# Narasimham Committee on Banking Sector Reforms (1998)

**Reports of the Narasimham Committees**

- The purpose of the Narasimham-I Committee was to study all aspects relating to the structure, organization, functions and procedures of the financial systems and to recommend improvements in their efficiency and productivity. The Committee submitted its report to the Finance Minister in November 1991.
- The Narasimham-II Committee was tasked with the progress review of the implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India. It focused on issues like size of banks and capital adequacy ratio among other things. The report of the *Committee on Banking Sector Reforms (Committee-II)* was submitted to the Finance Minister in April 1998.

**Major Recommendations of the 1998 Report**

- **Autonomy in Banking**
- Greater autonomy was proposed for the public sector banks in order for them to function with equivalent professionalism as their international counterparts. For this the panel recommended that recruitment procedures, training and remuneration policies of public sector banks be brought in line with the best-market-practices of professional bank management.
- Secondly, the committee recommended GOI equity in nationalized banks be reduced to 33% for increased autonomy. It also recommended that the RBI relinquish its seats on the board of directors of these banks. The committee further added that given that the government nominees to the board of banks are often members of parliament, politicians, bureaucrats, etc., they often interfere in the day-to-day operations of the bank. As such the committee recommended a review of functions of banks boards with a view to make them responsible for enhancing shareholder

value through formulation of corporate strategy and reduction of government equity.

- To implement this, criteria for *autonomous status* was identified by March 1999 (among other implementation measures) and 17 banks were considered eligible for autonomy.
- But some recommendations like reduction in Government's equity to 33%, the issue of greater professionalism and independence of the board of directors of public sector banks is still awaiting Government follow-through and implementation.

- **Reform in the role of RBI**
- First, the committee recommended that the RBI withdraw from the 91-day treasury bills market and that interbank call money and term money markets be restricted to banks and primary dealers. Second, the Committee proposed a segregation of the roles of RBI as a *regulator* of banks and *owner* of bank. It observed that *"The Reserve Bank as a regulator of the monetary system should not be the owner of a bank in view of a possible conflict of interest"*.
- Pursuant to the recommendations, the RBI introduced a Liquidity Adjustment Facility (LAF) operated through repo and reverse repos in order to set a corridor for money market interest rates. As for the second recommendation, the RBI decided to transfer its respective shareholdings of public banks like SBI, NHB and NABARD to GOI. Subsequently, in 2007-08, GOI decided to acquire entire stake of RBI in SBI, NHB and NABARD.

- **Stronger banking system**
- The Committee recommended for merger of large Indian banks to make them strong enough for supporting international trade. It recommended a three tier banking structure in India through establishment of three large banks with international presence, eight to ten national banks and a *large number of regional and local banks*. The Committee recommended the use of mergers to build the size and strength of operations for each bank. However, it cautioned that large banks should merge only with banks of equivalent size and not with weaker banks, which should be closed down if unable to revitalize themselves. Given the large percentage of NPAs for

weaker banks, some as high as 20% of their total assets, the concept of "narrow banking" was proposed to assist in their rehabilitation.

- There were a string of mergers in banks of India during the late 90s and early 2000s, encouraged strongly by the GOI in line with the Committee's recommendations. However, the recommended degree of consolidation is still awaiting sufficient government impetus.

- **Non-performing assets**
- The 1998 report blamed poor credit decisions, behest-lending and cyclical economic factors among other reasons (in addition to 'priority sector lending') for the build up of the non-performing assets of the banks to uncomfortably high levels.
- The Committee recommended creation of Asset Reconstruction Funds or Asset Reconstruction Companies to take over the bad debts of banks, allowing them to start on a clean-slate. The option of recapitalization through budgetary provisions was ruled out. Overall the committee wanted a proper system to identify and classify NPAs, with NPAs to be brought down to 3% by 2002 and for an *independent loan review mechanism* for improved management of loan portfolios. The committee's recommendations led to introduction of a new legislation which was subsequently implemented as the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), 2002.

- **Capital adequacy and tightening of provisioning norms**
- In order to improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This would also improve their risk taking ability. The committee targeted raising the capital adequacy ratio to 9% by 2000 and 10% by 2002 and have penal provisions for banks that fail to meet these requirements. For asset classification, the Committee recommended a mandatory 1% in case of standard assets and for the accrual of interest income to be done every 90 days instead of 180 days.
- To implement these recommendations, the RBI in Oct 1998, initiated the second phase of financial sector reforms by raising the banks' capital adequacy ratio by 1%

and tightening the prudential norms for provisioning and asset classification in a phased manner on the lines of the Narasimham Committee-II report. The RBI targeted to bring the capital adequacy ratio to 9% by March 2001.

- **Entry of Foreign Banks**
- The committee suggested that the foreign banks seeking to set up business in India should have a minimum start-up capital of $25 million as against the existing requirement of $10 million. It said that foreign banks can be allowed to set up subsidiaries and joint ventures that should be treated on a par with private banks.

- **Implementation of recommendations**
- Based on the other recommendations of the committee, the concept of a universal bank was discussed by the RBI and finally ICICI bank became the first universal bank of India. The RBI published an "Actions Taken on the Recommendations" report on 31 October 2001 on its own website. Most of the recommendations of the Committee have been acted upon (as discussed above) although some major recommendations are still awaiting action from the Government of India.

- **Criticism**
- There were protests by employee unions of banks in India against the report.
- However, during the 2008 economic crisis of major economies worldwide, performance of Indian banking sector was far better than their international counterparts. Perhaps the steps taken post-Narasimham Committee –II should get some credit for this.

Based on Presentation by Prof Abhijit Roy in Pre Examination Training for RBI Officers.