia Sahu Jain have 4 investment companies. The paid-up capital and investments of these companies in 1968-69, were Rs. 2.52 crores and Rs. 4.77 crores respectively. The total paid-up capital of the 4 companies controlled by the Bird Heilgers group is Rs. 1.59 crores, their investments being of the order of Rs. 2.52 crores. Similarly, Andrew Yule have

2 investment companies having paid-up capital and investments totalling to Rs. 1.47 crores and Rs. 4.15 crores respectively. Another important group is Goenkas with which are associated 4 companies. Their paid-up capital and investments were Rs. 1.33 crores and Rs. 1.37 crores respectively, in 1968-69. The four companies belonging to R. K. Agarwala group have a paid-up capital of only Rs. 0.09 crore. Jaipurias control 2 investment companies. Other industrial houses, *i.e.*, Kothari, Advani, Jardine Henderson, J. K. and Shapoorji Pallonji have one investment company each.

8. Available data regarding the capital structure of investment companies show that the share capital which accounted for 67 per cent of the total capitalization of the investment companies in 1956-57, virtually consisted of ordinary shares. In 1956-57, equity and preference capital accounted for 87 per cent and 13 per cent respectively of the total paid-up capital of the investment companies. In 1968-69, the relative proportion of preference capital declined to 12 per cent. It is interesting to note that only 16 investment companies have issued preference shares. In respect of 4 companies preference capital exceeded the equity capital. In fact, during the period under review there has been no addition to the preference capital although the equity capital registered an increase of about Rs. 1.88 crores.

9. Raising of capital through issue of debentures to the public is rare. In fact, out of 56 investment companies only three, *viz.*, Investment Corporation of India Ltd., Shree Sun Investment and Trading Company Ltd., and Shree Rishabh Investment Co. Ltd., have resorted to this source for raising money. The amount of debentures registered an increase of Rs. 0.50 crore—from Rs. 0.88 crore in 1956-57 to Rs. 1.38 crores in 1968-69.

10. Besides, investment companies have also obtained finances through borrowings. Bank borrowing which was Rs. 4.61 crores in 1956-57, has declined to Rs. 4.19 crores in 1968-69. Similarly, other borrowings including deposits have also declined by Rs. 0.93 crore from Rs. 2.14 crores in 1956-57 to Rs. 1.21 crores in 1968-69.

11. As regards investment in quoted and unquoted securities, the available data reveal that, of the total investment amounting to Rs. 28.22 crores in 1956-57, about Rs. 6.35 crores was in unquoted securities and the balance was in quoted securities. On a percentage basis the proportions of quoted and unquoted shares in 1956-57, were 77.50 per cent and 22.50 per cent respectively. The market value of quoted investments in 1956-57, was Rs. 27.86 crores, representing an appreciation of about 28 per cent over book value. The relative proportions of quoted and unquoted investments in 1968-69, were about 77.40 per cent and 22.60 per cent respectively. The market value of quoted investments showed an appreciation of about 42 per cent only over book value in 1968-69.

12. Information available in regard to security-wise investments reveals that ordinary shares account for a predominant part of investments. Preference shares and Government securities, specially the latter, are not significant. Investment in debentures is negligible. The trend of investment between 1956-57 and 1968-69 is towards variable dividend securities. Thus, in 1956-57 the investments of investment companies in different types of scrips were : ordinary shares 86.50 per cent, preference shares 8.10 per cent, debentures 1.90 per cent and Government securities 3.50 per cent. In 1968-69, ordinary shares accounted for 92.20 per cent of the total investment. The proportion of investment in preference shares was 6.90 per cent. Holdings in debentures and Government securities were negligible.

13. As already mentioned, a large number of investment trust companies in India are associated with leading industrial houses. The pattern of diversification of investment of the investment companies reflects "group association". The investment of investment trust companies in the securities of concerns in the same group was about 69 per cent in 1968-69. In the case of companies belonging to five groups, *viz.*, J. K., Jaipuria, Advanis, Jardine Henderson and R. K. Agarwala, almost 100 per cent investment was within the same group. Within group investment constitutes about 88 per cent of the total investment of investment companies belonging to the Andrew Yule group. The holdings of Bird Heilgers, Birlas and Dalmia Sahu Jain groups of investment companies in the same group amounted to 91 per cent, 85 per cent and 98 per cent respectively. Bangur group of investment companies has 78 per cent of investment in the same group. The share of group investment in the case of companies belonging to other groups are : Goenkas 61 per cent and Shapoorji Pallonji 30 per cent. In the case of Tatas a smaller percentage, *i.e.*, 37 per cent is in companies belonging to the same group. It is interesting to note that the non-group companies also have about 20 per cent of their total investment as "group investment". Some of these companies, as already mentioned, have subsidiary companies and holdings in them account for group investments.

14. Finally, we come to the growth of investment trust companies in India over the last 13 years, *i.e.*, 1956-57 to 1968-69. Total assets and investments have registered an increase of about 13 per cent and 15 per cent respectively. The share capital, however, has increased from Rs. 18.98 crores to Rs. 20.86 crores, *i.e.*, by 10 per cent only. The increase in share capital was in respect of only four companies, namely, Investment Corporation of India Ltd., India Discount Co. Ltd., F. E. Dinshaw Ltd., and Eastern Investments Ltd. The largest increase of Rs. 95.22 lakhs, out of a total increase of Rs. 188 lakhs, in the case of the Investment Corporation of India Ltd., was as a result of the amalgamation of the Oriental Life Assurance Co. Ltd., after business of this company had been taken over by the Government on nationalisation of life insurance in India, the balance representing bonus issue. The expansion is largely financed by reserves. It is, thus,

amply clear that despite the phenomenal growth of the corporate sector investment companies have failed to show any significant growth over the last 13 years. No wonder, therefore, that they do not count among the institutional investors in the Indian Capital market.

15. This should not, however, lead one to conclude that there is no scope for their growth. The developing economy of the country under the five year plans provides a favourable setting for the growth of such institutions.

PART II

Scope for the Growth of Investment Companies in India

16. This Part examines the requirements of the Indian economy and the role which the investment trusts can play. It also outlines the measures which would go a long way in making them an important instrument of economic and social development.

17. Mobilization of resources forms an integral part of the developmental process in India. Ability and willingness of the people to save notwithstanding, appropriate financial intermediaries are a *sine qua non* for stimulating capital formation. In the task of mobilization of resources, therefore, there is need to experiment with the creation of new financial intermediaries, coupled with reforming the existing ones, to appeal to the varied interests and preferences of the investing public. In this context, investment trusts hold promise of becoming an important investment vehicle for small investors on the one hand, and a source of fund for economic development on the other.

18. That the volume of savings in India, like other developing countries is too meagre in relation to its developmental needs is well-known. Apart from the miserably low level of savings, a significant part of it also gets directed into non-productive channels and is, thus, not available for meeting its growth requirements. One of the important reasons for this mis-direction of savings is the inadequate development of the financial mechanism in the shape of capital market, capable of providing safe, profitable and liquid avenues for investment of one's savings. To the extent the gaps in this direction are filled up, the practice of holding such irrational forms of investment would be discouraged (U.N.O. ; *Measures for Economic Development of Underdeveloped Countries*, p. 36). In the mobilization of domestic savings, attention has to be directed to this aspect.

19. Recent trends in the Indian Capital market show an augmentation of savings into stock exchange investment, particularly equities. This suggests that in addition to a substantial increase in the flow of savings into the

capital market, there has been, since the initiation of planned development, a notable shift in the investors' objectives of "savings for savings sake" to "savings for profits sake" so that besides safety and regularity of income, considerations of capital appreciation also influence the objectives of investors.

20. Investment of funds by an investor in fulfilment of his investment objectives involves a careful selection of securities, a diversification of risks and a continuous supervision of the portfolio. Some investors, because of the large amount of savings can engage experienced investment advisers in the selection and supervision of their fund and can readily attain adequate diversification through the purchase of many securities. The small investors, on the other hand, by their nature, temperament and economic setting cannot construct and successfully administer investment portfolio. In the absence of proper technical knowledge of the capital market and specially the stock market transactions they are not in a position to acquire the ownership of securities and are, therefore, not only debarred from the direct benefits in the country's growing prosperity but would also suffer heavy losses due to their ignorance of the soundness of investment. Thus, while on the one hand, the country needs greater mobilization of savings of small investors, on the other hand, it needs the services of experts to invest their savings. There is, thus need of some specialised agency that pools the funds of such investors and relieves investors of many of the cares of investment management and offers a means of recovering money when he wants to spend his savings. Investment Trusts, admittedly, provide a solution to the problem of many such individuals.

21. The cardinal principles of investment trusts are diversification and expert management. Investment trusts enable the investors, through a single commitment, to diversify investment over a large number of securities, thereby reducing the risk of capital depreciation and poor dividends. Also investment companies give to the investors the benefit of trained, experienced and specialised management, together with continuous supervision, neither of which the small investor is, as a rule, qualified to supply himself.

22. In brief, in the planned economy of India, investment trusts, in view of their unique characteristics, have a significant role to play. They will not only benefit the small investors, who, numerically at least, form the major part of the saving populace of the country by providing balanced portfolio of investment and technical knowledge of the market, but also the entire economy by siphoning the savings of the country into desirable productive lines *via* the capital market. Apart from mobilizing the savings of the relatively small investors, the investment trust would also help in the democratization of industrial share ownership and, thus, act to the furtherance of some of the objectives of the Directive Principles of State Policy of the Constitution (*vide* Articles 39 and 41).

Suggestions

23. On this background of the experience of investment trust in India and the requirements of the developing economy of the country we may proceed to outline remedial measures to streamline this sector of the industrial financial organisation to make it an instrument of economic and social development.

24. One of the most important reasons why investment companies represent underdeveloped financial sector in India is that they are not clearly differentiated in the investors' minds from other companies due to their association with industrial houses and due to the nature of their business. The group association of investment companies has led to the investment of the funds of these companies in concerns in which the group is interested, with the result that the basic principle of investment trust, namely, independent selection of securities purely on merit with due regard to safety and diversification is not served in India. Moreover, the investment companies in India are carrying on business which are not consistent with the basic principles of such institutions. For instance, the object clause of the Investment Corporation of India Ltd., a leading investment company, includes, *inter alia*, the following :

1. To carry on business of an investment company ;
2. to underwrite shares, stock and debentures, etc. ;
3. to purchase and acquire from M/s. Tata Sons Ltd., shares, securities and investment ;
4. to form, promote, subsidize, organise and assist companies ;
5. to act as administrators, managers, secretary and treasurer and managing agents, etc. ;
6. to borrow or raise money by the issue of debentures ;
7. to lend money with or without security ;
8. to act as trustees ;
9. to give guarantee ;
10. to hold in the name of others any property which the company is authorised to acquire ;
11. to take part in the management, supervision of control of any company ;
12. to transact and carry on agency business ;
13. to receive money on deposits ;
14. to carry on business as financiers.

(*Vide* Memorandum of Association, 1961, pp. 1-7)

25. If investment companies are to hold their own in the Indian capital market, radical changes in these respects are called for. True, if investment companies undertake other functions it would be of help in that it supplements their income. But this, by its very nature, involves, among other things, great financial risk, which the investment companies cannot afford to bear. Even foreign experience is against it. The English and American experience may be recalled here. During the depression of the 1890's, investment companies in England suffered heavy losses due to their undertaking such supplementary functions (Doane C. R. & Hills E. J., *Investment Trusts and Funds*, Great Barrington, Massachusetts, 1961, p. 25).

26. Similarly, the American investment companies had come to grief during the depression of 1920's (National Association of Investment Companies, *Investment Companies Facts Book*, New York, 1964, p. 5). In view of the concomitant financial risk involved as also in the light of the experience in foreign countries it may be suggested that investment companies in India should concentrate on the main function of such institutions, *i.e.*, mobilizing savings and investing purely on merit with due regard to safety and diversification. This will raise them in the public mind to the status of a saving institution.

27. It is sometimes argued that in view of the fact that there is a gap in the Indian Capital market in the sense that there are so far no institutions like Merchant Banks, perhaps investment companies could combine the functions of "true investment companies" with other functions like issue houses and promoters, etc.

28. It is rather difficult to agree with this view. By their nature such institutions cannot afford to play the role of 'gap-fillers' in the capital market. As already pointed out, investment companies can succeed in mobilizing savings only if they occupy the status of a saving institution. Their involvement in such other functions would have the effect, among other things, of distorting this image in the investors mind and fail, to that extent, to have their confidence. It is not without such weighty reasons that investment companies have been specifically prohibited from engaging in such activities in Japan.

29. In the context of the imperfectness of the Indian Capital market in the sense of the gap pointed out above, the role of gap-fillers, in my opinion, could well be assigned to the Development Banks. In fact, in addition to their traditional functions, they are moving, though belatedly, in this direction. A beginning, for instance, has already been made by the ICICI in engaging in placement of securities. A "Consortium Approach" by the specialised corporations, led by the IDBI, would probably be the best institutional arrangement insofar as the solution to the "gap" problem is concerned.

30. Regarding the problem to remedy the situation arising out of group affiliation it may be emphasized that only a diversified structure of investment companies would be able to deliver the goods. Viewed in this light, there appears to be a strong case for starting investment companies in the public sector but those in the private sector should not be discriminated. The only precaution to be taken is that investment companies in the private sector are not subservient to the group interest. This could be ensured if regulatory measures are taken with reference to the management and investment policy and so on. The proposed legislative measure in the form of a special Act would be, it appears to me, able to take care of this aspect.

31. Another consideration that will stimulate the growth of investment companies in India is the provision of safeguards and protection to investors. It may be of some interest to mention that even in the United Kingdom, the United States of America and Japan, where investors are more enlightened in matters of investment in equities, there are special legislations for regulating the working of investment companies. Investment Company Act 1940 in the U.S.A. and Securities Investment Trust Act 1951 in Japan are instances in point. Surely, a measure of this nature is long overdue in India, particularly because small investors are not competent to protect their interest themselves. In view of their special nature it would be better if, instead of functioning under the Companies Act, they are brought under a separate legislation.

32. In suggesting a special legislation for regulating the functioning of investment companies the overriding consideration is the creation of confidence in the investors in such institutions. That there is wide scope for dishonesty, malpractice and manipulation in investment companies, as a vehicle of saving mobilization, is amply illustrated by the experience of foreign countries, as also our own experience. Unless these organisations are able to engender confidence, the potential investors would not agree to part with their savings. In this context the experience in foreign countries has been that special regulatory measures have been an essential element in providing protection to investors and restoring confidence and to that extent an important contributory factor in the growth of such institutions. In India this is re-inforced by the fact that not only the investors, particularly small, are not enlightened enough to protect their interests themselves but also due to group affiliation the investment companies are following a policy more in consonance with the requirements of the particular groups rather than the interest of the investors. In brief, therefore, if investment companies are to enjoy wide public acceptance, as a tool of savings, as in foreign countries, the enactment of a special legislation is, to me, an imperative necessity.

33. From the above rationale of a separate legislation would flow the objectives of such a measure. The main aim should be to ensure that persons who invest in investment company shares should be fully informed

as to the company's affairs and fairly treated by management. In this connection I can probably do no better than quote, for the consideration of the Study Group, the broad objectives of the Investment Company Act 1940 in the U.S.A.

"(1) Provide investors with complete and accurate information concerning the character of investment companies and the circumstances and policies and financial responsibility of investment companies and their management;

(2) Assure that investment companies are organised and operated in the interest of share-holders rather than in the interest of officers, directors, investment advisers and other special groups of persons ;

(3) Prevent inequitable provision in investment company securities and protect the preferences and privileges of outstanding securities ;

(4) Prevent undue concentration of control through pyramiding and other devices and discourage management by irresponsible persons ;

(5) Assure sound accounting methods ;

(6) Prevent major changes in organisation and business without the consent of share-holders ;

(7) Require adequate assets or resources for the conduct of business."

(*Vide* A. Weisemberger & Co., *Investment Companies*, New York, 1962, pp. 31-32.)

34. In a scheme for promotion of investment companies, it may be noted, tax concessions have a significant place. Without this exemption it would mean that an investor who resorts to investment companies, as an intermediary, for investing in equities is worse-off than if he were to invest directly. For the investment income of the investment companies will be subject to income tax and this income will again be liable to deduction of tax at source, when this income of the investment trust is distributed to shareholders as dividend. This, in fact, is the position in respect of investment companies under the present scheme of taxation. To meet this situation it is desirable that investment companies should not be liable to pay any tax at all. This is because the attraction of investment in investment company shares lies not merely in its safety but also in a reasonable return with prospects of some appreciation of the original capital investment. Taxation systems in foreign countries recognise this. Thus, in terms of the provisions of the Revenue Act 1942 in the U.S.A. and Security Investment Trust Act 1951 in Japan investment trusts are exempt from the payment

of tax at the intermediate stage. Even in India, in the case of the Unit Trust of India, the Government has accepted, in principle, that since investment companies are conduits for channelizing the investment income from the industrial companies to investors they should not pay any tax. Fairness and equity demand that investment companies should be treated at par with the Unit Trust of India in the matter of taxation, if they are to give a a good account of themselves and the investors who hold their shares are not penalized.

35. Finally, the structural pattern of investment companies also merits attention. The official policy with reference to the structure of investment companies in India seems to favour the unit type (the British counterpart of open-end/Mutual funds in the U.S.A. and Japan). The establishment of the Unit Trust of India in the public sector, the tax exemptions and other concessions in the form of organising publicity for the sale of its units bear an eloquent testimony to it. This, it may be argued is not in keeping with the developmental requirements of the economy.

36. The problem in India, as already mentioned, is not only of resource-mobilization but also, of equal importance, resource-allocations along desired lines. The industrial financial organisation should take care of both these aspects. It will be shown presently that the present policy is not conducive to the realization of this two-fold objective.

37. Insofar as saving function is concerned the unit type of Investment Companies have a definite advantage over investment company type in that the former have more popular appeal for the investors for a number of reasons. In the first place, the continuous sale of securities, coupled with aggressive sales technique, will go a long way in popularizing investment trusts among investors. Further, the easy redemption of invested funds at any point of time, with consequent advantages from the point of liquidity, would encourage investors to purchase units of unit trust. Moreover, due to provisions of the distribution of capital gains along with the dividends the investors would prefer them. Finally, the purchase of units is more convenient in that units can be bought and sold in relatively small amounts as the investors are not required to undertake direct operations on the stock exchanges.

38. Obviously, the unit type of investment companies would be in a better position to attract larger savings. The contemporary experience in the advanced countries, particularly the U.S.A. and Japan, where the open-end type have outpaced the closed-end type is remarkable illustration of its superiority as a vehicle of saving mobilization. But their usefulness to the economy would be limited because of some constraints on their investment policy. The need for daily valuation of units on the part of unit trusts results in restricting the field of investment to a relatively narrow range of

scrips, *i.e.*, those which are actively traded on the security markets with the result that the companies whose shares are not so actively traded would be starved of funds. The small and medium companies are an important constituent of this segment of the industrial sector. It may not be out of place to mention that it is precisely these companies that face the 'Gap' problem. Investment trusts, in contrast, can reasonably operate over a much wider area of corporate securities. They offer the only solution to the problem of equity capital to small and medium companies. If the benefits of institutional investment are to be extended over as large a part of the security market as possible the investment trusts deserve as much encouragement as unit trusts.

39. Thus, while the unit trusts enjoy superiority over investment companies in respect of mobilization of savings the latter represent a better agency for investment allocation of funds. The official policy, therefore, calls for re-orientation to the encouragement of investment trusts. An integration of the saving-collection of unit trusts and fund-allocation of the investment trusts would be a useful financial technique to promote developmental use of available resources in keeping with the plan priorities in India. In a nutshell, the Government policy in this sector of the industrial financial system should aim at building up a diversified structure.

40. Should we have more investment companies in the private sector in India is a question that is pertinent here. True, the Unit Trust of India and the L.I.C. are finding it difficult to invest their funds in good scrips but their experience, it may be submitted, cannot be the desideratum mainly because of serious constraints on their *modus operandi*. In the case of the U.T.I., for example, it is statutorily laid down that not more than 5% of its investment would be in initial issues of new companies. In practice the U.T.I. is following even more conservative policy and its selective and overcautious approach has resulted in concentration of its investment in well-established large companies belonging mostly to leading business houses. Similarly, the L.I.C. also is being very selective in the capital market. The investment companies, on the other hand, as already pointed out, can operate on a wide field so that they represent the only solution to the problem of equity capital of small and medium companies.

41. There is yet another notable feature of the Indian Capital market which merits attention in this connection. The entire issues of capital are underwritten and a substantial part of it devolves on the underwriters, mostly specialised corporations. A healthy and active capital market presupposes the existence of investors, individual as well as institutional, who will ultimately take up these securities so as to enable the underwriters, with the funds so released, to undertake other commitments. That investment companies qualify for this is obvious.

42. In addition, one has to take a long-term view of things in consideration of such a question. The success of such institutions is essentially a function of the industrial development and the consequent growth of the corporate sector. In the context of the planned economic development in India such a presumption would not appear to be wide off the mark.

43. In brief, considering the requirements of the Indian economy, particularly from the long-term point of view, there is definite need to have more investment companies in the private sector in India. There is, however, a limiting factor which the Study Group would be well advised to take into account. And it relates to the official policy (involving a political decision). In terms of the socio-economic objectives of the State there are important implications for the financial system. A natural corollary of the scheme of planned development is that Government control and distribution of credit and finance is an essential part of the strategy of development. In the final analysis, therefore, the Government policy would be decisive in this respect.

ANNEXURE "A"

LIST OF INVESTMENT TRUST COMPANIES IN INDIA 1964-65

	Name of the Company	Registered Office	Paid-up Capital (Rs. in lakhs)	Investment (Book Value) (Rs. in lakhs)
	1.	2.	3.	4.
1.	Ashok Viniyog Ltd.	Calcutta	5·00	86·48
2.	Bengal Holdings Ltd.	Calcutta	2·23	5·82
3.	Bharat Nidhi Ltd.	Delhi	201·32	218·38
4.	Bhartia Company Ltd.	Calcutta	21·00	50·10
5.	Birds Investments Ltd.	Calcutta	44·00	63·84
6.	Bond Company Ltd.	Didwana (Rajasthan)	8·00	40·54
7.	Budge Budge Investment Co. Ltd.	Calcutta	0·69	8·67
8.	Calcutta Discount Co. Ltd.	Calcutta	8·52	237·68
9.	Calcutta Holdings Ltd.	Calcutta	2·23	4·19
10.	Calcutta Investment Co. Ltd.	Calcutta	55·00	40·32
11.	Clive Row Investment Holding Co. Ltd.	Calcutta	138·80	175·98
12.	Clover Investment Co. Ltd.	Calcutta	4·10	13·67
13.	Cotton Fabrics Ltd.	Baroda	17·82	39·78
14.	Dalhousie Investment Co. Ltd.	Calcutta	15·00	25·45
15.	Devkaran Nanjee Investment Co. Ltd.	Bombay	25·00	29·94
16.	Diamond Company Ltd.	Didwana	7·00	46·15
17.	Eastern Investment Ltd.	Calcutta	101·89	184·19
18.	Emerald Company Ltd.	Bombay	10·00	28·06
19.	F. E. Dinshaw Ltd.	Bombay	28·19	75.74
20.	Ganges Holdings Ltd.	Calcutta	2·23	3·16
21.	General Investment Co. Ltd.	Didwana	10·00	46·25
22.	General Investment Trust Ltd.	Udipi (Mysore)	5·56	9·21
23.	General Investment & Trust Co. Ltd.	Calcutta	4·25	5 15
24.	George Henderson & Co. Ltd.	Calcutta	60·00	22·54
25.	Gujarat Investment Trust Co. Ltd.	Surat	2·50	3·94
26.	India Discount Co. Ltd.	Calcutta	3·84	4·26
27.	Indian Holdings Ltd.	Calcutta	2·23	3·52
28.	Indian Investment Co. Ltd.	Didwana	18·00	23·12
29.	Indian Investment & Development Trust Ltd.	Kanpur	10·00	12·12

ANNEXURE "A"—(*Contd.*)

	Name of the Company	Registered Office	Paid-up Capital (Rs. in lakhs)	Investment (Book Value)
	1	2.	3.	4.
30.	Industrial Investors Ltd.	Calcutta	0·50	10·59
31.	Industrial Investment Trust Ltd.	Bombay	99·99	120·49
32.	Investment Corporation of India Ltd.	Bombay	220·22	557·31
33.	Investment & Finance Co. Ltd.	Calcutta	9·00	13·45
34.	Investment Trust of India Ltd.	Madras	10·00	13·41
35.	J. K. Investors (Bombay) Ltd.	Bombay	16·25	33·34
36.	Jaipur Investment Co. Ltd.	Calcutta	20·00	36·97
37.	Jaipuria Brothers Ltd.	Calcutta	86·00	30·04
38.	Jaipur Trust Ltd.	Jaipur	2·49	1·65
39.	Karnatak Investment Trust Ltd.	Belgaum (Mysore)	0·25	0·21
40.	Lohia Investment Company Ltd.	Calcutta	0·71	2·39
41.	New India Investment Corporation Ltd.	Calcutta	23·32	37·90
42.	Oriental Industrial Investment Corporation Ltd.	Bombay	63·89	78·20
43.	Oriental Investment Co. Ltd.	Bombay	100·00	11·48
44.	Palghat Investment Corporation Ltd.	Palghat (Kerala)	1·00	0·15
45.	Pilani Investment Corporation Ltd.	Gwalior	351·00	328·50
46.	Ravi Investment Co. Ltd.	Calcutta	1·00	8·35
47.	Sassoon J. David & Co. Ltd.	Bombay	100·00	201·00
48.	Sharedealers Corporation Ltd.	Kanpur	1·00	1·16
49.	•Shekhawati Traders Ltd.	Mahangarh (Rajasthan)	1·00	27·25
50.	Shekhawati Investment Corporation Ltd.	Fatehpur (Rajasthan)	5·25	4·47
51.	Shri Krishna Investment Co. Ltd.	Calcutta	10·00	60·77
52.	Shri Krishna Investment Co. Ltd.	Calcutta	45·00	119·71
53.	Shri Sun Investment & Trading Co. Ltd.	Calcutta	3·00	18·37
54.	Sun Shine Investment Co. Ltd.	Kotah (Rajasthan)	5·00	3·80
55.	Swadeshi Investment Co. Ltd.	Didwana	14·00	20·10
56.	United Investment Co. Ltd.	Calcutta	16·00	20·36
		TOTAL :	2020·27	3269·67

STATEMENT A·1—COMBINED BALANCE SHEET OF INVESTMENT COMPANIES IN INDIA—1956-57 TO 1968-69

(In crores of Rupees)

LIABILITIES	1956-57	1964-65	1968-69
A. PAID-UP CAPITAL	18·98	20·20	20·86
(1) Ordinary	16·53	17·75	18·41
(2) Preference	2·45	2·45	2·45
B. RESERVES AND SURPLUS	11·17	12·93	15·38
(1) Capital Reserve	3·22	3·71	3·46
(2) Other Reserves & Surplus	7·95	9·22	11·92
C. BORROWINGS	7·63	7·24	6·78
(1) Banks	4·61	4·59	4·19
(2) Debentures	0·88	0·90	1·38
(3) Others including deposits	2·14	1·75	1·21
D. CURRENT LIABILITIES AND PROVISIONS	3·02	2·85	3·24
(1) Sundry Creditors	0·73	0·51	0·40
(2) Provision for Taxation	1·04	1·41	2·11
(3) All others*	1·25	0·93	0·73
TOTAL (A + B + C + D)	**40·80**	**43·22**	**46·26**
ASSETS			
A. NET FIXED ASSETS	0·56	0·63	1·00
B. INVESTMENTS	28·22	33·32	32·38
(1) Quoted	21·87	25·40	25·07
(2) Unquoted	6·35	7·92	7·31
(3) Market Value of Quoted	27·86	32·27	35·59
(4) Ordinary Shares	24·41	30·50	29·85
(5) Preference Shares	2·29	2·55	2·26
(6) Debentures	0·53	0·18	0·22
(7) Government Securities£	0·99	0·09	0·05
(8) Shares of Subsidiary Companies	0·76	2·72	2·76
C. CURRENT ASSETS	11·81	8·37	11·27
(1) Cash and Bank Balances	1·19	1·27	1·95
(2) Loans and Advances	10·16	5·01	6·23
(3) All Others@	0·46	2·09	3·09
D. MISCELLANEOUS OTHER ASSETS**	0·21	0·90	1·61
TOTAL (A+B+C+D)	**40·80**	**43·22**	**46·26**

* Includes dividend provisions.
£ Includes foreign Government securities.
@ Includes penalty for non-payment of tax and advance payment of tax.
** Includes debit balance of P/L a/c, immovable property and underwriting commission receivable and tax paid under protest.

Notes : (1) Where break-up between quoted and unquoted is not available investment has been taken as unquoted.
(2) Investment in foreign enterprises which are not quoted on Indian Stock exchanges are shown under unquoted.

सत्यमेव जयते

STATEMENT A·2—COMBINED INCOME, EXPENDITURE AND APPROPRIATION ACCOUNT OF INVESTMENT COMPANIES IN INDIA—1956-57 TO 1968-69

(In lakhs of rupees)

	1956-57	1964-65	1968-69
A. INCOME	269·42	297·44	300·01
(a) *Interest*	39·00	24·69	36·75
(1) Interest on Securities	13·00	2·49	3·60
(2) On Loans and Advances	23·00	19·65	32·88
(3) Others	3·00	2·86	0·64
(b) *Dividends net of tax deductions @*	189·08	230·56	221·51
(1) Subsidiary Companies	1·52	19·20	13·03
(2) Other Companies	187·56	211·36	208·48
Add Tax at Source	15·47	54·07	49·14
(c) *Profit on Sale of Investment*	9·86	14·94	12·95
(d) *All Other Income+*	31·48	27·25	28·80
B. EXPENDITURE	84·76	86·61	98·11
(a) *Interest*	37·81	42·48	48·12
(b) *Loss on Sale of Investment*	14·87	11·14	10·52
(c) *Establishment Expenses£*	8·89	11·72	17·10
(d) *Managerial Remuneration**	5·04	3·33	3·60
(e) *All Other*	18·15	17·94	18·77
C. APPROPRIATIONS			
(a) *Profits before Tax*	184·66	210·83	201·90
(b) *Less Tax Provisions*	68·94	71·20	53·15
(c) *Profits after Tax (a—b)*	115·72	149·63	148·75
(1) Dividend	94·78	120·93	112·36
(i) Ordinary	85·12	110·97	102·87
(ii) Preference	9·66	9·96	9·49
(2) Profits retained	20·94	28·70	36·49
D. RATIOS			
(1) Ordinary Dividend as % of Equity Capital	*5·1*	*6·3*	*5·6*
(2) Preference Dividend as % of Preference Capital	*3·9*	*4·0*	*3·9*
(3) Earnings per Equity Capital@@	*6·4*	*7·8*	*7·6*
(4) Yield on Investments**	*7·2*	*7·0*	*7·0*

@Where tax deducted at source is not given it has been treated as net dividend. Also includes interest where it is not given separately.

+Includes Sales/Managing agency/insurance agency commission, Sales Tax refund, rent and brokerage, etc.

£ Includes salary wages, bonus, provident fund and all other welfare expenses.

* Includes remuneration to managing agents, secretary and treasurer, managing directors, etc., but excludes directors fee.

@@Ratio of net profits after taxation and preference dividend to equity capital.

**Net dividend and interest on securities as per cent of total investments.

STATEMENT A·3—PRINCIPAL SOURCES AND USES OF FUNDS OF INVESTMENT COMPANIES IN INDIA

(In crores of Rupees)

	1964-65	1968-69
A. SOURCES	**2·42**	**3·04**
(a) INTERNAL	2·08	3·61
(1) *Paid-up Capital (Bonus Issues)*	0·27	0·66
(i) Equity	0·27	0·66
(ii) Preference	—	—
(2) *Reserves and Surplus*	1·76	2·45
(i) Capital Reserve	0·49	—0·25
(ii) Other Reserves and Surplus	1·27	2·70
(3) *Provisions*	0·05	0·50
(i) Taxation	0·37	0·70
(ii) Others	—0·32	—0·20
(b) EXTERNAL		
(1) *Paid-up Capital (Right/New Issues)*	0·95	—
(2) *Borrowings*	—0·39	—0·46
(i) Banks	—0·02	—0·40
(ii) Debentures	0·02	0·48
(iii) Others including Deposits	—0·39	—0·54
(3) *Miscellaneous*	—0·22	—0·11
B. USES	**2·42**	**3·04**
(1) *Cash and Bank Balances*	0·08	0·68
(2) *Investments*	5·10	—0·94
(i) Government Securities	—0·90	—0·04
(ii) Shares of Subsidiary Companies	1·96	0·04
(iii) Others	4·04	—0·94
(3) *Loans and Advances*	—5·15	1·22
(4) *Fixed Assets*	0·07	0·37
(5) *Miscellaneous*	2·32	1·71

STATEMENT A·4—GROUP ASSOCIATION OF INVESTMENT COMPANIES IN INDIA—1968-69*

Name of Group	No. of companies	Paid-up Capital (Rs. crores)	Investments (Rs. crores) (A)	Group Investment (Rs. crores) (B)	(B) as % of (A)
1. Birlas	2	3·53	4·30	3·66	*85·00*
2. Bangur	8	0·75	2·60	2·03	*78·00*
3. Bird Heilgers	4	1·59	2·52	2·30	*91·00*
4. Tatas	2	3·37	7·20	2·66	*37·00*
5. Dalmia Jain	4	2·52	4·77	4·69	*98·00*
6. J. K.	2	0·17	0·20	0·20	*100·00*
7. Andrew Yule	2	1·47	4·15	3·67	*88·00*
8. Kothari	1	0·10	0·13	0·05	*40·00*
9. Goenkas	4	1·33	1·37	0·86	*61·00*
10. Jardine Henderson	1	0·60	0·18	0·18	*100·00*
11. Jaipuria	2	0·91	0·12	0·12	*100·00*
12. R. K. Agarwala	4	0·09	0·15	0·15	*100·00*
13. Shapoorji Pallonji	1	0·56	0·78	0·22	*30·00*
14. Advanis	1	0·64	0·80	0·80	*100·00*
15. Non-Group Companies@	18	3·23	3·11	0·65	*20·00*
Total	**56**	**20·86**	**32·38**	**22·24**	**69·00**

* Based on the Industrial Licensing Policy Inquiry (Dutt) Committee Report, 1969.
@ "Group investment" is accounted for by holdings in subsidiary companies.

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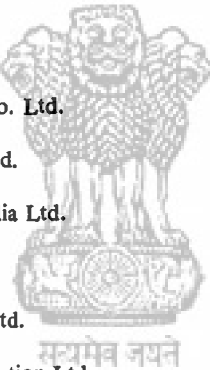
ANNEXURE "B"

LIST OF QUOTED INVESTMENT COMPANIES IN INDIA, 1968-69

1. Ashok Viniyog Ltd.
2. Bharat Nidhi Ltd.
3. Bhartia Company Ltd.
4. Birds Investments Ltd.
5. Calcutta Investment Company Ltd.
6. Clive Row Investment Holding Company Ltd.
7. Eastern Investments Ltd.
8. Emerald Company Ltd.
9. General Investment Trust Ltd.
10. General Investment & Trust Co. Ltd.
11. Industrial Investment Trust Ltd.
12. Investment Corporation of India Ltd.
13. Investment Trust of India Ltd.
14. Jaipur Investment Company Ltd.
15. New India Investment Corporation Ltd.
16. Oriental Industrial Investment Corporation Ltd.
17. Pilani Investment Corporation Ltd.
18. Shri Rishabh Investment Company Ltd.
19. Swadeshi Investment Company Ltd.



STATEMENT B·1—COMBINED BALANCE SHEET OF INVESTMENT COMPANIES (QUOTED) IN INDIA—1956-57 TO 1968-69

(In Crores of Rupees)

LIABILITIES	1956-57	1964-65	1968-69
A. PAID-UP CAPITAL	13·34	14·35	14·71
(1) Ordinary	11·41	12·42	12·78
(2) Preference	1·93	1·93	1·93
B. RESERVES & SURPLUS	3·96	6·28	8·70
(1) Capital Reserve	1·15	1·93	2·34
(2) Other Reserves and Surplus	2·81	4·35	6·36
C. BORROWINGS	3·99	4·68	4·69
(1) Banks	2·73	2·72	2·69
(2) Debentures	0·80	0·80	1·28
(3) Others including Deposits	0·46	1·16	0·72
D. CURRENT LIABILITIES & PROVISIONS	1·87	1·51	2·40
(1) Sundry Creditors	0·35	0·21	0·21
(2) Provision for Taxation	0·74	0·76	1·76
(3) All Others*	0·78	0·54	0·43
TOTAL (A+B+C+D)	**23·16**	**26·82**	**30·50**
ASSETS			
A. NET FIXED ASSETS	0·19	0·16	0·87
B. INVESTMENTS	18·49	23·19	22·56
(1) Quoted	14·87	19·18	17·63
(2) Unquoted	3·62	4·01	4·02
(3) Market Value of Quoted	18·96	23·90	28·06
(4) Ordinary Shares	15·58	21·96	20·69
(5) Preference Shares	1·79	1·14	0·70
(6) Debentures	0·53	0·05	0·22
(7) Government Securities	0·59	0·04	0·04
(8) Shares of Subsidiary Companies	0·27	1·27	1·39
C. CURRENT ASSETS	4·48	3·32	6·43
(1) Cash and Bank Balances	0·42	0·26	1·93
(2) Loans and Advances	3·72	2·31	2·95
(3) All Others@	0·34	0·76	1·55
D. MISCELLANEOUS**	—	0·15	0·64
TOTAL (A+B+C+D)	**23·16**	**26·82**	**30·50**

* Includes dividend provision.
† Includes foreign Government securities.
@ Includes penalty for non-payment of tax and advance payment of tax.
** Includes debit balance of P/L A/c, underwriting commission receivable and tax paid under protest.

Notes : (1) Where break-up between quoted and unquoted is not available investment has been taken as unquoted.
(2) Investments in foreign enterprises which are not quoted on Indian Stock Exchanges are shown under unquoted.

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STATEMENT B·2—COMBINED INCOME, EXPENDITURE AND APPROPRIATION ACCOUNT OF INVESTMENT COMPANIES (QUOTED) IN INDIA—1956-57 TO 1968-69

(In lakhs of Rupees)

	1956-57	1964-65	1968-69
A. INCOME	179·47	209·32	217·32
(a) *Interest*	22·66	12·52	26·34
(1) On Securities	6·75	1·16	1·19
(2) On Loans and Advances	13·70	8·87	24·54
(3) Others	2·21	2·49	0·61
(b) *Dividends after Tax Deductions**	136·59	175·79	168·36
(1) Subsidiary Companies	1·35	12·08	8·14
(2) Other Companies	135·24	163·71	160·22
Add Tax at Source	9·13	43·01	35·83
(c) *Profits on Sale of Investment*	6·45	8·85	5·46
(d) *All Other Income@*	13·77	12·16	17·16
B. EXPENDITURE	44·57	57·14	68·72
(a) *Interest*	18·65	30·45	32·68
(b) *Loss on Sale of Investment*	7·61	4·16	7·81
(c) *Establishment Expenses†*	4·62	8·56	11·70
(d) *Managerial Remuneration£*	3·41	2·29	2·97
(e) *All Other*	10·27	11·68	13·56
C. APPROPRIATIONS			
(a) *Profits before Tax*	134·91	152·18	148·60
(b) *Less Tax Provisions*	52·44	50·90	42·49
(c) *Profits after Tax (a—b)*	82·47	101·28	106·11
(1) Dividend	77·01	84·93	78·83
(i) Ordinary	68·71	75·94	70·36
(ii) Preference	8·30	8·99	8·47
(2) Profits Retained	5·46	16·35	27·28
D. RATIOS			
(1) Ordinary Dividend as % of Equity Capital	*6·0*	*6·1*	*5·5*
(2) Preference Dividend as % of Preference Capital	*4·3*	*4·7*	*4·4*
(3) Earnings per Equity Capital**	*6·5*	*7·4*	*7·6*
(4) Yield on Investment@@	*7·8*	*7·6*	*7·5*

* Where tax deducted at source is not given it has been treated as net. Also includes interest, where separately not available.

@ Includes sales/managing/insurance agency commission, tax refund, rent and brokerage.

† Includes salary, wages, bonus, provident fund and other welfare expenses.

£ Includes remuneration to managing agents, secretary and treasurers, managing directors, etc., but excludes directors' fee.

** Ratio of net profits after taxation and preference dividend to equity capital.

@@ Net dividend and interest on securities as % of total investments.

STATEMENT B·3—PRINCIPAL SOURCES AND USES OF FUNDS OF INVESTMENT COMPANIES (QUOTED) IN INDIA

(In crores of Rupees)

	1964-65	1968-69
A. SOURCES	**3·66**	**3·68**
(*a*) INTERNAL	2·26	3·67
(1) *Paid-up Capital (Bonus Issues)*	0·06	0·36
(*i*) Ordinary	0·06	0·36
(*ii*) Preference	—	—
(2) *Reserves and Surplus*	2·32	2·42
(*i*) Capital Reserve	0·78	0·41
(*ii*) Other Reserves and Surplus	1·54	2·01
(3) *Provisions*	—0·12	0·89
(*i*) Taxation	0·02	1·00
(*ii*) Others	—0·14	—0·11
(*b*) EXTERNAL	1·40	0·01
(1) *Paid-up Capital (New/Right Issues)*	0·95	—
(2) *Borrowings*	0·69	0·01
(*i*) Banks	—0·01	—0·03
(*ii*) Debentures	—	0·48
(*iii*) Others including Deposits	0·70	—0·44
(3) *Miscellaneous*	—0·24	—
B. USES	**3·66**	**3·68**
(1) *Cash and Bank Balances*	—0·16	1·67
(2) *Investments*	4·70	—0·63
(*i*) Government Securities	—0·55	—
(*ii*) Shares in Subsidiary Companies	1·00	0·12
(*iii*) Others	4·25	—0·75
(3) *Loans and Advances*	—1·41	0·64
(4) *Fixed Assets*	—0·03	0·71
(5) *Miscellaneous*	0·57	1·28

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STATEMENT B·4—GROUP ASSOCIATION OF INVESTMENT COMPANIES (QUOTED) IN INDIA—1968-69*

Name of Group	No. of Companies	Paid-up capital (Rs. Crores)	Investments (Rs. Crores)	Group Investments (Rs. Crores)
1. Birlas	1	3·52	4·28	3·64
2. Tatas	1	2·37	5·41	1·73
3. Bangur	2	0·24	0·51	0·39
4. Dalmia Jain	3	2·51	4.57	4·49
5. Bird Heilgers	3	1·50	2·38	2·17
6. Andrew Yule	1	1·39	1·44	0·96
7. Kothari	1	0·10	0·13	0·05
8. Goenkas	3	1·17	1·17	0·66
9. Advanis	1	0·64	0·80	0·80
10. Non-Group Companies@ ..	3	1·27	1·86	0·50
Total	**19**	**14·71**	**22·56**	**15·39**

* Based on the Industrial Licensing Policy Inquiry (Dutt) Committee Report.
@ "Group Investment" is accounted for by holdings in subsidiary companies.

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APPENDIX V

INVESTMENT COMPANIES & UNIT TRUSTS IN U.K., U.S.A. AND JAPAN

INVESTMENT TRUSTS AND UNIT TRUSTS IN U.K.

1. The history of British investment trusts dates back to the eighteen-sixties. At the end of 1964, investment trusts which made returns to the Bank of England numbered 332 and had assets of £ 2,890 mn. On 31st March 1964, the value of all types of securities of investment trust companies quoted on the London Stock Exchange (including loan capital, preference and preferred capital and ordinary and deferred capital) amounted to £ 2,689 mn.*

2. The unit trust movement in Britain started in the early nineteen-thirties, but it really got going only in the sixties. In 1939, unit trusts' assets amounted to some £ 80 mn. Despite rising stock market prices they were estimated to be only £ 100 mn., at the end of 1958. At the end of 1964, unit trusts' assets more than quadrupled to £ 406 mn.** At the beginning of 1969, the total fund commanded by the unit trusts amounted to £ 1,482 mn. as compared to £ 5,622 mn. commanded by the investment companies.†

3. Thus, as a medium of accumulated savings the assets of investment trusts far outweigh those of unit trusts. But in the last decade, the unit trust has scored a dramatic growth rate which made the 'Economist' comment that "investment trusts, for all their size, history and influence have been the cinderella of the savings movement."‡

4. According to Corner & Burton, the difference in the rates of growth of investment and unit trusts' assets is accounted for mainly by the fact that unit trusts' units are issued on tap, and by the greater number of block offers on the part of unit trusts compared with right issues on the part of investment companies.@ An additional reason may be, as the 'Economist' pointed out, that "they (*i.e*, investment trusts) have lost out in the publicity game currently monopolised by the unit trusts" because of the restrictions on advertising. It is remarkable that just as organised manufacturing industry has resorted to aggressive advertisements and marketing techniques for the sale of its pro-

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* Corner, D. C., and Burton, H., *Investments & Unit Trusts in Britain and America*, Eleck Books, London, 1968, p. 91.

** *Ibid*, p. 261.

† Investors Chronicle, 25th April, 1969.

‡ *The Economist*, 8th August 1970, p. vii.

@ Corner, D. C., and Burton, H., *op. cit.*, p. 261.

Note : 'mn.' indicates million.

ducts, so also the organised savings and investment industry of the West has, with great success, adopted the same techniques in the business of encouraging and attracting savings and channelising their investment in productive industry through unit trusts.

INVESTMENT COMPANIES AND MUTUAL FUNDS IN THE USA

5. "Investment trusts did not emerge as an important institution in the financial community until the early twenties, though investment trusts and institutions similar to investment trusts existed much earlier."*

6. In the USA also, the investment trust and the unit trust industry have enjoyed tremendous popularity with the investing public in the last twenty five years. Between 1941 and 1964, the aggregate assets of close-end (investment trusts) and open-end (mutual funds) companies increased almost 34 times from $ 925 mn. in 1941 to $ 31405 mn. in 1964.

TABLE 1—GROWTH OF INVESTMENT COMPANIES

	Value of assets $ mn	No. of shareholder accounts in thousands
1. Closed-end companies		
1941	523	450
1964	2,289	322
Growth (No. of times)	4.4	*—28* per cent
2. Open-end companies		
1941	402	293
1964	29,166	6,302
Growth (No. of times)	72.4	21.5

7. It may, however, be observed from the above table that the growth of open-end companies has been far more phenomenal than that of the close-end companies. Between 1941 and 1964, while the value of assets of the former expanded by 72.4 times from $ 402 mn. to $ 29,116 mn., thoseo of the latter expanded by only 4.4 times from $ 523 mn to $ 2,289 mn. During the same period the number of shareholder accounts in the case of open-end companies increased from 2.93 lakhs to 63.02 lakhs, while in the case of close-end companies it declined from 4.50 lakhs to 3.22 lakhs.

UNIT AND OPEN-END INVESTMENT TRUSTS IN JAPAN

8. Japan is yet another country, where investment trusts have made remarkable progress particularly since 1956. Investment trusts have demonstrated their ability to withstand adverse conditions in the stock market and enjoyed sustained growth over a long period. The essential feature of the

* Corner, D. C., and Burton, H., *op. cit*, p. 199.

Japanese unit investment trusts is that there is no addition made to capital after the initial establishment. As against this, the open-end investment trusts are generally patterned according to the mutual funds of the U.S. where the units are on tap at all times. In both the types of trusts, the units are redeemable by the issuing companies.

TABLE 2—GROWTH IN NET ASSET VALUE OF INVESTMENT TRUSTS*

	Unit Trusts	Open-end Trusts
	Billion Yens	
1952	51	0.9
1963	875	477
Growth (No. of times)	17.2	530

* *Investment Trust in Japan—Its History and Development*, Investment Trust Association, July, 1963, p. 22.

9. It may be observed from the data presented in the above table that the net asset value of unit investment trusts increased by 17.2 times from Y 51 billion in 1952 to Y 875 billion in 1963, while those of the open-end investment trusts increased by 530 times from less than Y 1 billion to Y 477 billion. The share of investment trusts in the total value of shares listed on the Japanese stock exchanges increased from 7.2% in 1959 to 9.1% in 1962, and their share in the market value of all listed shares increased from 8.1% to 10.9% The rapid growth and development of investment trusts is primarily attributable to (1) the sustained and accelerated economic growth ; (2) the natural thriftiness of the Japanese people ; (3) the advantages offered due to diversification of investments, professional management at low cost and easily negotiable bearer-type beneficiary certificates; and (4) the general up-trend in the stock market.

APPENDIX VI

SALIENT FEATURES OF SPECIALISED HOUSING FINANCE INSTITUTIONS IN SELECTED FOREIGN COUNTRIES

1. There are specialised housing finance institutions in a number of countries like Australia, Belgium, Denmark, Finland, France, U.K., and U.S.A. Mention may be made especially of building societies in the U.K. and the Savings and Loan Associations (SLAs) in U.S.A., because they have certain interesting features which can be adapted with advantage to our own conditions.

Building Societies in U.K.

2. The main functions of a building society* in U.K. are to accept savings from the public and lend them against home mortgages. There are two kinds of members—investing members who invest money in or subscribe to the shares of the society and borrowing members who borrow money from the society. Any person may belong to both these classes. A building society does not have fixed share capital nor are its shares issued, sold or purchased on the stock exchange. Building society's shares are generally known as "paid-up shares". Some societies also issue what are called "subscription shares". A subscription shareholder pays a weekly or monthly amount for an agreed period which may run to several years at the end of which he becomes a fully paid shareholder.

3. The shares of building societies carry a rate of interest fixed by the Directors of the society and may vary from time to time in accordance with the change in monetary conditions. The societies also accept deposits which carry a rate of interest which is usually less than that paid on shares. There is a statutory minimum period for notice of drawal of deposits. The period of notice required for the withdrawal of shares varies from 1 month to 6 months. In practice, small sums are paid out at once and larger amounts at short notice. As the building societies in U.K. accept deposits, their liquid assets in the form of cash and government securities are as high as 15% to 25% of their total assets.

4. Most of the loans by building societies are made on the security of private dwelling houses purchased for owner occupation. The advances are usually repayable by fixed monthly or quarterly instalments which include both capital and interest over periods ranging upto about 30 years. They usually lend on mortgages for about 80% of the value of the property. Sometimes the extent of the loans may go up to 95% provided that the bor-

* Building societies do not build houses. They are only housing finance agencies.

rower can produce some additional security, *e.g.*, guarantee by an insurance company, a local authority or a bank. In April 1968, Government introduced an Option Mortgage Scheme under which it shares the risks with insurance companies when they guarantee loans granted by building societies upto 100% of the value of property or its purchase price.

5. Some building societies are prepared to combine the mortgage with endowment insurance also to assure that the outstanding debt will be automatically paid should the borrower die during the term of the mortgage. Under such a scheme, a loan is made by the building society in the normal way and, at the same time an insurance policy is taken by the borrower. The sum so assured should be equal to the mortgage loan, and the life of the mortgage and the life of the policy must coincide. During the period of the policy the borrower pays only interest to the society on the loan he has received and premia to the life insurance company. At the end of the term, the insurance company hands over the sum assured to the building society thus repaying the loan in full.

6. A notable feature of the British housing finance system is that most of the building societies think that loans to builders engaged in creating large number of houses is the business of commercial banks and not of the societies. Life insurance companies play a relatively minor role. Their assistance is generally sought by those who go in for expensive dwellings because building societies do not advance very large amounts. Thus, the commercial banks give short/medium-term loans to builders and the prospective home owners get a long-term loan for purchasing a house from the building society. Another interesting feature may be mentioned here. Some persons may find that they do not satisfy the requirements of building societies or that payments over amortisation period of 20-25 years are rather high. For such persons, the Government decided that the building societies should be encouraged to give loans. In 1964, the Housing Act enabled the Government to set up Housing Corporation to promote the growth of housing societies to whom long-term loans of over 40 years will be given for constructing new houses to be occupied by the above mentioned categories of persons. For financing the housing societies, the building societies have undertaken to lend two-thirds of the amount required and the remaining one-third is lent by the Housing Corporation which is a second mortgagee.

Housing Finance System in the U.S.A.

7. In the U.S.A., there is a well organised housing finance system and a developed mortgage market. There are specialised institutions providing housing finance although a number of financial institutions including commercial banks extend mortgage credit. There are also a number of Government agencies which regulate, supervise and support the housing finance system in various ways.

8. The most important institutions providing residential mortgage credit are the SLAs, Mutual Savings Banks, life insurance companies and the commercial banks. These four institutions together held over 4/5th of the total residential mortgage credit at the end of 1969. Mention may also be made of mortgage companies. Essentially these companies function as brokers in the mortgage market bringing together lenders and borrowers. According to the figures for 1969, the sales of mortgage loans by mortgage companies were almost equal to the loans made by them and the mortgages purchased by them.

9. The predominant position the SLAs occupy in the residential mortgage credit in the U.S.A. can be seen from the following table :

TABLE 1

	Share in the residential mortgage loans outstanding at the end of 1969
	(%)
SLAs	*40.7*
Mutual Savings Banks	*15.2*
Commercial banks	*14.0*
Life insurance companies ..	*12.8*
All others	*17.2*
	100.0

10. Apart from the fact that SLAs are the most important institutions in the housing finance system of the U.S.A., a feature that distinguishes them from the other institutions providing housing finance is that the bulk of investments of SLAs has to be in the form of loans secured by residential mortgages, whereas other financial institutions like commercial banks, mutual savings banks and life insurance companies can keep their funds in a wide range of financial assets. Also, SLAs are leaders in origination of residential mortgage loans, *i.e.*, they make loans directly rather than purchase mortgage loans from other lending institutions.

Functions of SLAs

11. The major functions of SLAs are to raise savings in the form of share capital and savings account deposits* and to grant long-term mortgage

* The original law regulating the SLAs had specially provided that no federal SLA could call its saving accounts savings deposits and that payment made to savers had to be referred to as dividends or earnings. The Housing and Urban Development Act, 1968 amended the law and permitted federal SLAs to issue accounts in the form of savings deposits. The new law declared that the return on savings placed with SLAs could be called 'interest'. The Housing Act recognised that SLAs were depository institutions. It went a long way in removing the public relation handicap associated with the old terminology of 'shares' and 'dividends'. The new law followed the precedent of many recent court decisions that there is no difference between a savings deposit in a bank and in an Association. (*Source :* U.S. Savings and Loan League, *Savings and Loan Fact Book*, 1970, p. 64).

loans for the purchase, improvement or construction of houses. They can be defined as locally owned and privately managed thrift and finance institutions. Most of them are mutual type institutions although there are some Associations of the capital stock type also. They provide a number of saving media to cater to the needs of a wide section of savers. Their role as saving institutions can be judged by the fact that the ratio between the number of their savers and borrowers is 4 : 1. They are also the third largest financial institution in the U.S.A., next only to commercial banks and life insurance companies. They serve both as thrift associations to the small savers and as depository institutions for the large savers. Distribution of savings accounts by size of balances shows that a large majority of account holders hold a relatively small balances although the bulk of the total balances belongs to a small percentage of account holders with relatively large balances.

12. SLAs are by law, custom and regulation local institutions sponsored by the local community. In fact, there are restrictions on the distance within which a SLA can operate. In order to ensure mobility of funds between different localities and regions, SLAs can enter into participation arrangements with other specified associations. At the end of 1969, there were 5,898 SLAs in the U.S.A.; thus the population per association was only 34,034. If the branches of SLAs are also taken into account, the population per office was only 20,378.

13. From the point of view of regulation and their place in the housing finance system, SLAs can be divided into those federally chartered and those chartered by the States. Like the commercial banking system in the U.S.A., SLAs have a dual system of chartering and supervision. State associations are chartered under the State statutes and supervised by their respective savings and loan departments. Federal associations are chartered under the Home Owners' Loan Act, 1933, and are subject to the supervision of the Federal Home Loan Bank Board.

Government Agencies and Their Functions

14. This brings us to the discussion of the role of the major government agencies in the housing finance system of U.S.A. The importance of government agencies is derived from the part they play in supervising the system, giving short-term finance to lending institutions as and when needed, providing insurance and guarantee facilities and encouraging an active mortgage market.

(a) Federal Home Loan Bank (FHLB) System

15. The Federal Home Loan Bank system consists of the Federal Home Loan Bank Board, 12 regional banks and the members of the system. All the federally chartered associations are required by law to be members of the

FHLB system. Membership is also open on a voluntary basis to qualified State chartered savings associations, mutual savings banks and life insurance companies. The charter and regulation under which an Association operates embody well-defined principles with respect to investment safeguards, lending policies and operational practices.

16. The main function of the FHLB system is to provide a central credit facility to meet the seasonal and emergency credit requirements of its members and to provide a link between them and the capital market. FHLBs sell their consolidated obligations in the capital market. Thus, SLAs and other member institutions are able to have access to the resources of the national capital market. The regional banks serve as central credit institutions for member institutions. Member institutions transact their business through the regional bank of their district.

Federal Savings and Loan Insurance Corporation (FSLIC)

17. An agency governed by the FHLB Board, *viz.*, the Federal Savings and Loan Insurance Corporation, provides insurance cover for savings placed with federal associations and State associations qualifying for insurance cover. Like the Federal Deposit Insurance Corporation the FSLIC insures accounts upto $ 20,000. Some States also have their own insurance and guarantee organisation for insuring accounts. The provision of insurance cover enables the SLAs to compete successfully for the country's savings with other institutions like the commercial banks and the mutual savings banks.

(b) Federal Housing Administration (FHA) and Veterans Administration (VA)

18. While the FSLIC insures deposits of SLAs there are two government agencies which insure or guarantee the repayment of mortgage loans. Federal Housing Administration which was established during the depression years primarily to create employment and to support the home construction programme, insures institutions like SLAs, commercial banks, mutual savings banks and life insurance companies against loss on mortgage loans and short-term loans made to finance alterations, repairs, etc., to existing structures.

19. Another guaranteeing agency, Veterans Administration, is of special benefit to the military personnel. This agency offers encouragement to lenders by way of guaranteeing mortgage loans made to veterans. It also offers special benefit to borrowers. For instance, interest on VA guaranteed loans cannot exceed a specified maximum rate and no brokerage/commission is involved in such loans. Loans insured and guaranteed by FHA and VA have lower (or nil) down payment and longer maturity than conventional loans.

20. It is interesting to note that SLAs have not made much use of the insurance and guarantee facilities provided by FHA and VA. The reasons

lie both in the history of SLAs and the practical problems involved in getting their loans insured or guaranteed. SLAs with a thorough knowledge of the real estate conditions in their operating area have a very long experience of the technique of monthly loan repayments and thus are not much attracted by the insurance facilities provided by the aforesaid agencies. Also, maximum interest rates involved in FHA and VA loans as well as the procedural delays associated with the loans are said to discourage them from taking advantage of the insurance facilities offered.* It may, however, be pointed out that other lending institutions make considerable use of the insurance and guarantee facilities.

Government Agencies Supporting the Secondary Mortgage Market

21. A discussion of the role of Government agencies in the housing finance system in the U.S.A. will be incomplete without reference to the efforts made by the Government to create a secondary market in mortgages. The Federal National Mortgage Association which is a Government sponsored private corporation, performs the functions of maintaining a secondary market by buying, selling and serving the FHA and VA guaranteed loans. It also provides liquidity to the mortgage market by buying mortgages when investment funds in the market are in short supply and selling mortgages when ample funds are available in the market. Another agency — Government National Mortgage Association — performs the management and liquidation functions of FHA and VA mortgages. In addition, it guarantees the timely payment of principal and interest on securities backed by FHA and VA mortgages. This increases the attractiveness of mortgage paper to investors by eliminating the cumbersome and time-consuming procedure involved in mortgage investment.

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22. The above discussion of the U.S. housing finance system shows the following main characteristics of the institutional aspects of the system : (*a*) highly successful specialised local institutions which combine the function of mobilising savings with making housing loans; (*b*) an elaborate system to supervise the lending institutions and providing help to them as and when they need it ; (*c*) Government agencies which encourage mortgage lending through insuring deposits with SLAs and guaranteeing mortgage loans of the lending institutions ; and (*d*) active efforts made by the Government to create a secondary mortgage market and making mortgages an attractive instrument for investors.

23. It will be seen that both in the American and the British systems of housing finance there is a close relationship between savings and lending for housing construction. This is a feature which is common to the housing finance institutions of many other countries too. In France, for instance, a scheme was introduced in 1965, under which, if a person opens a housing

* *Ibid*, p. 79.

savings account, he can get a loan at 3.5 per cent to 4 per cent following a period of savings of at least 18 months. In 1969, housing saving plans were introduced under which savers may obtain a loan at 5.5 per cent following four years' savings. The State pays a saving bonus equal to the interest accrued during the savings phase. In Japan the borrower is required to deposit a certain sum for a certain period in the form of time deposits ; at the end of the deferment period he can obtain a loan equal to 3 to 5 times of the deposit amount. The deferment period is 1 to 5 years. In Sweden, in order to enable persons of limited means to acquire houses of their own, the savings banks have started an extensive movement to stimulate savings for housing. The system with so-called savings points, provides opportunities for owning either a house or a co-operative flat. A depositor gets savings points according to his savings. When the savings banks offer a construction credit to the builder, they lay down a condition that all or most of the houses or flats should be offered to their savers, primarily to those who have the largest 'savings points'. While the saver is under no obligation to complete his savings, he nevertheless knows that a regular fulfilment of the plan from his side gives him the possibility to get a new home in due course and also puts his savings bank under the obligation to assist him with final borrowing when his project is realised. In Turkey, a person who wants to get a housing loan from the Government Enlak Credit Bank has to maintain a stated minimum deposit for a specified period. Thereafter he gets a loan equal to 65 per cent of the value of the property mortgaged, subject to a maximum amount. It has been found that in many countries (*e.g.*, Peru, Chile) dramatic results have been achieved, particularly when the saving has been in connection with the prospect of purchasing a home or in repaying a loan that was extended for this purpose.*

सत्यमेव जयते

24. It is also interesting to observe how the available funds in the capital and the money markets have been harnessed for housing purposes in different countries. Significantly, housing finance schemes have succeeded especially in those countries which have a developed mortgage market. The experience of Denmark may be cited in this connection†. In Denmark, housing loans are given by more than one mortgagee on the security of the same property. A peculiar feature is that loans are given by Credit Associations not in the form of cash but in the form of bonds. When a property is mortgaged, the proper amount of loan is determined by the Credit Association. Thereafter, the borrower is given the option to choose one of the three interest rates. Corresponding to the interest rate the face value of the bond is indicated. The higher the interest rate the lower will be the face value of the bonds because on the mortgage market bonds with higher interest rates will command a higher market value. The mortgagor

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* U. N. O., *Finance for Housing and Community Facilities in Developing Countries, New York, 1968, page 39.*

† The material in this paragraph is based on V. V. Chari's Report on Housing Finance—submitted to the Government of India—1965, (unpublished).

having selected his interest rate and hence the bond, sells it in the mortgage market. The sale proceeds are approximately equal to the amount which the Credit Association estimates as a loan that may be given on the mortgage property.* The mortgagor can during the period of amortisation make a lump sum repayment of the loan in either of the two ways. He can buy in the market, bonds of the same series and carrying the same rate of interest as those which were issued to him and hand them over to the Association in repayment of the loan. Alternatively, he can repay the loan in cash which is used by the Association to buy bonds of the requisite amount from the market and cancel them. Thus, the Credit Associations do not have any capital apart from the reserve funds. There are also second and third mortgage institutions. They also work like Credit Associations with the difference that the total amount of loans given by the first and second mortgage institutions should not exceed a stated percentage of the value of the property mortgaged. The Government gives guarantee to the third mortgage institution which provides loans in excess of the loan given by the first two institutions. The problem of providing interim finance has been solved in Denmark by commercial banks guaranteeing temporary advances during the period of construction. On the basis of such guarantee, an Association gives bonds to the bank. The banks sell the bonds on behalf of the borrower and finance the construction by releasing funds from time to time on the basis of the progress of construction. Payment is made by the bank to the contractor. The main advantage of the bond system is that a person who has real estate which can be mortgaged, is able to get a loan at current mortgage market rates. He does not have to depend on the resources of any one institution.

25. The Danish example, among other things, shows a close co-ordination between the different financial institutions. Another example of coordination is provided by the Finnish system. The savings banks which are

* The following example illustrates the procedure :

Face value of bonds which the credit association offers	Corresponding rate of interest	Market value of the bonds with face value of 100 kr. which the borrower gets in the money market
Kr.		Kr.
113000	7%	75
120000	6%	70
130000	5%	65

The market value for all the three alternatives is much below the face value, because the interest rate offered is in each case much less than the ruling market rate. Whatever be the alternative chosen by the borrower, he will, by selling his bonds, get a sum approximately equal to 84,000 kr.

specialised housing finance institutions there, do not themselves sell or act as intermediaries in the sale of building property. But in most savings banks there is a representative of the firm Kiinteistovalitys Oy (Real Estate Company) who deals with these questions. The shareholders of the building firm Kiinteistovalitys Oy are the regional savings bank association. Thus a co-ordination between the activities of the savings banks and the builders is assured.

26. It is also worth noting that commercial banks have played an important role as housing finance institutions in many countries. In Australia, commercial banks give loans to building societies not purely from the point of view of investing their funds but from that of certain collateral advantages which accrue to them by giving such loans. This applies particularly to banks which frequently finance a housing society in a district where they are about to open a new branch. Commercial banks in Finland and Norway also play an important role in providing housing finance. In the U.S.A., residential mortgage loans accounted for 23.7 per cent of the total savings and time deposits of commercial banks in 1969.

27. The share of Government agencies in the financing of housing construction varies from country to country. In almost all countries, however, Governments have taken steps for providing cheap housing loans to low and middle income groups. Many States encourage housing through fiscal measures, by providing insurance facilities for deposits and for loans and generally encouraging the financing agencies to give more loans.