NARASIMHAM COMMITTEE (1991) ON THE BANKING SYSTEM IN INDIA

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ABSTRACT

The Narasimham Committee (1991) was primarily interested in improving the financial health of public sector banks and development financial institutions (DFls). So as to make them viable and efficient and meet fully the emerging needs of the real economy. The basic approach of the Committee was the greater market orientation would strengthen the financial system and thus improve its effective its efficiency: "the solvency, health and efficiency of the institutions should be central to effective financial reform". The major recommendations of the Narasimham Committee finance institutions (DFls) and the money and capital markets.

Keywords – India, Narasimham Committee, Bank, Reforms, Economy

Since independence, a conscious effort was made for was made for planned economic development of the courtry in which the banking system was intended to play a very significant role. This has raised the expectation about the role of commercial banks much beyond the traditional deposit-lending function In 1955, the then Imperial Bank of India (SBI) with the main purpose of developing banking habits by opening branches in rural saving Subsequently, the Government of India, with effect from 19 July 1969 (by an ordinance issued on that date), nationalized 14 major commercial bank by the Government of India to acquire ownership in order to achieve the objective of social control over banks and to enable banks to play more effectively the role of catalytic agent for economic growth by extending banking facilities to un banked and under banked areas and regions of our country Encouraged by the development of the Government of India took another steps in 1980 to nationalize six more commercial banks. Shwan Cole. The Effect of Ownership of Banking, MIMEO, MIT, 2004. Rafael Lal Porta, Lopzde-Silanes Florencio, and Shleifer Andrei, Government Ownership of Banks, Journal of Finance 57:265-301 (2002). Atif Mian, Creditor Incentives and privatization, MIMEOm MIT, Reserve Bank of India, 2000, Directory of Commercial Bank offices in India, vol. 1, Mumbai (2000). The Bill nationalizing these banks was passed by the parliament as 'Banking Companies (Acquisition and Transfer of Undertaking as 'Banking companies (Acquisition and Transfer of Undertaking Act), 1970'. In 1980, six more commercial private sector banks (second round Nationalization) were nationalized. There were thus 19 banks in the public sector excluding SBI and its seven associate banks (formerly called 'subsidiaries'), exclusive of regional rural banks. These banks had 29,606 Indian branches as on 31 March 1991.

At the outset, the Narsimham Committee (1991) acknowledged the spectacular success of the public sector banks since their nationalization in July 1969.

(a) Massive branch expansion, particularly in rural areas;

(b) Expansion in the volume of deposits-bank deposits now constituted two-fifths of financial assets of the household sector in 1991.

(c) Rural penetration of the banking system-rural deposits as a proportion of total deposits had increased from 3 percent to 15 percent

(d) Diversion of an increasing portion of the bank credit to priority sectors, viz…, agriculture, small industry, transport, etc. the priority sector credit had gone up from 4 percent to 41 per between 1969 and 1991;

(e) Increase in deposit and borrowed accounts-over 300 million deposit accounts in the country and over 35 million browed accounts (there were barely 4,00,000nborrow account in 1969); and

(f) More involvement in the relatively under banked states-the expansion of priority sector lading and the emphasis on area approach as almost evened-out regional disparities and the concentration of banking business was relatively less in 1991.

While the banking system in Indian had thus recorded spectacular progress since nationalization, it had also suffered serious decline in productivity and efficiency and consequent erosion in profitability. Narasimham Committed (1991) pointed out that Government directed investment and Government directed programmers were the two major causes for this state of affairs.

COMMITTEE ON BANKING SECTORS REFORMS (1998)

The finance ministry of the government of India appointed Mr. Narsimham as chairman of one more Committee; this tie it was called the Committee on the Banking Sector Reforms. This Committee was asked to "review the progress of banking sector reforms to date and chat a programmer on financial sector reforms necessary to strengthen India's financial system and make it internationally competitive. " The Narsimham Committee on the Banking Sector Reforms submitted its report to the Government in April 1998. This report covers the entire gamut of issues, ranging from capital adequacy, bank mergers, the creation of global-size banks, recasting bank boards and revamping bank legislation. Important findings and recommendations of the Narasmham Committee (1998) are as follows:-

(i) **Need for a stronger banking system.** The Narasimham Committee on Banking Reforms (1998) has made out a strong case for a stronger banking system in the country, especially in the context of capital account convertibility (CAC) which would involve large inflows and outflows of capital and consequent complications for exchange rate management and domestic liquidity. To handle such problems.

The Committee has also supported that two or three large Indian banks be given international or global character.

(ii) **Experiment with the concept of narrow banking;** The Narasimham Committee (1998) was seriously concerned with the rehabilitation of week PSBS which have accumulated a high percentage of non-paying assets (NPAS), which, in some cases was as high as 20 percent of the total assets.

(iii) **Small, local banks.** The Narasimham Committee (1998) has argued: "While two or three banks with an international orientation and 8-10 large national bank should take care of the needs of the large and medium corporate sector and the larger of the smaller enterprises, there will still be a need for a large number of local banks, "The Committee as, therefore, suggested the setting up of small, local banks would be confined to States or cluster of districts in order to serve local trade, small industry and agriculture. At the same time, these banks should have strong corresponding relationship with the larger national and international bank.

(iv) **Capital Adequacy Ratio.** The Narasimham Committee (1998) has also suggested that Government should consider raising the prescribed capital adequacy ratio to improve. The inherent strength of banks and to improve their risk absorption capacity.

(v) **Public ownership and real autonomy.** The Narasimham Committee (1998) has argued that Government ownership and management of banks does not enhance autonomy and flexibility in the working of public sector bank.

(vi) **Review and update Banking Laws.** The Narasimham Committee (1998) has suggested the urgent need to review and amend the provisions of RBI Act. Banking Regulation Act, State Bank of India Act. Bank Nationalization Act, etc. so as to bring them in line with the current needs of the banking industry.

Other recommendations relate to the need for computerization process in PSBs. professionalizing and depoliticizing bank boards, review of recruitment procedures. training and remuneration policies etc.

Maintenance of adequate liquid assets is a basic principle of sound banking. Hence commercial banks in India were required by the Banking Regulation Act, 1949 (Under Section 24) to maintain liquid assets in the form of cash. gold and unencumbered approved securities. That is. Government securities and Government guaranteed securities-equal to not less than 25 percent of their total demand and time deposit liabilities.

(a) A higher SLR forced commercial banks to maintain a larger proportion of their funds in government securities and government guaranteed securities (of public sector financial institutes) and thus reduced that capacity of commercial banks to grant loans and advances to business and industry.

(b) A higher SLR diverted bank funds away from loans and advances to industry and trade to investment in Government securities (G-Sec); this was said to have an anti-inflationary effect.

The Narasimham Committee (1991) accepted the view, though indirectly, that the high SLR was a fraud perpetrated by the Finance Ministry of the Government of India on the captive banking system. By using Section 24 of the Banking Regulation Act, the Finance Ministry could manage to get a much as 38.5 percent of the aggregate deposits of banks for (a) financing its own expenditure and at the sme time, (b) pay a rate of interest lower than what the banks were paying to their depositors. The Finance Ministry could at least be justified if it used these funds for development purpose; But the Government was using bank funds even for paying salaries of Government employees in certain years.

Cash Reserve Ratio (CRR). Under the reserve Bank of India Act, 1934, every scheduled bank had to keep certain minimum cash reserves with the RBI-initially; it was 5 percent against demand deposits and 2 percent against time deposits. By an amendment of 1962, RBI was empowered to vary the cash reserve ratio between 3 percent to 15 percent of the total demand and time deposits Generally, CRR is changed only occasionally be Central Bank in other countries but this was not so in India. The CRR had been changed many times, as part of the overall strategy of demand management. By 1991, the CRR was raised to the statutory maximum of 15 percent on the average.

The Narasimham Committee (1991) found the rate of interest received by the scheduled banks from RBI for their eligible cash balances were below the rate which the scheduled banks had to pay their depositors for one year deposits. Likewise, the rate of interest the banks received on government securities was much lower than market rate. Thus the reserve requirements imposed on the scheduled banks were like taxes and had led to continuous loss in potential income of banks which in turn, had adversely affected their profitability.

A major objective of bank nationalization in July 1969 was to extend the reach of bank credit both geographically to UN banked regions and functionally to agriculture and other hitherto neglected sectors, designated as "priority sectors." In course of time, the Government added more categories of sectors like the export sector, food procurement operations etc. for the special attention of scheduled banks. Banks were asked to make a success of these directed credit programmes. They were also told to shift from security-oriented credit t purpose-oriented credit.

According to the Narasimham Committee (1991), the most serious damage to the public sector banks was the political and administrative interference in credit decision making. For instance, loan meals organized by Congress Party leaders in the 1970's and 1980's to direct bank credit to their supporters in rural and urban areas were contrary to the principle to sound banking. Commenting on the loan melas, the Narasimham Committee 1991 (stated). The intended socially oriented credit in the process. Degenerated into irresponsible lending". This was also the case in the distribution of IRDP loans among the poor and the economically weak in our rural areas. "In many cases of IRDP lending, banks have virtually abducted their responsibilities in undertaking need-based credit assessment and appraisal of potential viability and instead have tended to rely on lists of identified borrowers prepared by Government authorities." According Narasimham Committee (1991), as much as 20 percent of agricultural and small industrial credit, is of this "infected" or "contaminated" portfolio.

The committee emphasized that adequate and timely access to credit was far more important than its cost. The policy makers in his country had clearly ignored the facts that institutional finance was much cheaper than the alternative informal sector finance (from money lenders and indigenous bankers). According to the Narasimham Committee (1991), there was actually no need for interest subsidy which only reduced the ability of the banking system to build its strength and to extend the coverage of bank credit even wider. Besides, there was the question of basic morality or logic in forcing banks to make available their funds to Government at low rates of interest or for the finance Ministry of the Government of India to use bank funds for IRDP at concession rates of interest. The public who keep their hard-earned savings with banks for safe custody have a right to expect a decent rate of interest on then savings. The Finance Ministry has no moral right to use rather waste the funds of the public sector banks.

The Narasimham Committee 1991, mentioned the following points:

(i) Phenomenal increase in branch banking, without any relation to demonstrated need and potential viability,

(ii) The lines of command and control tended to weaken central office supervision, internal inspection and audit, and increased un reconciled inter-branch and inter-bank entries.

(iii) Rapid growth in staff in number and in accelerated promotions: this had led to deterioration in the quality of manpower, over-manning at all levels, etc.

(iv) Role of trade unions: they had contributed increasingly to the restrictive practices regarding promotions, transfers, discipline and work culture, mechanization and computerization, etc. Remunerations and their upward revisions were not related to productivity to either individual banks or to the system. Inefficient customer service and de customer service and declining labour productivity were the consequences.

(v) Extension of the coverage of bank credit to agriculture an industry where the unit cost of administering the loans was high, besides, this type of credit was at low rates of interest, as mentioned earlier.

Thus, despite impressive quantitative achievements in resource mobilization and in extending the credit reach, several distortions had, over the years, crept into the banking system. Several public sector banks had become weak financially and were unable to meet the challenges of a competitive environment. Recommendations of the Narasimham Committee, 1991.

REFORM OF THE BANKING SECTOR (1992-2005)

Despite stiff opposition from bank unions and political in the country. the Government of India accepted all the major recommendations of Narasimham Committee (1991) and started implementing them straight away:

(1) Statutory liquidity ratio (SLR): on incremental net demand and time liabilities (DTL) has been reduced from 38.5 per cent to 25 per cent and SLR on outstanding net domestic demand and time liabilities were reduced gradually from 38.5 per cent to 25 per cent in October 1997: this was the minimum stipulated under section 24 of Banking Regulation act, 1949.

(2) Cash Reserve Ratio (CRR): The incremental cash reserve ratio (ICRR) of 10 per cent was abolished. But RBI could not reduce CRR immediately. When conditions eased and money growth started slowing down since 1995-96, RBI reduced CRR gradually from 15 percent to 5.5 percent in December 2001. The purpose of reducing CRR was to release funds locked up with RBI for lending to the industrial and other sectors which were starved of bank credit.

(3) Interest rate slabs; were gradually reduced from 20 to 2 by 1994-95.The important changes in interest rates since 1991-92 are as follows:

(a) Interest rate on domestic term deposits has been decontrolled:

(b) The prime lending rate of SBI and most other banks on general advances of over Rs 2 lakhs has been reduced.

(c) Rate of interest on bank loans above Rs. 2 lakh has been fully decontrolled.

(d) The interest rates on deposits and on advance of all co-operative banks (except urban co-operative banks) have been deregulated.

(4) Prudential norms: have been started by RBI as part of the reformative process. The purpose of prudential system of recognition of income, classification of assets and provisioning of bad debts is to ensure that the books of the commercial banks reflect their financial position more accurately and in accordance with internationally accepted accounting practices. These help in more effective supervision of banks.

(5) Capital adequacy norms: were fixed at 8 percent by RBI in SApril 1992 and banks had to comply with them over a three year period.

A new capital frame work was introduced for Indian scheduled commercial banks based on the Basle Committee recommendations presenting two tiers of capital for the bank:

(a) Tier 1 or core capital, considered the most permanent and readily available support against unexpected losses. Includes paid-up capital, statutory reserves, share premium and capital reserve: and

(b) Tier II capital consisting of undisclosed reserves fully paid-up cumulative perpetual preference shares revaluation reserves, general provisions and loss reserves etc.

The working Group under Mr. S. Padmanabhan, set up to review the system of on-site supervision of banks, has recommended extensive changes in bank inspection which include target appraisal of major portfolios and control systems and a discriminatory approach to supervision and inspection that distinguishes sound banks from problem banks.

(II) Recovery of debts. The Government of India passed "Recovery of Debts due to banks and Financial institutions Act, 1993" in order to facility and speed up the recovery of debts due to banks and financial institutions. Six Special Recovery Tribunals have been set up at Calcutta, New Delhi, Jaipur, Ahmedabad, Bangalore and Chennai to facilitate quicker recoveries of loan arrears within six months) and an Appellate Tribunal has also been set up in Mumbai.

EVALUATION OF NARASHIMHAM REPORT (1998)

Really speaking, there was no purpose in setting up the second Narasimham Committee on Banking Sector Reforms even before a decade had elapsed for the full implementation of the First Committee (submitted in 1991). Commented. As one ccitic "Barring, that is a stray recommendation here of there like the categorical rejection of the merger of weak with strong banks and the suggestion to try out narrow banking, as far as al other issues are concerned, whether it is organization, restructuring, freeing bank boards from day-to day management and interference or segregating the regulatory and supervisory role of the Reserve Bank of India (RBI), it is like watching an action reply of the earlier report." We can attempt a comparison of some of the major recommendations of the 1991 and 1998 reports of the Committees presided over by Mr. Narasimham.

In simple terms, the setting of the Narasimham Committee of Banking Sector Reforms was clearly, the brainwave of the officials of the Banking Division of the Finance Ministry who have actually no real work to do. It is worth noting here that two members of the Narasimham Committee (1991) clearly recommended the closing down of the Banking Division of the Finance Ministry as redundant and unnecessary and that all matters pertaining to the banking system should be the responsibility of only one authority viz., RBI. Obviously, this recommendation was not accepted by the Finance Ministry.

There was an upward swing in the stock market, from 1988-89 spearheaded by excellent performance by market leaders, industry-friendly policies by successive governments, such as liberalization of licensing procedures liberal fiscal measures, liberal and positive export-import policy, greater scope for the private sector etc. The upward trend displayed by the market in the previous in the previous three was given a big boost by Dr. Manmohan Singh's 1991-92 budget with a series of market friendly policies, RBI's all India index number of army share prices (1981-82-100) rose from 189 at the end or March 1988 to 528 at the end of March 1991 and crossed 1.000at the beginning of February 1992.

Jankiraman Committee in its Final Report went into the environment in which these irregularities took place. According to the Committee, there were three factors:

(a) Public Sector Undertaking (PSUs), flushed with funds, were looking for profitable avenue of investment;

(b) banks, burdened with CRR and SLR commitments on the one side and social commitment of priority lending on the other, were faced with the problem of low interest income and possible loses and were looking for opportunities for making quick profits; and

(c) The stock exchange exchange was booming during this period and the bulls desperately needed funds to finance their over-bought positions.

Banks who had accepted funds from PSUs saw that the only way they could earn high returns was to fiancé stock brokers in booming marks.

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