BANKING SECTOR REFORMS: NARASIMHAM COMMITTEE 1 AND 11: AN ANALYSIS

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ABSTRACT

The banking sector in India is dominated by public sector banks, which account for almost 70% of the market. Banking is one of India's fastest-growing industries. The Narasimham-II Committee was entrusted with reviewing the progress made in implementing banking reforms since 1992 in order to improve India's financial institutions. It concentrated on topics such as bank size and capital adequacy ratio, NPAs and others. This paper aims at studying the recommendations made by Narasimham committee 1 and 11. Further an analysis was made to study the progress of banking sector and NPAs during different years and it was observed that there is a tremendous growth in banking but there is a much need to be done in near future to make it internationally comprtitive.

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Key words: NPAs, CAR, CFS, PSBs, OMO, ARF

The creation of the General Bank of India in 1786 marked the beginning of modern banking in India. The East India Company founded the first Presidency Bank in Kolkata in 1806. The Bank of Bombay and the Bank of Madras were founded in 1840 and 1843, respectively. The Reserve Bank of India (RBI) was established on April 1, 1935, when the Reserve Bank of India Act, 1934, was enacted. (Varughese, Georgi Mathew). The Reserve Bank was established to "control the issue of banknotes and the holding of reserves with a view to securing monetary stability in India," according to the preamble to the RBI Act. Post-Independence Banks were mostly urban-oriented and out of reach of the rural population even after independence. Moneylenders were still the go-to source of loans for a huge portion of the rural population. As a result, the government decided to nationalize all of India's major banks. The first Nationalization occurred in 1969, followed by the second in 1985. Since 1985, a succession of reform initiatives have been implemented, but the first phase of comprehensive banking reforms can be traced back to the Committee on the Financial System's 1991 Report, often known as the Narasimham Committee I and in 1998 known as Narasimham committee 2.

What are the goals of reforming the banking sector?

The fundamental purpose of banking sector reforms was

- To establish a more diverse, efficient, and competitive financial system.
- To increase resource allocative efficiency .
- To increase operational flexibility, financial viability, and institutional strengthening.
- To boost the Indian banking sector's overall performance
- To bring about a transition in the banking system's structure, efficiency, and stability.
- To integration with worldwide markets.
- To make Indian banks more competitive on a global scale.
- To bring India's banking system up to international standards in terms of capital adequacy and other regulatory requirements.

The major goal of India's financial sector reforms, which began in the early 1990s, was to establish an efficient, competitive, and stable financial industry that could then help to drive growth more effectively. Simultaneously, the monetary policy framework began a gradual transition away from direct monetary management instruments and toward a greater dependence on indirect measures. However, because effective price discovery of interest rates and exchange rates is required for proper monetary transmission in the overall functioning of financial markets, the establishment of the money market, government securities market, and foreign exchange market became necessary. As a result, reforms in diverse areas have to be coordinated. The Indian economy's expanding integration with the rest of the globe is also a part of this process. By the early 1990s, the Indian banking system had largely become government-owned; therefore banking sector reforms were essentially two-fold. First, the amount of competition within the banking sector was gradually enhanced while worldwide best practices in prudential regulation and supervision were introduced and customized to Indian conditions. Special emphasis was placed on strengthening Indian banks' risk management capabilities, as well as steps to ensure flexibility, operational autonomy, and competitiveness in the banking sector. Second, active measures to strengthen institutional arrangements, such as the legislative framework and technology system, have been taken. Because of the critical function of supervision in the formation of an efficient financial system, the supervisory system was overhauled.

FIRST PHASE OF REFORMS – THE NARASIMHAM COMMITTEE I

"The Committee on Financial System" (CFS) The Government of India created a High-Level Committee under the Chairmanship of M. Narasimham to rebuild the financial health of commercial banks and make their operating efficient and profitable. The committee issued its recommendation in November 1991, which served as the foundation for India's first-generation banking reforms. On August 14, 1991, to look at all aspects of the financial system's structure, organization, function, and processes; based on its recommendations, a complete banking reform was implemented in fiscal 1992–93. The CFS (Narasimham Committee I) made suggestions aimed at assuring

1. Operational flexibility;
2. Internal autonomy for public sector banks (PSBs) in decision-making.
3. A higher level of professionalism in banking operations.

The committee's objectives are listed below.

1. Make recommendations for improving and modernizing organizational systems and procedures, as well as managerial policies.

2. Make recommendations for infusing greater competitive viability into the system, allowing banks and financial institutions to respond more effectively to the economy's emerging credit needs.

3. Examine the cost, composition, and adequacy of the various financial institutions' capital structures, and make appropriate recommendations.

THE RECOMMENDATIONS OF THE COMMITTEE ARE:

1. **Improving Bank Financial Health:** The first and most important measure was to improve bank financial health. These policies attempted to reduce banks' vulnerability in the face of economic swings. The implementation of prudential regulations that were more or less in line with worldwide thought was one of them.
2. **Financial Statement Transparency:** The Committee was of the opinion that bank and financial institution balance sheets should be made transparent, with complete disclosures as required by the International Accounting Standards Committee. In 1992, the RBI changed the format of bank balance sheets to comply with this advice.
3. **Institutional Strengthening**: Because an institutional framework conducive to bank development must be built, one of the most essential aspects of banking sector reform was to enhance the banking system's institutional base. These included a number of steps such as allowing new private-sector banks to be licensed, allowing public-sector banks to go to the market to raise capital, and establishing Debt Recovery Tribunals to deal with loans owed to commercial banks.
4. **Asset Reconstruction Fund:** The Committee recommended creating an Asset Reconstruction Fund (ARF) to take over defective and dubious assets on banks' and DFIs' balance sheets at a discount, allowing the banks to recycle the capital gained through this process into new productive assets. Independent auditors will assess the rate of discount based on clearly defined rules.
5. **Direct Investment:** The RBI was recommended not to employ the CRR as a primary tool for monetary and credit control, and instead to depend more on open market operations (OMOs). Regarding the CRR, two recommendations were made: I the CRR should be gradually reduced from its current high level of 15% to 3 to 5%; and (ii) the RBI should pay interest on the CRR of banks above the basic minimum at a rate of interest equal to the banks' one-year deposit. In the next 5 years, it was recommended that the SLR be reduced to the bare minimum (i.e., 25%) from its current high of 38.5 percent (it was reduced to 25%).

6. **Directed Credit Program:** The ideas under this sub-heading focused around banks' compulsion of priority sector lending (PSL): I The scheme of directed credit should be phased out progressively. Agriculture and small scale industries (SSIs) had reached a mature stage, according to the committee, and did not require any particular assistance; two decades of interest subsidy was sufficient. As a result, concessional interest rates may be unnecessary. (ii)Directed credit should not be a regular programme; rather, it should be a one-time boost to specific poor areas, and it should be transitory rather than permanent. (iii)The concept of PSL should be modified to only include the most vulnerable members of the rural community, such as marginal farmers, rural craftsmen, village and cottage industries, and small businesses.
7. **Interest Rate Structure:** The following are the major recommendations for interest rate structure: (i)Interest rates to be broadly determined by market forces; (ii)All interest rate controls on deposits and lending to be withdrawn; (iii)Concessional rates of interest for PSL of small sizes to be phased out and IRDP loan subsidies to be withdrawn; (iv)Bank rate to be the anchor rate and all other interest rates to be closely linked to it; and (v)The RBI to be the central bank.
8. **Structural Reorganization of Banks:** Several key recommendations were made for bank structural reorganization: I Significant reduction in the number of PSBs through mergers and acquisitions—to improve banking efficiency; (ii)Dual control of the RBI and the Banking Division (of the Ministry of Finance) should be abolished immediately, and the RBI should be made the primary agency for banking system regulation; (iii)The PSBs should be made free and autonomous; (iv)The RBI should examine all guidelines and directions issued to the banking system in the context of the India
9. **Asset Reconstruction Fund:** Companies/Funds for Asset Reconstruction The committee proposed the establishment of asset rehabilitation companies/funds to combat the threat of rising non-performing assets (NPAs) among banks and financial institutions (taking clue from the US experience). The PSBs' sorry status was specifically blamed by the committee on the Government of India and the Ministry of Finance. The government of India, officials, bank staff, and trade unions all utilized and abused these banks, according to the report. The recommendations were innovative in many ways, and bank unions and leftist political groups rejected them.

IMPLEMENTATION OF REFORMS ON BANKING SECTOR:

The following reforms or important policy advances in the banking sector have been implemented, according to the Report on "Trend and Progress of Banking in India" (2002): I. The Reserve Bank of India (RBI) has liberalized the rules governing the issuance and price of shares by private sector banks. All private sector banks will be permitted to offer bonus and rights issues without the RBI's prior permission under the proposed rules. Furthermore, the bonus issue will no longer be related to the rights issue. II. Banks can provide smart cards to select clients with high financial standing (both online and offline) if they ensure that the "know your customer" idea is implemented. III. All scheduled commercial banks, with the exception of Regional Rural Banks (RRBs), have been advised to maintain their compliance with the regulations.

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- ✓ The opening of new private sector banks was permitted in 1993.
- ✓ Prudential norms relating to income recognition.
- ✓ Asset classification and provisioning by banks were established.
- ✓ The introduction of capital adequacy norms (i.e., CAR provisions).

(Board for financial supervision, 1994)

SECOND PHASE OF REFORMS – THE NARASIMHAM COMMITTEE II

Mr. Narsimhan was named chairman of a new committee by the government in 1998. The Banking Sector Committee is its official name. It was given the task of reviewing the success of banking reform and developing a plan to further enhance India's financial system. The committee looked into a variety of topics, including capital adequacy, bank mergers, and bank legislation. The goal was to assess how far banking reforms had progressed since 1992, with the goal of further strengthening India's financial institutions. The report concentrated on topics such as bank size and capital adequacy ratio.

MAIN RECOMMENDATIONS OF THE COMMITTEE ARE:

1. **Strengthening Indian Banks:** In the framework of the Current Account Convertibility 'CAC,' the committee evaluated a stronger banking sector in India. In view of CAC, it was felt that Indian banks must be capable of dealing with domestic liquidity and currency rate management issues. As a result, it advocated for the consolidation of powerful banks, which would have a "multiplier effect" on the industry.
2. **Capital Adequacy Ratio:** The committee suggested that the Government boost the statutory capital adequacy criteria in order to improve the inherent strength of the Indian banking system. This will also help to increase their absorption capacity. The capital adequacy ratio for Indian banks is now at 9%.
3. **Banking laws review:** The committee believed that it was critical to examine and revise key laws controlling the Indian banking industry, such as the RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalization Act, and others. This upgrade will bring them up to date with the current needs of India's banking sector.
4. **Narrow Banking:** At the time, several public sector banks were dealing with non-performing assets (NPAs) (NPAs). NPAs accounted for much to 20% of their assets in some cases. As a result, the 'Narrow Banking Concept' was advocated for the successful rehabilitation of these banks, in which weak institutions would be allowed to invest their cash exclusively in short-term, risk-free assets.
5. **Bank ownership:** As previously said, it believes that government influence over banks in the form of management and ownership and bank autonomy do not go hand in hand, and thus it recommends a review of boards' roles and enables them to embrace professional corporate governance practices.

By the early 1990s, the Indian banking system had largely become government-owned; therefore banking sector reforms were essentially two-fold. First, the amount of competition within the banking sector was gradually enhanced while worldwide best practices in prudential regulation and supervision were introduced and customized to Indian conditions. Special emphasis was placed on strengthening Indian banks' risk management capabilities, as well as steps to ensure flexibility, operational autonomy, and competitiveness in the banking sector. Second, active measures to strengthen institutional arrangements, such as the legislative framework and technology system, have been taken. Because of the critical function of supervision in the formation of an efficient financial system, the supervisory system was overhauled.

To improve the banking system's health, measures have included:

i. Restoring public sector banks' net worth through recapitalization where necessary.

ii. Streamlining the supervision process with a combination of on-site and off-site surveillance as well as external auditing.

iii. Introducing risk-based supervision.

iv. Introducing a structured and discretionary intervention process for problem banks through a prompt corrective action (PCA) mechanism.

ANALYSIS OF BANKING SECTOR REFORMS

In the post-reform period, banks saw robust balance sheet growth in an atmosphere of operational flexibility, according to a review of the banking sector. The financial health of banks has improved noticeably, as evidenced by large increases in capital adequacy and better asset quality. It's worth noting that these gains were made despite the implementation of worldwide best practises in prudential standards. Proactive technological development and flexible human resource management have also aided competitiveness and productivity increases. These large benefits were achieved while renewing our social banking aims, namely, maintaining the banking system's broad reach and allocating credit to essential but disadvantaged areas of society. A brief assessment of the banking sector's performance.

Progress of Banking Sector

The banking system's broad reach, as measured by branch expansion and loan and deposit growth, suggests sustained financial depth (Table 1). Since the 1980s, the population per bank branch has been stable at roughly 16,000 people.

Table 1: Progress of Commercial Banking in India							
		1969	**1980**	**1991**	**1995**	**2000**	**2005**
	1	2	3	4	5	6	9
1	No. of Commercial Banks	73	154	272	284	298	288
2	No. of Bank Offices	8,262	34,594	60,570	64,234	67,868	68,339
	Of which						
	Rural and semi-urban bank offices	5,172	23,227	46,550	46,602	47,693	47491
3	Population per Office ('000s)	64	16	14	15	15	16
4	Per capita Deposit (Rs.)	88	738	2,368	4,242	8,542	16,699
5	Per capita Credit (Rs.)	68	457	1,434	2,320	4,555	10,135
6	Priority Sector Advances@ (per cent)	15	37	39	34	35	40
7	Deposits (per cent of National Income)	16	36	48	48	54	65

Source: Reserve Bank of India

Despite the tightening of regulations, bank asset quality has improved significantly. In 2004, India switched from a 180-day to a 90-day NPL recognition period. Nonetheless, since the mid-1990s, non-performing loans (NPLs) as a percentage of total advances and assets have been steadily declining (Table 3). Improvements in the credit appraisal process, the upturn in the business cycle, new initiatives for NPL resolution (including the promulgation of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act), and increased provisioning and write-off of NPLs enabled by higher profitability have all contributed to a low level of incremental NPLs.

Table 2: Non-Performing Loans (NPL) of Scheduled Commercial Banks (Per cent)				
	Gross NPL/ advances	**Gross NPL/ Assets**	**Net NPL/ advances**	**Net NPL/ Assets**
1	2	3	4	5
1996-97	15.7	7	8.1	3.3
1997-98	14.4	6.4	7.3	3.0
1998-99	14.7	6.2	7.6	2.9
1999-00	12.7	5.5	6.8	2.7
2000-01	11.4	4.9	6.2	2.5
2001-02	10.4	4.6	5.5	2.3
2002-03	8.8	4	4.4	1.9
2003-04	7.2	3.3	2.9	1.2
2004-05	5.2	2.6	2	0.9
Source Reserve Bank of India.				

Concluding Observations:

To summarize, India's financial sector has experienced significant reform through a gradual, careful, and steady process. Through well-sequenced and coordinated policy actions aimed at making the Indian financial industry more competitive, efficient, and stable, it has been converted into a reasonably complex, diverse, and robust system. Simultaneously, good monetary management has permitted price stability while also assuring credit availability to promote investment demand and economic growth. Finally, in contrast to the experience of many developing and emerging countries, the multi-pronged strategy to capital account management, combined with a prudential and careful approach to financial liberalization, has ensured financial stability. This is despite the fact that we were hit by a slew of global and domestic shocks. To face the challenges posed by all of these shocks, India's monetary policy and banking sector reforms had to be fine-tuned. In this light, the achievement of pricing and financial stability is all the more commendable.

As the economy moves toward faster growth and greater opening and financial integration with the rest of the globe, the financial sector, in all of its forms, will require further significant development, as well as commensurate regulatory modernization and strengthening measures. The overall goal of price stability in the context of economic growth and financial stability will stay unchanged.

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