A Study of Second Phase of Banking Sector Reforms in India

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Abstract:-
Banking sector reforms were introduced to remove the deficiencies in banking sector. The lack of autonomy is reflected in the fact that there is a common wage package for all bank employees irrespective of the health of the bank concerned. Kannan, the Chief Executive Officer of Bank of Baroda, says: "Give us the freedom to fix our own wages and offer market remuneration to professionals. Do not tie us down to a common wage structure. Let each bank decide its appropriate level of wages." The study is based on the secondary data. The scope of the study is limited to five years data. The study is related to Nationalised Banks and Foreign Banks.

KEY WORDS: GROSS NPA, REFORM, CAPITAL MARKET, SARFAESI

1. Introduction:-

In spite of the optimistic views about the growth of banking industry in terms of branch expansion, deposit mobilization etc, several distortions have crept into the system which are enumerated as follows:

1. Increasing competitions
2. Increasing NPA
3. Obsolete technology

Hence while observing above distortions, the Government of India appointed second Narasimham Committee under the chairmanship of Mr. M.Narasimham in 1998 to review the first phase of banking reforms and chart out a programme for further reforms, necessary to strengthen India’s financial system so as to make it internationally competitive. This situation has arisen mainly due to the global changes occurring in the world economy, which has made each industry very competitive. The committee reviewed the performance of the banks in light of first phase of reforms and submitted its report with some repaired and some new recommendations. Major recommendations of this committee were:

1. Gradual reduction of CRR and SLR.
2. Prudential norms and capital adequacy measures were initiated in line with the International standards.
3. Deregulation of the interest rates.
4. Priority sector lending (40 per cent)
5. Free entry and exit of banks (private and foreign)
6. Permission to access capital market to meet their requirements.
7. Affording operational flexibility to banks in the assets/liability managements.
9. Reduction in Non-Performing Assets (NPA) and introduction of Voluntary Retirement Scheme (VRS) for reducing surplus staff.
11. Enactment of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002, which enabled the setting up of asset management companies for addressing the problems of NPA of financial institutions.
As a result of the implementation of these major reforms, Indian Banking Sector has undergone a sea change as compared to a decade ago.

2. Objectives:-

i) To estimate Gross NPA of Nationalised Banks and Foreign Banks  
ii) To examine Gross advances of Nationalised Banks and Foreign Banks  
iii) To study Narasimham Committee recommendations on banking sector reforms

3. Methodology:-

The study is based on the secondary data. The scope of the study is limited to five years data. The study is related to Nationalised Banks and Foreign Banks.

### Gross NPA of Nationalised Banks and Foreign Bank  
(Amounts in Rs. Lakhs)

<table>
<thead>
<tr>
<th>Year</th>
<th>Nationalised Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>2629100</td>
<td>209500</td>
</tr>
<tr>
<td>2008</td>
<td>2511900</td>
<td>274500</td>
</tr>
<tr>
<td>2009</td>
<td>2680380</td>
<td>626507</td>
</tr>
<tr>
<td>2010</td>
<td>3547031</td>
<td>587844</td>
</tr>
<tr>
<td>2011</td>
<td>4290739</td>
<td>401474</td>
</tr>
</tbody>
</table>

Source: - www. Department of Banking supervision, RBI

The above table shows that gross NPAs of Nationalised Banks falls from the year 2007 to 2008 from Rs.2629100 lakhs to Rs.2511900 lakhs but thereafter it continues rise through out the year up to 2011. Incase of Foreign Banks gross NPAs rises from the year 2007 to 2009 but thereafter it continues to fall up to 2011.

### Gross Advance of Nationalised Banks and Foreign Banks  
(Amounts in Rs. Lakhs)

<table>
<thead>
<tr>
<th>Year</th>
<th>Nationalised Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>97573300</td>
<td>10016700</td>
</tr>
<tr>
<td>2008</td>
<td>121855400</td>
<td>13057300</td>
</tr>
<tr>
<td>2009</td>
<td>153560191</td>
<td>13857628</td>
</tr>
<tr>
<td>2010</td>
<td>174640025</td>
<td>13702112</td>
</tr>
<tr>
<td>2011</td>
<td>217696671</td>
<td>16155716</td>
</tr>
</tbody>
</table>

Source: - www. Department of Banking supervision, RBI

The above table shows that gross advances of both Nationalised Banks as well as Foreign Banks continues to rise throughout the year from 2007 to 2011.

### Recommendations of Narasimham committee on Banking Sector Reforms

Banking sector reforms were introduced to remove the deficiencies in banking sector. The problems faced by banking sector since 1991 were as follows:
i) highly regulated by the RBI
ii) eroded productivity and efficiency of public sector banks
iii) continuous losses born by public sector banks year after year
iv) increasing NPA
v) deteriorated portfolio quality
vi) poor customer service
vii) obsolete work technology
viii) unable to meet competitive environment

Hence, the need of the hour was to introduce some policies to remove the above said deficiencies. In light of above distortions, the Narasimham Committee was appointed in 1991 and it submitted its report within three months November 1991, with detailed measures to improve the adverse situation of the banking industry. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability. The banking sector reforms have changed the financial environment and new challenges are emerging along with immense opportunities.

Recommendations of the First Narasimham Committee Of Banking Sector Reforms included the following:
1. Reduction in SLR & CRR
2. Deregulation of interest rates
3. Transparent guidelines or norms for entry and exit of private sector banks
4. Public sector banks allowed for direct access to capital markets.
5. Branch licensing policy has been liberalized
6. Setting up of Debt Recovery Tribunals
7. Asset classification and provisioning
8. Income recognition
9. Asset Reconstruction Fund (ARF)
10. At least 40 percent of the total advances should be in priority sector

The first phase of banking sector reforms, termed as ‘curative’ measures came up with its main objective to improve the operational efficiency of banks. Although, the first phase of banking sector reforms has seen improvement in the performance of the banks, but competition has also increased with more liberalization, privatization and globalization. With better use of technology, the entrants have been able to spur competition, and the public sector banks have suffered as they are not using the technology to large extent rather only to an affordable extent, mainly due to opposition from trade unions and high initial costs of installation.

The Narasimham Committee has made radical recommendations to dilute government equity in nationalized banks to 33%. It has also suggested that the RBI nominees on bank boards step down. The rationale behind this suggestion appears to be that real autonomy is inconsistent with public ownership, although an earlier panel, the Committee on Financial Supervision (CFS), had held that productive efficiency and profitability were ownership-neutral as long as banks were given the freedom to function within a well-defined framework of regulation and prudential norms.

Is functional autonomy really inconsistent with public ownership? Most chairmen of nationalized banks seem to think so. They say that it is not so much directed credit that has eroded their viability (after all, even private banks are subject to the same lending quotas but are still profitable); it is the lack of operational autonomy as well as interference in their day-to-day functioning that are at the root of their poor performance.
The lack of autonomy is reflected in the fact that there is a common wage package for all bank employees irrespective of the health of the bank concerned. Kannan, the Chief Executive Officer of Bank of Baroda, says: "Give us the freedom to fix our own wages and offer market remuneration to professionals. Do not tie us down to a common wage structure. Let each bank decide its appropriate level of wages."

Vigilance is another bugbear of bankers. Government officials, who are clueless about banking economics, are posted as vigilance officials and there is the threat of a vigilance inquiry each time a bonafide lending decision results in a bad account. Bankers point out that they are flush with funds, but credit is not taking off because of fear psychosis.

Another problem area that the Narasimham report has commented on is behest-lending. Bank boards are staffed with government nominees (often Members of Parliament or Legislative Assemblies or other politicians) who, bankers allege, interfere in their day-to-day functioning apart from seeking to have a say in the policy decisions of the board.

The logic of linking performance to public ownership appears flawed. Even within the framework of public ownership with its attendant lack of autonomy, not all the nationalized banks have performed badly.

For the Narasimham Committee, big is beautiful. Therefore, it has recommended that the establishment of three large banks with international structure, eight to ten national banks and a large number of regional and local banks. This, the committee has suggested, can be done through mergers. Bankers agree that size is a critical criterion for international operations, but disagree that the merger route is appropriate for building strength.

Mergers will have to result in greater efficiency and rationalization of branch network and operations. Otherwise they will not be profitable. Bankers also believe that mergers cannot be ordered by fiat; they have to be driven by business considerations. This is a point conceded by the report. Top bankers favour the equity route to expansion rather than the merger route. They say that although the State Bank of India took over many banks, it did not opt for mergers.

Non-performing assets (NPA) have been the bane of the industry. Experts have identified poor credit decisions by managements, cyclical changes in the economic environment, directed credit and crude forms of behest-lending as the factors responsible for poor asset quality. They point a finger at priority sector credit as having a high contamination coefficient and suggest that quantitative targets have caused erosion of asset quality. The fact is that infusion of recapitalisation funds notwithstanding, NPA remains uncomfortably high. Yet they recommend that advances covered by government guarantees that have turned sticky should also be reckoned as net NPA.

The Narasimham Committee's solution for NPA is the creation of an Asset Reconstruction Fund (ARF), which will take over the bad debts of banks from their balance sheets to enable them to start on a clean slate. Recapitalization through budgetary infusion, experts correctly point out, is not a sustainable option. But bankers are skeptical about the workability of the ARF.

The committee had recommended that net NPA be brought down to less than 5% by the year 2000 and 3% by the year 2002. The committee has also recommended that banks should not lend to defaulters, but bankers say that this is unrealistic. They claim that in the absence of fresh loans, the defaulting companies will close down, leading to loss of jobs. "Will that be acceptable?" bankers ask. Bankers also complain that they are forced by the Board for Industrial and Financial Reconstruction (BIFR) to lend to sick companies, yet more often than not there is no turnaround and the accounts turn bad.
The committee has also recommended increasing capital adequacy and tightening provisioning norms. It targets 9% capital adequacy by the year 2000 and 10% by the year 2002. Accrual of interest for income recognition should be done in 90 days instead of 180 days. Even in the case of standard assets, an 1% provision is recommended. Another important recommendation is that the RBI withdraws from the 91-day treasury bills market and that inter-bank call money and term money markets be restricted to banks and primary dealers.

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

4. Conclusions:-

Reforms have paved the way for building our banking system capable to meet the requirements of the open and competitive economy. But, on the other side, some deficiencies have persisted despite these reforms, which include low level of priority sector advances, decreasing interest income, share of NPAs still not up to the mark, growing influence of foreign banks witnessed by their tremendously increasing non-interest income etc.

References

8. Table B7: Bank-wise Gross Non-Performing Assets, Gross Advances and Gross NPA Ratio of Scheduled Commercial Banks-2010.