

## 1. ECONOMIC LIBERALISATION AND BANKING SECTOR REFORMS

### ■ New Economic Policy

Since July 1991, the Government of India took up the task of redesigning its economic policy through the following measures : (a) controls to be replaced by liberalisation ; (b) private sector to be expanded in place of public sector ; (c) private foreign investment to be stimulated ; (d) improved technology of production to be introduced ; (e) modernisation of agriculture to be encouraged ; (f) trade policy, fiscal policy and monetary policy to be suitably amended ; (g) budgetary deficit to be checked.

The thrust of the new economic policy is towards creating a more competitive environment in the economy as a means to improve the productivity and efficiency of the system. To achieve the objectives of the new economic policy, various reforms have been introduced in the industrial policy, trade policy, fiscal policy and monetary policy.

Various reforms under the new economic policy (1991) may be broadly divided into two parts :

1. **Structural Reforms.** These reforms relate to consolidating the supply side of the economic system of the country. They include : (a) liberalism, (b) privatisation, (c) globalisation, and (d) competitive public sector.
2. **Stabilisation Reforms.** These reforms relate to consolidating the demand management and include monetary and fiscal policy reforms.

### ■ Economic Liberalisation

Economic liberalisation is the most important aspect of the new economic policy of the government (1991). Liberalisation means liberalising the trade and industry from unnecessary restrictions and making them more competitive and efficient.

The following liberalisation measures were taken under the new economic policy :

- (i) Excepting 18 industries, all other industries were delicensed. In other words, to set up these other industries, no licensing is required.
- (ii) Most of the industries are free to expand themselves according to the needs of the market.
- (iii) Producers are free to decide, on the basis of the conditions in the market, what commodity they are to produce.
- (iv) While taking investment decisions, the firms need not obtain prior sanction from the government.
- (v) Industries are free to buy foreign exchange from the open market and make necessary imports.

### ■ Past Performance of Indian Banking

Since nationalisation (1969), Indian banking system has made a remarkable progress in extending its geographical spread and financial reach. But, despite this progress, there has been a gradual fall in its operational efficiency. A number of factors were responsible for the decline in the efficiency and profitability of the banking sector: (a) massive and uneconomic expansion of bank branches ; (b) directed investment ; (c) directed credit programmes ; (d) inadequate attention to portfolio quality ; (e) weakness in the internal organisational structure of banks ; (f) lack of sufficient delegation of authority ; and (g) inadequate internal controls.

### ■ Objectives of Financial (Banking) Sector Reforms

In order to meet the changing needs of the liberalised economy, the government has introduced many banking sector reforms. The broad objectives and directions of these reforms, as stated in the Eighth Five Year Plan Document, are as follows :

- (i) The Narasimham Committee's recommendations will form the starting point of financial sector reforms.
- (ii) The financial sector reforms will be aimed at improving the financial strength of the banks and other financial institutions and will cover (a) the reduction of directed credit, (b) adequacy of reserves of banks and other financial institutions, (c) framing prudential norms and guidelines, (d) stock market reforms.
- (iii) Diversification of variety of institutions in the financial sector will be encouraged; and their entry and exit will be eased.
- (iv) Diversification the financial instruments will be encouraged.
- (v) The central control on the rates of return on various financial instruments and investments will be relaxed.
- (vi) Financial market prices and investment practices will be such as to direct funds efficiently and to harmonise the rates of return.
- (vii) Special arrangements will continue to be necessary to ensure that funds flow to new, small and rural enterprises and investments of high social priority.
- (viii) The overall thrust of these reforms will be to ensure that the financial system operates on the basis of operational flexibility and financial autonomy with a view to increase efficiency, productivity and profitability.

## 2. FINANCIAL SECTOR REFORMS

The New Economic Policy (NEP) of structural adjustments and stabilisation programme was announced in June 1991 and financial system reforms received special attention in the policy. After the announcement of NEP, the government appointed a high level committee (popularly known as Narsimham Committee) on financial system to examine all aspects relating the structure, organisation, functions and procedures of the financial system. The committee submitted its main report in November 1991. On the basis of this report, the authorities introduced a large number of reforms in the financial sector.

### ■ Need for Reforms

The need for financial (particularly banking) sector reforms had arisen because of the alarming increase of sickness in this sector.

The main indicators of this sickness are summed up below :

- (i) Despite its impressive quantitative growth and achievements, the financial health, integrity, autonomy, flexibility and vibrancy in the financial sector had deteriorated over the period of time.
- (ii) The allocation of resources had become distorted, the portfolio quality had fallen and productivity, efficiency and profitability had declined in the system.
- (iii) Customer service was poor, work technology remained outdated, and transaction costs were high.
- (iv) The capital base of the system remained low, the accounting and disclosure practices were faulty, and the administrative expenses had increased.
- (v) The system suffered from lack of delegation of authority, inadequate internal controls and poor housekeeping.

In short, financial (banking) sector reforms were necessitated by the growing sickness in the system which, in turn, was caused mainly by (a) The state induced rigidities, (b) directed credit allocation and investment, and (c) politicisation of the working of the financial institutions.

### ■ Objectives of Reforms

Important objectives of the financial sector reforms are given below :

- (i) to develop a market-oriented, competitive, world-integrated, diversified, autonomous, transparent financial system ;
- (ii) to increase allocative efficiency of credit ;
- (iii) to increase the effectiveness, accountability, profitability, viability, vibrancy, balanced growth, operational economy and flexibility, professionalism and depoliticisation in the system ;
- (iv) to increase the rate of return on investment ;
- (v) to ensure rationalisation in the interest rate structure and to discard the administered system of interest rates ;
- (vi) to improve the effectiveness of directive credit programmes ;
- (vii) to build a financial infrastructure relating to supervision, audit, technology, and legal matters ;
- (viii) to modernise the instruments of monetary controls.

In short, all these objectives can be summed up by the key words of liberalisation, deregulation, modernisation, privatisation and globalisation.

### FINANCIAL SECTOR REFORMS IN INDIA

#### ■ Features and Impact of Reforms

Some of the features and consequences of financial sector reforms can be summed up in the following points :

- (i) Financial sector reforms covered banks, stock markets, government securities market, external sector, institutional development and operational as well as monetary policy matters.
- (ii) Reforms have improved the working of commercial banks as indicated in their cleaner balance sheets, reduction in NPAs, increase in their operational profits, increase in capital base.
- (iii) The reforms have failed to improve the health of financial system as a whole. The state of credit or state of confidence is at the low level.
- (iv) There is an emergency of universal banking.
- (v) Scams and frauds of various magnitudes have increased even after the reforms.

#### ■ Narasimham Committee Report

The Government of India set up a nine-member committee under the chairmanship of Sh. Narasimham, former Governor of Reserve Bank of India, to examine the structure and functioning of the existing financial system of India and suggest financial sector reforms. The report of the committee was tabled in the Parliament of December 17, 1991.

Objectives. Main objectives of the committee were :

- (i) to examine the existing structure of the financial system and its various components;
- (ii) to make recommendations for improving the efficiency and effectiveness of the system, with particular reference to economy of operations, accountability and profitability, and for infusing greater competitive vitality into the system so as to make the banks and other financial institutions to respond more effectively to the emerging needs of the economy;
- (iii) to review the existing supervisory arrangement relating to the various entities in the financial sector and make recommendations for ensuring appropriate and effective supervision ; and
- (iv) to review the existing legislative framework and to suggest necessary amendments for implementing the recommendations.

Approach. The approach of the committee to the subject of financial sector reform was based on the three broad and inter-related premises :

- (i) The spirit of efficiency which is sought to be brought about in the real sectors of the economy should also cover the financial sector for the exercise to be meaningful and successful.
- (ii) To be able to perform this task effectively in an environment of competitive efficiency, the financial system itself should be healthy and profitable.

(iii) For the financial sector to operate on an efficient basis it would need to have a measure of operational flexibility, and more importantly, autonomy in decision making and credit and investment decisions should be based on professionalism and be free from any type of extraneous pressure.

**Recommendations.** The main recommendations of the committee are :

- (i) Establishment of four-tier hierarchy for the banking structure with 3 or 4 large banks including State Bank of India at the top (which should be international in character) and rural banks (including RRBs) at the bottom (confined to rural areas and mainly engaged in financing agriculture and related activities);
- (ii) having off supervisory functions over banks and financial institutions to a separate quasi-autonomous body under aegis of the Reserve Bank of India;
- (iii) a phased achievement of 8% capital adequacy ratio as recommended by Banking Committee ;
- (iv) Abolition of branch licensing policy ;
- (v) Phased reduction in Statutory Liquidity Ratio (SLR) ;
- (vi) deregulation of interest rates which are to be related to the Bank Rate on the basis of the guidelines given by the Chakravarty Committee ;
- (vii) competition among financial institutions which will adopt a syndicating or participating approach;
- (viii) retention by Industrial Development Bank of India (IDBI) of only its refinancing role and delegation of its direct lending activities to a separate corporate body;
- (ix) prudential guidelines governing the functioning of financial institutions ;
- (x) proper classification of assets and full disclosure and transparency of banks and financial institutions.

Most of the recommendations have been accepted by the government and will be implemented in the 8<sup>th</sup> plan.

### ■ Golpotha Committee Report : Customer Service Reforms

In September 1990, Reserve Bank of India set up a committee under the chairmanship of Sh. M.N. Golpotha, chairman of State Bank of India to examine the problem of customer service in banks and suggest measures to improve the situation. The main objectives of the committee were: (a) to look into the cause of below-par customer service in banks ; (b) to identify structural and operational rigidities in the banking system; (c) to find ways and means to upgrade technology in banks; (d) to point out deficiencies in bank service and (e) suggest ways to improve work culture among bank employees. The committee submitted its report on 6th December, 1991.

**Main recommendations of the committee are as follows :**

- (i) extension of banking hours for all transactions except cash ;
- (ii) change in the commencement of working hour for bank staff to facilitate timely opening of bank counters ;

- (iii) immediate credit of outstation cheques upto ₹ 5,000 as against ₹ 2,500 at present;
- (iv) enhancement of interest rate on saving account ;
- (v) introduction of tax benefits against bank deposits;
- (vi) full use of discretionary powers vested in the bank staff at all levels ;
- (vii) expeditious despatch of document lodged for collection and regular follow-up with the foreign bank to facilitate timely realisation of export proceeds in the case of export finance;
- (viii) extension of teller's duties ;
- (ix) modernisation of banks ;
- (x) opening of specialisation branches for different customer groups ;
- (xi) introduction of a new instrument in the form of Bank Order ;
- (xii) introduction of restricted holidays in banks.

### ■ Financial (Banking) Sector Reforms Announced (1992-93)

On the basis of the recommendations of Narasimham Committee Report, a number of banking sector reforms were announced during 1992-93 for improving the efficiency and promote competition in the banking sector to enable it to respond more effectively to the emerging needs of the liberalised Indian economy.

**Important reforms are given below :**

1. **Reduction in SLR and CRR.** The high Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) are a tax on the financial savings in the banking system and serve to encourage flows in market where this tax does not apply. It is, therefore, essential in the interest of a healthy financial system to phase out this distortion. The government announced in 1992-93 its decision to reduce the SLR in stages over a three-year period from 39.5% to 25% and to reduce the CRR over a four-year period to a level below 10%.
2. **Interest Rate Policy.** The interest rates on deposits and on advances are to be deregulated. In other words, the banks will have the freedom to set their interest rates. The purpose of deregulation of interest rates was to stimulate healthy competition among banks and encourage their operational efficiency.
3. **Prudential Norms.** In pursuance of the recommendations of the Narasimham Committee, the RBI issued new prudential norms relating to income recognition, classification of assets and provisioning for bad debts.
4. **Income Recognition.** The new income recognition norms ensure that interest not actually paid cannot be shown as accrued, a practice which exaggerates the profitability of the banks.
5. **Policy for Non-Performing Assets (NPAs).** Norms have also been specified for categorising non-performing accounts and for making provisions for sub-standard, doubtful and loss making assets. An account is deemed non-performing if interest cannot be collected within one month after it is due. New prudential

reforms require banks to make 100% provision for all loss assets or non-performing assets. The concerned borrower in such non-performing accounts will be subjected to corrective steps for all the facilities availed from banks, including other accounts in which the borrower may have been regular in making all payments due.

As funding required for provisioning was placed at ₹ 14,000 crore, it was phased over two years. Banks were required to make at least 30% provision against doubtful and bad debts during 1992-93 and the balance 70% in 1993-94.

6. **Capital Adequacy Norms.** Minimum capital standards have been prescribed in accordance with the internationally accepted Basle Committee norms under which banks have to maintain minimum capital funds equivalent to 8% of the aggregate of risk-weighted assets and other off-balance sheet exposures. Time schedule for capital adequacy norms was : (a) 8% to be attained by foreign banks operating in India by 31st March 1993; (b) 8% to be attained by Indian banks with branches abroad by 31st March 1994; (c) 4% to be attained by other banks by 31st March 1993 and 8% by 31st March 1996.

7. **New Format for Balance Sheet and Profit-Loss Account.** Revised format for balance sheet and profit-loss account reflecting actual health of the scheduled commercial banks was introduced from the bank accounting year 1991-92 and the bank accounts for 1990-91 were to be reformatted.

8. **Branch Licensing.** Bank attaining capital adequacy norms and prudential accounting standards can set up new branches without the prior approval of the RBI. Banks have the freedom now to rationalise their existing branch network by relocating branches, opening of specialise branches, spinning off business, setting up of controlling offices/administrative units, etc.

9. **Setting up of Private Banks.** The RBI has announced guidelines for setting up of private banks as public limited companies. (a) The banks in the private sector should be financially viable. (b) They should avoid shortcomings, such as, unfair pre-emption and concentration of credit, cross-holdings with industrial groups, etc. (c) They will be required to observe priority sector lending targets as applicable to other domestic banks.

10. **Other Reform Measures.** (a) New Board of Financial Supervision will be set up in the RBI to tighten up the supervision of commercial banks. (b) Special Recovery Tribunals will be set up to expedite the loan recovery process. (c) Guidelines will be provided for objective selection procedures for non-official directors of the banks.

The aim of these reforms is to provide commercial orientation to the commercial banks for which they must satisfy the following objectives : (a) show better returns on the saving of the investors ; (b) adopt strategies to generate additional revenues; (c) reduce the financial risks by creating new services ; (d) improve income to cost ratios and increase operational efficiency ; and (e) attend seriously the problems of low profitability and high and growing non-performing assets.

### Financial Sector Reforms during 1990s

On the basis of the recommendations of Narasimham Committee Report, a number of monetary policy measures and financial sector reforms have been undertaken during 1990s for improving the efficiency and promote competition in the financial system to enable it to respond more effectively to the emerging needs of the liberalised Indian economy.

Important reforms are given below :

- Autonomy to Monetary Policy.** On September 9, 1994, the Government of India entered a historic agreement with RBI to limit borrowing from the latter through ad hoc Treasury Bills. With this accord, the linkage between fiscal and monetary policy has been weakened and greater autonomy is given to monetary policy. With greater autonomy, the Reserve Bank will be both more able and more responsible for controlling the overall growth of money and credit to check inflation while meeting the genuine credit needs of the economy.
- Monetary Policy Measures.** Major monetary and credit policy measures taken during 1990s are :
  - Satutory Liquidity Ratio (SLR) in incremental net demand and time liabilities (NDTL) is reduced from 36.5% in 1991-92 to 25%.
  - Incremental Cash Reserve Ratio (CRR) of 10% has been removed and one-third of the impounded cash balances under incremental CRR is released.
- Interest Rate Policy.** Major interest rate policy reforms are :
  - With effect from October 18, 1994, the lending rate for bank advances of over ₹ 2 lakh has been deregulated.
  - Interest rates on deposits and advances of all cooperative banks have been deregulated.
  - Number of administrated interest rates has been reduced from 20 in 1989-90 to 2 in 1994-95.
- Banking System.** Important banking system reforms are :
  - Banking Companies Act has been amended to enable the public sector banks to access the capital market.
  - Ten private sector banks have started functioning up to 1996-97.
  - Banks have been allowed to raise capital contribution from foreign institutional investors upto 20% and from Non-resident Indians upto 40%.
  - Prudent norms for incomes recognition, classification of assets and provisioning for bad debts have been introduced.
  - Capital adequacy of 4% has been attained by all banks by March 31, 1993.
  - Banks have been given freedom to open new branches and upgrade extension counters.
  - Union Bank of India has been merged with Punjab National Bank.

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(viii) A Board of Financial Supervision has been set up with an Advisory Council to strengthen the supervisory system of Banks and financial institutions. A separate Department of Supervision has been established in the RBI in December 1993 for assisting the Board.

(ix) Recovery of Debts due to Banks and Financial Institution Act, 1993 has been passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan arrears. Five Tribunals have started functioning at Calcutta, Delhi, Jaipur, Ahmadabad and Bangalore and an Appellate Tribunal has been set up at Bombay.

(x) Union agreement in 1993 paved way for faster computerisation in banks.

(xi) Bank lending norms have been liberalised.

(xii) Guidelines have been issued to banks to ensure qualitative improvement in bank's customer service.

(xiii) Under Banking Ombudsmen Scheme 1995, eleven Ombudsmen have been appointed by RBI out of a total of 15 to look into and resolve customers' grievances in a quick and inexpensive way.

(xiv) During 1996-97 (a) interest rates on term deposits of over one year have been decontrolled; (b) selective credit controls have been removed from bank advances against most commodities; (c) banks were given permission to provide foreign currency loans to their customers who would bear foreign exchange risk.

(xv) Banking regulation Act, 1949 has been amended (a) to enable a banking company to have a non-executive chairman, upto three directors from among the directors of promoting institutions; (b) to raise the ceiling for exercising the voting rights for a shareholder to 10% and (c) to raise the penalties for contravention of the Act.

5. **Financial Institutions. Main reforms in the other financial institutions are :**

(i) Industrial Finance Corporation of India (IFCI) has been converted into a company and its maiden public issue raised over ₹ 800 crore as equity.

(ii) Convertibility clause is no longer obligatory for assistance sanctioned by term lending institutions.

(iii) Floating interest rate on financial assistance has been introduced by some all India development banks.

(iv) Financial institution's access to SLR has been reduced and they are encouraged to approach capital market for funds.

### 3. NARASIMHAM COMMITTEE REPORT-2 ON BANKING REFORMS

The Narasimham Committee on banking sector reforms submitted its second report to the Finance Minister, Mr. Yashwant Sinha, on April 23, 1998. The agenda of the

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committee was to review the progress in the reforms in the banking sector over the past six years and suggest a future course of action. According to the report, since 1991-92, several steps have been taken to improve productivity, efficiency and profitability of the banking sector on the one hand and provide it greater operational flexibility and functional autonomy in decision making on the other.

In its report, the Committee suggested the second phase of banking reforms which would focus on (a) strengthening the foundations of banking system, (b) streamlining procedures, (c) upgrading technology and human resources development and (d) making structural changes in the system, including three-tier banking system.

The important recommendations of the Committee are stated below :

(i) The Committee suggests the merger of strong banks because such merger will have a multiplier effect on industry.

(ii) The committee is against the merger of strong banks with the weak banks because it will have a negative effect on the asset quality of the strong bank.

(iii) Some large Indian banks should be given an international character.

(iv) Concept of narrow banking can be tried to rehabilitate weak banks.

(v) Small, local banks should be confined to states or cluster of districts in order to serve local trade, small industry and agriculture.

(vi) Government role in the public sector should be reexamined on the issue whether real autonomy and flexibility of banks is consistent with public ownership.

(vii) Functions of boards and managements should be reviewed so that the boards remain responsible for enhancing shareholder value.

(viii) Minimum prescriptions for capital adequacy needs to be reviewed because, among other things, banks are getting more exposed to off-balance sheet risks.

(ix) Reserve Bank of India Act, Banking Regulation Act, Nationalisation Act, and State Bank of India Act should be updated. Some of the provisions of these Acts are required to be amended to bring them in line with the current needs of the banking industry.

(x) Regulations of associated supervision should be concerned with laying down prudential and disclosure norms and sound procedures and to ensure adherence to these, instead of getting involved in day-to-day management.

(xi) Non-Bank Financial Companies' lending activities should be integrated with the financial system.

(xii) Rural credit facilities should be linked with other constituents of the financial system.

(xiii) Recruitment procedures, training and remuneration policies should be reviewed.

(xiv) There is a need for public sector banks to speed up computerisation and focus on relationship banking.