

## **History of Banking**

The History of Banking begins with the first prototype banks of merchants of the ancient world that made grain loans to farmers and traders carrying goods between cities; recorded as having occurred at about 2000 BC within the areas of Assyria and Babylonia. Later on, in ancient Greece and during the Roman Empire, lenders based in temples made loans and added two important innovations: the accepting of deposits and the changing of money. Archaeology from this period in ancient China and India, shows the existence also of money lending activity.

Banking, in the modern sense of the word, can be traced to medieval and early Renaissance Italy, to the rich cities in the north such as Florence, Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14th century Florence, establishing branches in many other parts of Europe.

The development of banking spread through Europe also and a number of important innovations took place in Amsterdam during the Dutch Republic in the 16th century and in London in the 17th century. During the 20th century, developments in telecommunications and computing resulting in major changes to the way banks operated and allowed them to dramatically increase in size and geographic spread. The Late-2000 financial crisis saw significant number of bank failures, including some of the world's largest banks, and much debate about bank regulation.

### **Earliest forms of banking**

The history of banking is closely related to the history of money but banking transactions probably predate the invention of money. Deposits initially consisted of grain and later other goods including cattle, agricultural implements, and eventually precious metals such as gold, in the form of easy-to-carry compressed plates.

In the times before the establishment of Christianity, the economic lives of the people circulated about the houses of the *familiaregala* and their priesthood, where security was afforded for storage and distribution principally of crops. Thus the buildings utilized primarily by this elite, the palaces and temples, became the location of the earliest of social exchange bearing some similarity to banking practices of contemporary culture, where-in the

safeguarding of the wealth of society was assured. Temples and palaces were the safest places to store also gold, as they were constantly attended and well built.

The original banks were "merchant banks" which were first invented in the middle ages by Italian grain merchants. As the Lombard merchants and bankers grew in stature based on the strength of the Lombard plains cereal crops, many displaced Jews fleeing Spanish persecution were attracted to the trade. They brought with them ancient practices from the Middle and Far East silk routes. Originally intended for the finance of long trading journeys, these methods were applied to finance the production and trading of grains.

The Jews could not hold land in Italy, so they entered the great trading piazzas and halls of Lombardy, alongside the local traders, and set up their benches to trade in crops. They had one great advantage over the locals. Christians were strictly forbidden the sin of usury, defined as lending at interest (Islam makes similar condemnations of usury). The Jewish newcomers, on the other hand, could lend to farmers against crops in the field, a high-risk loan at what would have been considered usurious rates by the Church; but the Jews were not subject to the Church's dictates. In this way they could secure the grain-sale rights against the eventual harvest. They then began to advance payment against the future delivery of grain shipped to distant ports. In both cases they made their profit from the present discount against the future price. This two-handed trade was time-consuming and soon there arose a class of merchants who were trading grain debt instead of grain.

The Jewish trader performed both financing (credit) and underwriting (insurance) functions. Financing took the form of a crop loan at the beginning of the growing season, which allowed a farmer to develop and manufacture (through seeding, growing, weeding, and harvesting) his annual crop. Underwriting in the form of a crop, or commodity, insurance guaranteed the delivery of the crop to its buyer, typically a merchant wholesaler. In addition, traders performed the merchant function by making arrangements to supply the buyer of the crop through alternative sources—grain stores or alternate markets, for instance—in the event of crop failure. He could also 'keep the farmer (or other commodity producer) in business during a drought or other crop failure, through the issuance of a crop (or commodity) insurance against the hazard of failure of his crop.

Merchant banking progressed from financing trade on one's own behalf to settling trades for others and then to holding deposits for settlement of "*billette*" or notes written by the people who were still brokering the actual grain. And so the merchant's "benches" (bank is derived

from the Italian for bench, banca, as in a counter) in the great grain markets became centers for holding money against a bill (*billette*, a note, a letter of formal exchange, later a bill of exchange and later still a cheque). These deposited funds were intended to be held for the settlement of grain trades, but 'often were used for the bench's own trades in the meantime. The term bankrupt is a corruption of the Italian *bancarotta*, or broken bench, which is what happened when someone lost his traders' deposits. Being "broke" has the same connotation.

By the end of the 16th century and during the 17th, the traditional banking functions of accepting deposits, moneylending, money changing, and transferring funds were combined with the issuance of bank debt that served as a substitute for gold and silver coins.

New banking practices promoted commercial and industrial growth by providing a safe and convenient means of payment and a money supply more responsive to commercial needs, as well as by "discounting" business debt. By the end of the 17th century, banking was also becoming important for the funding requirements of the relatively new and combative European states. This would lead on to government regulations and the first central banks. The success of the new banking techniques and practices in Amsterdam and also the thriving trade city of Antwerp help spread the concepts and ideas to London and helped the developments elsewhere in Europe.

### **1980s deregulation and globalisation**

Global banking and capital market services proliferated during the 1980s after deregulation of financial markets in a number of countries. The 1986 'Big Bang' in London allowing banks to access capital markets in new ways, which led to significant changes to the way banks operated and accessed capital. It also started a trend where retail banks started to acquire investment banks and stock brokers creating universal banks that offered a wide range of banking services. The trend also spread to the US after much of the Glass-Steagall Act was repealed in the 1980s, this saw US retail banks embark on big rounds of mergers and acquisitions and also engage in investment banking activities.

Financial services continued to grow through the 1980s and 1990s as a result of a great increase in demand from companies, governments, and financial institutions, but also because financial market conditions were buoyant and, on the whole, bullish. Interest rates in the United States declined from about 15% for two-year U.S. Treasury notes to about 5% during the 20-year period, and financial assets grew then at a rate approximately twice the rate of the world economy. This period saw a significant internationalization of financial markets. The

process of financial innovation advanced enormously in the first decade of the 21 century increasing the importance and profitability of nonbank finance. Such profitability priorly restricted to the non-banking industry, has prompted the Office of the Comptroller of the Currency (OCC) to encourage banks to explore other financial instruments, diversifying banks' business as well as improving banking economic health. Hence, as the distinct financial instruments are being explored and adopted by both the banking and non-banking industries, the distinction between different financial institutions is gradually vanishing.

The first decade of the 21<sup>st</sup> century also saw the culmination of the technical innovation in banking over the previous 30 years and saw a major shift away from traditional banking to internet.

### **The Evolution of Banking Services and its History in India**

Banking in India has a very hoary origin. The Vedic period has literature which records the giving of loans to others. Banking was synonymous with money lending. The *Manusmriti* speaks of deposits, pledges, loans and interest rate. Interest could be legally charged at between two and five per cent per month in order of class. The maximum amount of interest collectable on the principal was laid down by the State. Usury was not allowed. Payment of debt was made a pious obligation on the heir of a dead person. With the growth of trade and commerce, the trading community soon evolved a system of money transfer throughout the country.

Modern banking in India began with the rise to power of the British. The British consolidated their power and became the most powerful force in India after vanquishing Tipu Sultan in the battle of Srirangapattanam in 1799. The quest for power by Lord Mornington (Later Marquess of Wellesley). Governor General of Fort William in Bengal at that time led to a serious depletion of the resources of the East India Company, This led to the Company promoting the Bank of Calcutta in 1806 to raise resources. The situation prevailing at that time could be known by the writing of some Britishers, C.N. Cooke, Deputy Secretary and Treasurer of the Bank of Bengal, writing in his book "Banking in India", has stated that usury prevailed in India more than in any other country in the nineteenth century. The native money lender lent to the farmers at 40, 50 and 60 per cent interest. The European community was relatively better off. He attributed the very high rates to the riskiness of many of the lending

and the difficulties in realising them. Indian businessmen very often acted as lender to the European businessmen with a rate of interest lower than the market rate.

Till the advent of the three Presidency Banks, the European Agency Houses acted as bankers. They accepted deposits [from British Officers serving in India and Europeans who had served in India and had returned to Europe. They financed trade with such funds and at certain times even helped the Government. There was a very effective credit network for flow of funds from one part of India to the other provided by the Indian banking firms.

As the Agency Houses had prospered they also sought to operate Banks. Alexander & Company a leading Agency House started managing the Bank of Hindustan from 1770's. The exact date of the founding of that bank is not known. The Bengal Bank and the General Bank of India, too, were started by the other Agency Houses in Bengal in the eighteenth century. In 1819 the Commercial Bank and in 1824 the Calcutta Bank were floated by the Agency Houses. None of these banks enjoyed limited liability nor were they proper joint stock banks. They were partnership firms with unlimited liability. The concept of limited liability was not put on the statute books till the 1860 Companies Act. Till that date Banks had to either obtain a special Charter from the Crown to operate or had to operate under unlimited liability.

The Bank of Calcutta started in 1806 was the precursor of the Bank of Bengal. In 1862 the right of note issue was taken away from the Presidency Banks. The Government also withdrew their nominees as Directors on their Board. However, they were given the privilege of managing the Government treasury at the Presidency Towns and at their branches.

The Bank of Bombay collapsed in 1867 and was put into voluntary liquidation in early 1868. It was finally wound up in 1872, but the bank was able to meet its liability in full to the general public.

Subsequently a new bank, aptly called the New Bank of Bombay, was started in 1867 to commence banking operations. The Presidency Banks Act of 1876 was passed in order to have a common law for all the three Banks in order to enable the government to regulate the working of these Banks. The Government had earlier withdrawn its shareholding from these three banks.

The Swadeshi Movement which prompted Indians to start many new institutions also provided an impetus for starting new banks. The number of joint stock banks increased remarkably during the boom of 1906-13. The People's Bank of India Ltd., The Bank of India,

The Central Bank of India, Indian Bank Ltd. and the Bank of Baroda were started during this period. This boom continued till it was overtaken by the crash of 1913-17, the first crisis that the Indian joint stock banks experienced.

In 1921 the three Presidency Banks at Calcutta, Bombay and Madras were merged into the Imperial Bank by the passing of the Imperial Bank of India Act 1920. This bank did not have the power of issuing bank notes, but was permitted to manage the clearing house and hold government balances. With the passing of the Reserve Bank of India Act of 1934, the Reserve Bank of India came into being to act as the Central Bank. It acquired the right to issue notes and acted as the banker to the Government in place of the Imperial Bank. However, the Imperial Bank was given the right to act as the agent of the Reserve Bank of India in places where the Reserve Bank had no branches.

By the passing of the State Bank of India Act 1955, the Imperial Bank was taken over and the assets vested in a new bank, the State Bank of India. The Reserve Bank was originally a shareholder's bank. It was nationalised by the Reserve Bank Amendment Act 1948, consequent to the nationalisation of the Bank of England in 1946.

### **Bank Nationalisation**

The major historical event in the history of banking in India after independence is undoubtedly the nationalisation of 14 major banks on 19th July 1969: The imposition of social control on the banks in early 1969 was deemed unsuccessful as the government felt that the Indian commercial banks did not increase their lending to the priority sectors like agriculture, small scale industry etc., Nationalisation was deemed as a major step in achieving the socialistic pattern of society. The nationalised banks were to increase lending to areas of importance to the government and to use their resources for subserving the common good. A detailed scheme of objectives, regulations, management, etc. was drawn up for these banks.

In 1980 six more private sector banks were nationalised extending the public domain further over the banking sector.

Nationalisation was a recognition of the potential of the bank system to promote broader economic objectives. The banks had to reach out and expand their network so that the concept of mass banking was given importance over class banking. Development of credit in the rural area was a prime objective.

The benefits of nationalisation has indeed been impressive. The branch network of these banks have spread practically all over 'the country especially in the rural and previously unbanked areas. The branch network which was 8262 in June 1969 expanded to over 60000 by 1992 with a major expansion (80%) in rural areas. The average number of people served by a branch came down from over 60000 to 11000. The deployment of credit is more widely spread all over the country as against only in the advanced states. In 1969 deposits amounted to 30% of G.D.P and advances to 10%. By 1990 deposits grew to 30% and advances 25% of G.D.P. Rural deposits as a percentage of deposits grew from 3% to 15% making for increased mobilisation of resources from the rural areas. Deposits grew from a figure of Rs 4669 crores in July 1969 to Rs. 2,75,000crores on 31.3.1993. 40% of the total credit was directed to the priority sector. More than 45% of the total deposits was used by the government to fund its five year plans.

However, this growth did not come without its costs. The banking system has grown too large and unmanageable Customer service has suffered due to increasing costs and low productivity. The directed credit program has led to large overdues affecting the very viability of the banking system.

### **Various Types of Banking Services**

The flow chart given below shows the following types of banking services.

1. Central Banking Services
2. Commercial Banking Services
3. Specialized Banking Services
4. Non-banking financial services;

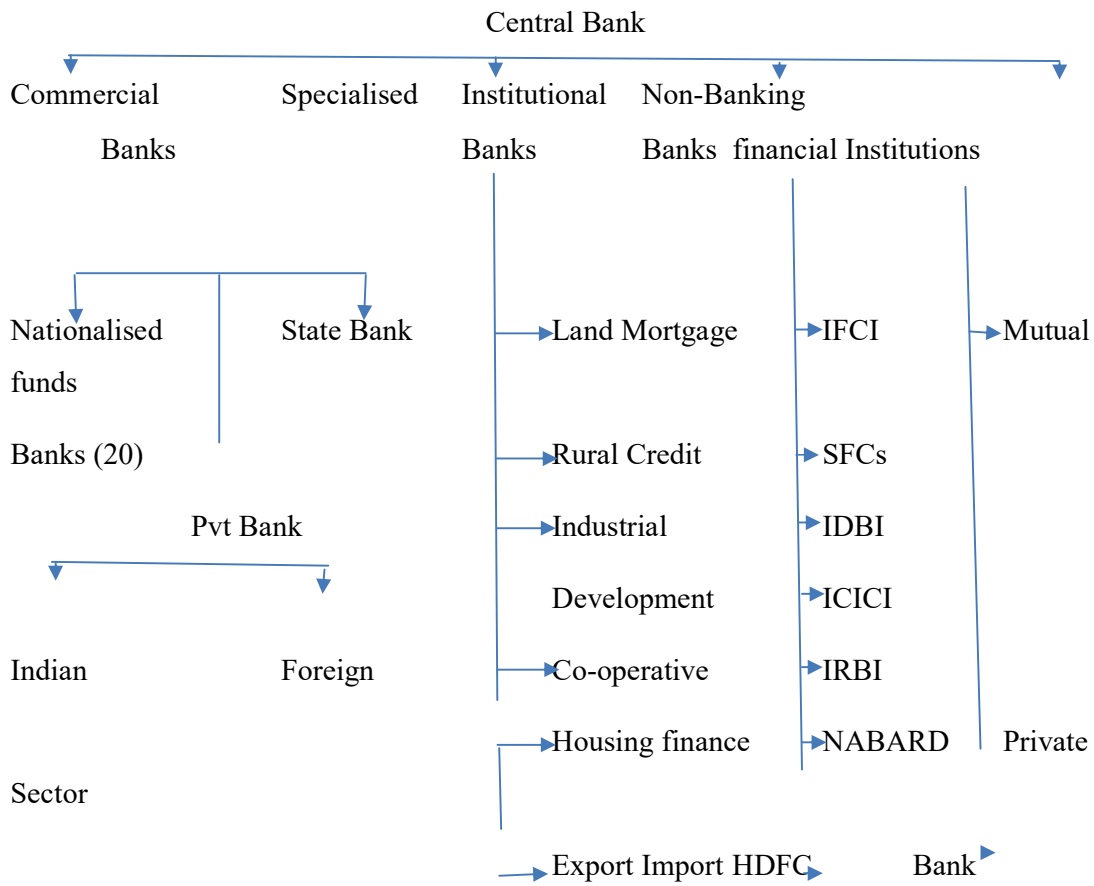
**1. Central Banking Services :** The Central Bank of any country (i) issues currency & bank notes; (ii) discharges the treasury functions of the Government, (iii) manages the money affairs of the nation & regulates the internal and external value of money, (iv) acts as the bank of the Government and last but not the least, acts as the bankers' bank.

**2. Commercial banking services:** Commercial banking services include (i) receiving various types of deposits; (ii) giving various types of loans, (iii) extending some non-banking customer services like facilities of locker, rendering services in paying directly house rent, electricity bill, share-calls. money or insurance premium and the like. Commercial bank also advises on investment re-investment, allotment or transfer of funds.

**3. Specialized banking services:** Special banking institutions are established for definite specialized banking services like industrial banks to supply industrial long term credit and working capital; land mortgage bank for granting loans on equitable mortgage; Rural Credit Banks for generating funds for extending rural credit; developmental banks to support any developmental activities. These types of banks accept all types of deposits but mobilises the amount in its specially focused area.

**4. Non-Banking Financial Services:** Many institutions are established for carrying on non-banking financial services. Mutual funds are institutions accepting finances from its members and investing in long term capital of companies both directly in the primary market as well as indirectly in the capital market. financial institutions acting as portfolio managers receive funds for the public and managing the funds for or on behalf of its depositors. This portfolio managers undertake the responsibility of managing the funds of the principal so as to generate maximum return.

### Various Types of Banks and Banking Functions



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1. RESERVE BANK OF INDIA ACT,1934
2. BANKING REGULATION ACT, 1949