

## “ HISTORICAL DEVELOPMENT OF BANKING “

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### Abstract:

In order to understand the various dimensions of banker customer relationship first we have to study the origin and evolution of banking, after which we can understand the changing dimension as per the change in time and situation. The evolution of banking has its deep roots in the barter system prevailed in olden days. The defect and drawback in the barter system made necessity of invention of money, there are two theories regarding invention of money, i.e. Theory of Invention and Theory of Spontaneous Growth.

Key-words: Bank, Money, Banking Law

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### Introduction:

A **bank** is a financial institution that accepts deposits and channels those deposits into lending activities. Banks primarily provide financial services to customers while enriching investors. Government restrictions on financial activities by banks vary over time and location. Banks are important players in financial markets and offer services such as investment funds and loans.

There is difference of opinion in this regard. According to some authorities the word 'Bank' itself is derived from the word "bancus" or "banque" that is bench<sup>2</sup>. The early bankers, the Jews in Lombardy, transacted their business on benches in the market place. When a banker failed, his "banco" was broken up by the people, hence the word "bankrupt". This etymology is, however, reticulated by Macleod on the ground that "The Italian money changers as such were never called Banchieri in the Middle Ages".

There are others, who are of the opinion that the word "bank" is originally derived from the German word "back" meaning a joint-stock fund which was Italianized into "banco", when the Germans were masters of a great part of Italy. This appears to be more possible. But "whatever is the origin of the word 'bank'". As Prof. Ramchandra Rao says<sup>3</sup>, "It would tress the history of banking in Europe from the middle ages".

The origin of the word bank lies in the city of Italy, where the Lombard Jews were used to keep benches in the market place to transact the business. The Italian word 'banco' which means a bench. Such banco arrangements were used to be made for smooth exchange of money and other bills of business. From those banco arrangements, people used to call them as the banco personnel or the banco area or some specific banco. Gradually, with the mix up of the population and spreading the banco styled business, same banco word started giving rise to bank. Later on, when the financial organization started to function with the similar objectives, people gave them the name banco and then the bank. Though, majority of the bankers believe the above theory of development for the bank word.

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<sup>2</sup> Byashyam & Adiga, Negotiable Instrument Act, Delhi: Bharat Law House Pvt. Ltd., 1<sup>st</sup> Edition, 1990

<sup>3</sup> Present-day Banking in India. 1<sup>st</sup> edition, p. 88

But few also say that the bank word has its origin in the French word beque; incidentally, it also means a bench. This is not the end. Another group was there who advocates German word as the ancestor of today's English word bank. In German, bank means a heap of anything or joint stock fund. English bank is also nothing but a junk place of all unnecessary papers, which actually could have gone to somebody's pocket say mine.

### **Historical Development:**

The first banks were probably the religious temples of the ancient world, and were probably established sometime during the third millennium B.C. Banks probably predated 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. Temples and palaces were the safest places to store gold as they were constantly attended and well built.<sup>4</sup> As sacred places, temples presented as extra deterrent to would be thieves. There are extant records of loans from 18<sup>th</sup> century BC in Babylon that were made by temple priests and monks to merchants.

Ancient Greece holds further evidence of banking. Greek temples, as well as private and civic entities, conducted financial transactions such as loans, deposits, currency exchange, and validation of coinage. There is evidence too of credit, where by in return for a payment from a client who could 'cash' the note in another city, saving the client the danger of carting coinage with him on his journey. Pythius, who operated as a merchant banker throughout Asia Minor at the beginning of the 5<sup>th</sup> century BC, is the first individual banker of whom we have records. Many of early bankers in Greek city states were 'metic' or foreign residents. Around 371 BC, Pasion, a slave, became the wealthiest and most famous Greek banker, gaining his freedom and Athenian citizenship in the process. The fourth century BC saw increased use of credit based banking in the Mediterranean world. In Egypt, from early times, grain had been used as a form of money in addition to precious metals, and state granaries functioned as banks. When Egypt fell under the rule of a Greek dynasty, the numerous scattered government granaries were transformed into a network of grain banks, centralized in Alexandria where the main accounts from all the state granary banks were recorded. This banking network functioned as a trade credit

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<sup>4</sup> M.L. Tannan, Banking Law and Practice in India, 21<sup>st</sup> edn., 2006, Wadhwa Nagpur

system in which payments were affected by transfer from one account to another without money passing.<sup>5</sup>

### **MEANING OF BANKING LAW**

The law of Contract, the law of Torts and other branches of commercial and civil law are applicable to banks as to others. It may be stated that Indian Banking Law is passed to a very large extent though not entirely upon the English Banking Law, it is therefore necessary to pass in review the main land marks of the history of banking legislation in England.<sup>6</sup>

### **EARLY MEDIUM OF EXCHANGE**

During the primitive ages, the system of barter was prevailed among the inhabitant of different region. The term barter means a trade by exchange of goods and services without the money. For the purpose of bartering, certain commodities in due course came to be widely used by the people. They became the slandered of measure, by which other commodities where compared in bartering. The dependence on barter system did not last long. People begin to realize that the available mediums of exchange were not only perishable but also lacked uniformity and storage capacity.<sup>7</sup> They found barter system to inconvenient and disadvantages.

### **INVENTION OF MONEY**

There are two views which explain how the invention of money had taken place.<sup>8</sup> One is Theory of Invention and other is Theory of Spontaneous growth. Theory of Invention says that due to the inherent drawbacks of the barter system, people begin to search for variable alternative to replace commodities use. This exploration led to the discovery of metal. It was a good substitute to be used as a medium of exchange. Another theory, theory of Spontaneous growth is

<sup>5</sup> Dr. B.R.Sharma & Dr. R.P. Nainta, Banking Law and Negotiable Instruments ct, 3<sup>rd</sup> edn. 2006, Allahabad Law Agency

<sup>6</sup> M L Tannan, Banking Law and Practice in India, 21<sup>st</sup> edn., 2007

<sup>7</sup> Agibalova and Donskoy, History of Middle Ages, Progress Publishers, 1988

<sup>8</sup> Garg K.N. on Money, Banking, Trade and Finance, 1<sup>st</sup> Edition 1974 Allahabad Publication

based on the spontaneous or voluntary aspect of invention. According to this theory, money was invented without there being a deliberate search for the same. It was discovered by chance, without being sought for. Once metal was discovered, its necessity and requirement as money made it indispensable.

### **BANKING LAW IN BRITISH ERA**

The first recognizable bank developed in the medieval Italy. The term bank deriving from the merchant market place bench which in Italian was called a 'banco'. The best known examples of the medieval bank were the Medici bank, which was established by powerful and wealthy Medici family of Florence in 1397. It had branches and representatives throughout Europe. Many Italian merchants from Lombardy came to London at these times to set up in business as money lenders and the banking centre of the city London, where they settled is still known as Lombard Street.

Later, the centre of European economical and financial powers shifted north ward from Italy to Amsterdam, London, and Paris. Even so in 1601, when Queen Elizabeth-I died, there were still no formal banks in Britain. During the second half of the seventeenth century, however banking did begin to develop in London, a city that was not only the capital of England, but also a very important centre for trade.

#### **(a) Bank of England**

In 1694 the first great British Bank, the Bank of England, was established in London by royal charter, primarily to raise money for the conduct of the French wars. The new bank lent the government £ 1,200,000 and quickly became not only the Government bank, but was also the banker's banker, used by private banks for the safe keeping of surplus funds. In 1708 the terms of renewal of the charter stated that it should remain the only bank in England allowed to have more than six partners, this prevented the formation of joint stock banks in England for over a century.<sup>9</sup>

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<sup>9</sup> A.I.G. Prince v. Emperor

**(b) Victorian Period**

During the Victorian period the banks flourished. The growth of industry and commerce and social improvement led to an increased need for the services of banks from businesses and the wealthy manufacturing, merchant and professional classes. Banks at this time looked after people money by keeping it in a safe place or investing it, made loans and processed service they charged interest or fees. Joint stock banks flourished and the number of private banks declined.

Increasingly the bank of England became 'Central Bank', largely serving the government. Its note issue was made legal tender from 1833 and 1844 (1845 in Scotland) it was decreed that no new bank, nor any bank that was taken over by another, had the right to issue bank notes. This gradually led to the disappearance of banks of issue in England by 1921, although the right has been preserved by the main Scottish banks to this day.

Improved communication also allowed the development of larger banks during the Victorian period with lots of branch offices. Initially these banks were regional, based in a particular town or country, but by 1900 a few large banks with branches throughout the country and principal offices in London and Edinburgh had begun to develop, creating the basis of today's banking system. The term 'clearing bank' came into use to describe those banks that settled payments to each other through the London Clearing House.

In the early nineteenth century only wealthy people had bank accounts, but by the turn of the century even the working classes were using special local saving banks to look after their money. Many Victorian bankers were wealthy and respected and, like leading Victorian industrialists, became important people in the towns where they lived.

**(c) Twentieth century**

In many ways the British banking industry has changed more in recent decades than ever before, due to the introduction of new products and services, the growing importance of a small number of leading banks, rapid advances in technology and the development of a national and, more recently, a global marketplace. In 1900 there were around 250 private and joint stock banks in Britain and London was undoubtedly the world's largest and busiest banking centre. The business of banking was, however, fairly limited in scope. Only the wealthy had bank accounts

with the big banks and services were restricted to providing loans, current and deposit accounts, and safe storage for valuables. All banking transactions were carried out in person or by correspondence.

The First World War, however, brought rapid change as the banks were drawn into funding the government and the enlistment of bank staff meant that women had to be employed for the first time. Overall the volume of banking business grew during the war and afterwards many banks merged.

During the 1920 the banks, affected by nationwide economic depressions, launched 'home safe' savings accounts. This was the first attempt by banks to attract small savers who had previously used saving banks and building societies thousand of new customers opened bank accounts for the first time. In addition, a number of banks began to offer such new services as changing foreign currency, and trustee and executor facilities. Handwritten passbooks were replaced by typed account statements, contributing to a huge increase the number of women employed in the industry. Change continued during second world's war, which again brought staff shortages and war time controls.

In the last fifteen years banks have changed more quickly than ever before has new financial products have been offered based on use of the latest computers and communication technology allowing transactions to be handled electronically on a national and international and online internet banking have been introduced.

### **HISTORY AND EVOLUTION OF BANKING IN INDIA**

Banking was in exercise in India during Vedic times from 2000 BC to 1400 BC. Loans and usury were well understood in those days. Money lending was regarded as an old art. Rishis, not hermits occasionally lamented their state of indebtedness.<sup>10</sup> Money lending was practiced in the early Aryan days. During those days, money lending was considered as one of the four honest callings, the other three being 'tillage, trading and harvesting.' 'Rina' (debt) is often mentioned from the 'Rig Veda' onwards reflecting a normal condition prevalent in the Vedic

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<sup>10</sup> H.R. Suneja, Practice & Law of Banking, (Mittal Publication, New Delhi. 1<sup>st</sup> edn. 1990

society. To pay off debt was called 'Rnam Sam-m.' allusion are also made to debts contracted without intention of payment.<sup>11</sup>

The transition from money-lending to banking must have occurred before Manu. He says, "a sensible man should deposit his money with a person of good family, of good conduct, well-acquainted with the law, veracious having many relatives, wealthy and honorable (Arya)."<sup>12</sup>

Manu has also give rules which governed the policy of loans and rates of interest. Dr. Parmath Nath Banarjee, in his book Public Administration in Ancient India quotes from Gautama, Brihaspati and Budhayana, verses regarding the regulation of interest. Even the Kautilya in his Arthasastra also made reference to the same.

Banking in those days must have meant money lending financing kings and their wars, though certain rudiments of modern banking were not known to then bankers.

(a) **Development of Banking system in India**

Banking in India originated in the last decades of the 18th century. The oldest bank in existence in India is the [State Bank of India](#), a government-owned bank that traces its origins back to June 1806 and that is the largest commercial bank in the country. Central banking is the responsibility of the [Reserve Bank of India](#), which in 1935 formally took over these responsibilities from the then Imperial Bank of India, relegating it to commercial banking functions. After India's independence in 1947, the Reserve Bank was nationalized and given broader powers. In 1969 the government nationalized the 14 largest commercial banks; the government nationalized the six next largest in 1980.

Currently, India has 96 scheduled commercial banks (SCBs) - 27 public sector banks (that is with the [Government of India](#) holding a stake), 31 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 38 foreign banks. They have a combined network of over 53,000 branches and 17,000 [ATMs](#). According to a report by ICRA Limited, a rating agency, the public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively.

<sup>11</sup> Dr. S.R. Myneni, Law of Banking, (published by S.P. Gogia., Hyderabad. 1<sup>st</sup> edn. 2006, p. 5)

<sup>12</sup> Civilization in Ancient India by R.C. Dutt, vol. I, p. 30



(b) **Early history**

The first banks were The General Bank of India which started in 1786, and the Bank of Hindustan, both of which are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the [Bank of Bengal](#). This was one of the three presidency banks, the other two being the [Bank of Bombay](#) and the [Bank of Madras](#), all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the [Imperial Bank of India](#), which, upon India's independence, became the State Bank of India.

Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49. The [Allahabad Bank](#), established in 1865 and still functioning today, is the oldest Joint Stock bank in India. It was not the first though. That honor belongs to the Bank of Upper India, which was established in 1863, and which survived until 1913, when it failed, with some of its assets and liabilities being transferred to the [Alliance Bank of Simla](#).

When the [American Civil War](#) stopped the supply of cotton to [Lancashire](#) from the [Confederate States](#), promoters opened banks to finance trading in Indian cotton. With large exposure to speculative ventures, most of the banks opened in India during that period failed. The depositors lost money and lost interest in keeping deposits with banks. Subsequently, banking in India remained the exclusive domain of Europeans for next several decades until the beginning of the 20th century.

Foreign banks too started to arrive, particularly in [Calcutta](#), in the 1860s. The [Comptoire d'Escompte de Paris](#) opened a branch in Calcutta in 1860, and another in [Bombay](#) in 1862; branches in [Madras](#) and [Pondichery](#), then a French colony, followed. [HSBC](#) established itself in [Bengal](#) in 1869. Calcutta was the most active trading port in India, mainly due to the trade of the [British Empire](#), and so became a banking center.

The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in [Faizabad](#). It failed in 1958. The next was the [Punjab National Bank](#), established in [Lahore](#) in 1895, which has survived to the present and is now one of the largest banks in India.

Around the turn of the 20th Century, the Indian economy was passing through a relative period of stability. Around five decades had elapsed since the [Indian Mutiny](#), and the social, industrial and other infrastructure had improved. Indians had established small banks, most of which served particular ethnic and religious communities.

The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian [joint stock](#) banks. All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally under capitalized and lacked the experience and maturity to compete with the presidency and exchange banks. This segmentation let Lord Curzon to observe, "In respect of banking it seems we are behind the times. We are like some old fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbersome compartments."

The period between 1906 and 1911, saw the establishment of banks inspired by the [Swadeshi](#) movement. The Swadeshi movement inspired local businessmen and political figures to found banks of and for the Indian community. A number of banks established then have survived to the present such as [Bank of India](#), [Corporation Bank](#), [Indian Bank](#), [Bank of Baroda](#), [Canara Bank](#) and [Central Bank of India](#).

The fervour of Swadeshi movement lead to establishing of many private banks in [Dakshina Kannada](#) and [Udupi district](#) which were unified earlier and known by the name **South Canara** ( South Kanara ) district. Four nationalised banks started in this district and also a leading private sector bank. Hence undivided Dakshina Kannada district is known as "Cradle of Indian Banking".

## Conclusion

The period during the First World War (1914-1918) through the end of the Second World War (1939-1945), and two years thereafter until the independence of India were challenging for Indian banking. The years of the First World War were turbulent, and it took its toll with banks simply collapsing despite the Indian economy gaining indirect boost due to war-related economic activities. At least 94 banks in India failed between 1913 and 1918 as indicated in the following table:

Years	Number of banks that failed	Authorized (Rs. Lakhs)	Paid-up Capital (Rs. Lakhs)
1913	12	274	35
1914	42	710	109
1915	11	56	5
1916	13	231	4
1917	9	76	25
1918	7	209	1

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