Proposals for Financial Sector Reforms in India: An Appraisal

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The Narasimham Committee Report has made a number of recommendations regarding the structure, organization, functions and procedures of the Indian financial system.

In this article, Bhole has attempted a critical appraisal of the Report with a view to place the recommendations in a proper perspective and also to generate some thinking on the emerging issues.

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The Indian Government introduced the policy of liberalization and globalization in the real sector of the economy in a very big way in June 1991. Given the perceived relationship between the real and financial sectors, it was but natural that the authorities would think about liberalizing the financial sector also as a matter of follow-up. Therefore, on August 14, 1991, a nine-member High Level Committee on the Financial System was set up "to examine all aspects relating to the structure, organization, functions, and procedures of the financial system." The Committee headed by Mr Narasimham, submitted a summary Report to the Government of India on November 8, 1991, and the Main Report on November 16, 1991 (RBI, 1991). Predictably, this Report has generated considerable expectations as well as apprehensions regarding the direction of change in the Indian financial system.

It is in this context that this paper seeks to analyse this Report in order to generate some critical thinking on the issues emerging from the recommendations.

Terms of Reference, Diagnosis and Approach

The terms of reference of the Committee were wide-ranging and they related to the entire financial system rather than to any one of its parts. The Committee was asked to examine: (a) the existing organization and structure of the financial sector, (b) the cost, composition, and adequacy of capital structure of financial institutions, (c) the relative roles of financial institutions, and (d) the existing supervisory arrangements as well as the legislative framework in the financial sector. It was also asked to make suitable suggestions and recommendations in respect of all these aspects and any other subject it regarded relevant, so as to increase the efficiency, effectiveness, economy of operations, accountability, profitability, competitive viability, and balanced growth in the financial sector.
According to the Committee, despite its impressive quantitative growth and achievements, the financial health, integrity, autonomy, flexibility, and vibrancy in the financial sector have deteriorated over the past 30 years. The allocation of resources has become severely distorted, the portfolio quality has deteriorated, and productivity, efficiency, and profitability have been eroded in the system. The customer service is poor, work technology remains outdated, and transaction costs are high. The capital base of the system has remained low, the accounting and disclosure practices are faulty, and the administrative expenses have increased phenomenally. The system is characterized also by a lack of delegation of authority/inadequate internal controls, and poor housekeeping. On the whole, there has been an alarming increase of sickness in the financial sector which warrants urgent remedial measures.

In the Committee’s view, this has been the consequence of the following factors: (a) Policy induced rigidities, (b) Excessive degree of centralized administrative direction of investments, credit allocations, and internal management of banks and financial institutions, (c) Massive branch expansion, overstaffing, and union pressures in the case of banks, (d) Compulsion on the financial system to provide cheap credit to the government and public sector, (e) Excessive political intervention, interference and pressures.

The Committee believes that the basic remedial measure consists of deregulation of the financial sector as in the case of industrial and business sectors. An efficient and market oriented financial system is regarded by it as a necessary concomitant or complement to the market-based decision-making in the real sector. The strategic objective for the financial sector, as indeed for the rest of the economy, should be competitive efficiency and globalization. Operational flexibility, greater autonomy, professional management, competitive viability and vibrancy, market orientation, self-denial by the government, and depoliticization are some of the key words which define the Committee’s approach to financial sector reforms in India.

An Appraisal of Major Recommendations

Internal Administration, Quality of Assets and Related Matters

We begin our critical analysts of the Report by welcoming a number of sensible recommendations which the Committee has made regarding bad debts, quality of assets, and the internal administration and control of banks and financial institutions. It rightly expects that the implementation of the following steps over a period of 3 to 4 years may help banks tide over certain internal difficulties and become financially viable:

(i) Income should not be deemed to have accrued in respect of non-performing assets, i.e., the assets on which interest remains due for more than 180 days as on the balance sheet date, (ii) The assets should be classified as standard, substandard, doubtful, and loss by using health codes; appropriate provisioning be made in a phased manner against assets other than the first type; and these provisions be made permissible deductions under the Income Tax Act. (iii) Full disclosures of activities should be made in balance sheets, (iv) Special tribunals should be set up to speed up the recoveries of loans and enforcement of securities charged to them, (v) The Assets Reconstruction Fund, to be subscribed to by banks and financial institutions, should be set up to take over a portion of their bad and doubtful debts at a discount, (vi) The system of common recruitment of officers should be replaced by separate recruitment by each bank, (vii) The nature of internal organization should be left to individual banks, and the government and the Reserve Bank of India (RBI) should minimize their guidelines as well as directives with regard to internal administration.

Capital Adequacy

In keeping with capital adequacy standards fixed by the Basic Committee on Banking Regulations and Supervisory Practices appointed by the Bank of International Settlements (BIS), the Committee has recommended that while Indian banks operating on an international scale should achieve the capital ratio norm of 8 per cent by March 1994, other banks should achieve the capital ratio of 4 per cent by March 1993, and the norm of 8 per cent by March 1996. This is to be done by issuing fresh capital to mutual funds, insurance companies, public sector companies, bank employees and the general public in the case of reputed, profitable banks, and through subscriptions and loans by the government in the case of other banks.

In principle and as per conventional thinking, this may be an acceptable recommendation. However, it is theoretically weak, and under conditions obtaining in India, it is unrealistic, unnecessary, and in the manner of much ado about nothing. It has been made primarily to announce our conformity with the thinking of the BIS.

The advocates of privatization in India are being unrealistic in assuming that the subscriptions to equity capital on such a huge scale as would be required under the spate of privatization of everything—banks, finan-
cial institutions, public sector units, etc. — will actually materialize. Such an assumption is not in tune with the actual investment preferences of the Indian public. In spite of loud declarations regarding the growth of stock market, the equity culture is nowhere around the corner here. Excepting the year 1988, the amount of annual fresh equity capital raised as a part of total capital issued has not been more than 15 to 20 per cent during 1987 to 1991. The other suggestion regarding government subscriptions and loans is nothing more than accounting rearrangement of the capital structure of banks, and, in any case, the RBI has already done this to a certain extent in the recent past.

The financial strength and viability of banks should really be measured in terms of the quality of their assets and the good rate of growth of their deposits year after year; the measure of equity/capital or equity-debt ratio used for this purpose in the case of manufacturing and business concerns is not much relevant in the case of banks. This ratio is bound to remain very low in their case because of the fund-based nature of their business, and it can never be raised enough to offer a measure of safety to their depositors. Banks deal in other people's money and they work on public faith, and this means that the equity-debt ratio has very limited relevance in their healthy functioning.

Further, in the particular case of the Indian banking system, which invests a sizable portion of its resources in government and government-guaranteed securities which are owned by the government, higher equity-capital ratio becomes all the more irrelevant and redundant.

**Utilization of Bank Funds**

Among the Committee's recommendations regarding the deployment of bank funds, three major ones are: (a) The direct credit programmes be phased out; the priority sector be redefined; and the credit target for this sector be fixed only at 10 per cent of the total bank credit, (b) The Statutory Liquidity Ratio (SLR) be reduced to 25 per cent of net demand and time liabilities of banks in a phased manner, making a beginning in the current year itself, (c) The RBI should consider progressive reduction in the Cash Reserve Ratio (CRR) from its present level.

We find that the Committee's perception of the issues involved in (a) and (b) above is different from that of the Chakravarty Committee; the latter's approach was deeper, more realistic, and free from ideological overtones (RBI, 1985). It had argued that the credit needs of the priority sector, and of the govern-

ment as an entrepreneur and development agent, must be recognized; and, therefore, the cost concessions but not the availability of credit to them should be drastically reduced. The underlying principle here was that the availability of credit should be regarded more important than its cost.

The Committee wants both higher cost and less availability of credit to these sectors. It does not appear to be worried about the imperfections in credit markets, and about the principles of equity and social justice in credit allocation. It has unrealistically assumed that the priority sector borrowers can now stand on their own feet. It also appears to have forgotten that unless the government is actually successful in reducing the level of its expenditure, the reduction in the SLR would tend to increase the monetary deficit, and it would also have a destabilizing impact on the government securities market as well as the balance sheets of banks and financial institutions.

It should be appreciated that the Committee has been more cautious while making recommendations in respect of the CRR. It has recognized that the CRR is a monetary policy tool, and that the RBI should be allowed requisite freedom to change it according to monetary policy requirements. But then, it should not have made definitive recommendations of reducing the CRR and increasing the rate of interest on cash reserves. Both these recommendations are contrary to the steps taken by the RBI in the recent past, namely, an increase in the CRR, an increase in the maximum permissible level of CRR, and a reduction in the rate of interest on cash reserves of banks.

The Committee's recommendation to reduce the CRR is predicated on the expectations that deficit financing is going to be definitely reduced, and that interest rates are going to be deregulated. While the latter has actually materialized to a great extent, the former remains a Gordian Knot. Moreover, the deregulation of interest rates does not guarantee that the RBI will be definitely in a position to reduce the CRR; it is quite obvious that the direction of change in the CRR will have to depend upon the macro-economic conditions in the country. The effective conduct of monetary policy requires a combined, balanced, and coordinated use of different techniques of monetary control, and this may very well mean an increase in both the CRR and interest rates. It is paradoxical that the Committee talks of the freedom of RBI on the one hand and on the other binds it to change the CRR in a predetermined direction.

Incidentally, the high levels of CRR and SLR in India have been severely criticized by many, including
the IMF and the World Bank, for their alleged adverse impact on the profitability of banks. However, is it not possible to say that they have acted as a "safety net" or "captive demand" for bank funds, and provided banks with assured revenue without much hassle?

**Lending Practices**

The Committee has recommended some important changes in lending practices of banks and financial institutions: (a) That the system of consortium lending be abolished and be replaced by the system of loan syndication and participation, (b) That the practice of a sharp dichotomy between working capital finance and term loans be re-examined and the artificial segregation of business between banks and financial institutions be removed, (c) That there be a greater measure of competition between banks and financial institutions.

While the role-integration of banks and financial institutions is welcome, the Committee's view on consortium lending is not comprehensible; it reflects, in our view, the ideological overloading of the Report. The consortium lending served:

- to avoid multiple financing of the same borrower
- to avoid multiple loan applications and negotiations in the case of large borrowers
- to ensure optimum use of available resources in the system
- to bring about integration in the system
- to facilitate credit planning.

If it resulted, as it is alleged, in the cartelizeation of lending, one fails to understand how the system of free loan syndication or participation would avoid this drawback. In fact, it is the free syndication arrangements which are widely well-known to be more promotive of the collusive, cartelized, and imperfect practices in all types of markets.

**Interest Rates Policy**

The rate of interest is a crucial factor which determines savings and allocation of resources, and it was but natural that the Committee on financial sector reforms should have made many important recommendations regarding the future changes in interest rates policy. They are: (i) The interest rate on cash reserves should ultimately be raised to the level of banks' average cost of deposits, and to a one-year deposit rate during the period of transition, (ii) The government borrowing rates should progressively become market-related, (iii) The concessional rates on priority sector loans should be phased out, (iv) The current lending rates of banks and financial institutions are quite high and cannot be raised further, (v) The total deregulation of interest rates on bank deposits is not immediately feasible because such a step would push up lending rates. But the ceiling on deposit rates should be raised, (vi) Although the medium-term objective of the policy should be to deregulate interest rates completely, this cannot be achieved immediately in the absence of reasonable control over government deficit, macro-economic balance, and inflation, (vii) All discriminatory and ad-hoc fiscal concessions in respect of different saving instruments should be eliminated over a period of time, (viii) The RBI should be the only authority to determine the level and structure of interest rates, and the latter should be greatly simplified by it. (ix) The bank rate should be made an anchor or a pivot of all the interest rates in the financial system and it should signal changes in the direction and level of those rates.

Almost all these recommendations are in the right direction; and are in line with the thinking of the Chakravarty Committee, the Vaghul study group (RBI, 1987), and Bhole (1985); they are also consistent with the interest rates changes introduced by the RBI in October 1991 and they reflect a high level of realism concerning interest rates policy in India. The seventh, eighth, and ninth recommendations are particularly noteworthy.

**Structural Reorganization, Marketization, and Globalization**

The Committee has recommended many changes in the structure of commercial banks and other financial institutions, including the RBI and the Industrial Development Bank of India (IDBI). It would like the number of public sector banks to be substantially reduced through voluntary, negotiated, and, if necessary, the government-RBI-persuaded mergers, consolidation, and acquisitions. Consistent with its basic philosophy of competitive, market-driven, privatized, and profit-oriented financial sector, it has recommended the following changes:

(i) The banking structure should consist of: (a) 3 or 4 large banks, including the State Bank of India (SBI), which could become international in character; (b) 8 to 10 national banks with a network of branches throughout the country and engaged in universal banking; (c) several new local and region-specific banks, and (d) rural banks, including Regional Rural Banks (RRBs). Pending the emergence of strong international banks, those Indian banks which have the largest presence abroad and strong financial position should jointly set up one or more
subsidiaries to take over their existing branches abroad. Further, national sponsor banks should segregate the operations of their rural branches from their other operations, and the former should be taken over by their newly created one or more rural subsidiaries, which would be treated on par with RRBs. The RRBs may retain their separate identity or merge with rural subsidiaries just mentioned.

(ii) There should be free entry into the financial sector and the establishment of new banks in the private sector should be allowed.

(iii) There should not be any further nationalization of banks.

(iv) The policy with regard to allowing foreign banks to open offices in India either as branches or as subsidiaries should be liberalized. Joint ventures between foreign banks and Indian banks should be actively encouraged.

(v) The system of branch licensing should be abolished and Indian banks should be given full freedom to open or close branches (other than rural branches for the present).

(vi) The chairmen-cum-managing directors of banks and financial institutions should be appointed by the government in consultation with the RBI. Similarly, the government, but not the RBI, should be represented on the boards of directors of banks and financial institutions.

Recommendations on Restructuring: A Critical Evaluation

In our view, the Committee's recommendations on the restructuring and privatization of banks are vague, dogmatic, riddled with inconsistencies, and in the manner of a numbers game. Some examples of contradictions are: (a) the number of public sector banks should be reduced but that of private sector banks should be increased; (b) the expansion of the number of branches is said to have resulted in many ills in banking, and yet it is recommended that branch licensing should be abolished, and that there should not be any restrictions on banks operating in any part of the country; (c) competition among banks is good but it is not good enough in the case of rural banking; (d) ownership of banks is not the real issue, yet public ownership is bad while private and foreign ownership are necessarily good.

The delicensing proposal goes counter to the policy of consolidation which the RBI has been implementing over the past few years. It has already introduced the Service Area Approach (SAA) and action plans to arrest the indiscriminate increase in bank branches, and to bring about greater mechanization, computerization, and modernization in banking. In comparison with the reform proposals, this guided policy is more beneficial because it ensures that rural branches are not closed, that new branches do not gravitate towards urban areas, and that mechanization takes place with a human face.

It is not clear whether the region-specific local banks are expected to be only urban-oriented. If not, why has the Committee made a separate recommendation for setting up of rural banks and rural subsidiaries? The Committee appears to be in favour of winding-up of the RRBs. However, it is not clear how the device of creation of subsidiaries by the same banks that have sponsored the RRBs would automatically improve matters in rural banking.

The Committee has not enlightened us on the rationale behind its restructuring proposal; it has not thought it necessary to undertake a systematic and comprehensive analysis of issues relating to costs, margins, efficiency, and optimum scale in banking in India before making such a proposal. As in the case of other aspects, this proposal also appears to be an imitation of the thinking abroad; it is interesting to note that it is quite similar to the restructuring scheme which is being currently thought of in the USA (Bryan, 1991).

More importantly, the proposal is basically antithetical to the Committee's own philosophy of competition; it would further strengthen the oligopolistic, concentrated, and centralized banking scenario in the country. It is true that the Committee has talked about local and rural banks also. But, if these banks are truly independent of big banks, they are bound to become sick very soon because there cannot be competition among unequals; it is against the principle of 'level-playing fields" advocated by the Committee itself. And if local banks are to be merely subsidiaries or holding companies of big banks, it is a localization or decentralization only in name and not in spirit.

The dogmatic nature of the Committee's position is amply reflected in the suggestion that there should be a separation between the ownership and control of banks, and that the government should exhibit the virtue of self-denial. Would the private sector also accept this principle? Or is it the case that the society runs best on double standards? Similarly, it is difficult to reconcile or rationalize the glowing tributes the Committee has paid to the multifarious quantitative and qualitative
achievements of the nationalized banks on the one hand, and its recommendation in the next breath that banking sector in India needs to be privatized.

There cannot be two opinions on the need for freeing the Indian financial system from political interference and bureaucratic stranglehold. Similarly, the financial system must become healthy and must build up the confidence of depositors, savers and investors. However, the Committee's religious faith in competition as a panacea to achieve such things is misplaced; it is without theoretical and empirical foundations. Private sectors and competitive set-ups are well-known for pursuing pecuniary gains indiscriminately and for neglecting the principles of liquidity, safety, prudence, and social responsibility. Historically, this has often resulted in the failure of financial institutions and banks, and the consequent financial and general instability.

The fact cannot be overlooked that sickness in banking is at least a partial derivative of sickness in the private business sector. Therefore, before accepting the remedy of privatization, the question as to why sickness exists on a comparable scale in private business and financial sectors needs to be settled first. We cannot forget the sorry episode of a short-lived mushroom growth of private and competitive leasing industry in early 1980s, or the current extremely undesirable and worrisome happenings in the competitive mutual funds sector. Similarly, the currently existing private sector banks (and cooperative banks) are also sick in large numbers. Further, widespread cheating, frauds, purely speculative booms and crashes, and a number of other highly objectionable goings-on in the stock market should at once open our eyes to the dangers of competitive pursuit of money and profit.

It is a serious drawback of the Committee that by advocating a return to marketism and competition, it has sought to simply write-off the startling disclosures regarding the private industrial (business) sector, banks, and financial institutions made by many committees during the past 30 years such as the Monopolies Commission, the Hazari Committee, the Dutt Committee, the Dehejia Committee, and the Tandon Committee, to name only a few. The findings of these Committees enabled us to understand why regulations, controls, directives, and public ownership became necessary first. They have shown that the trumpeted virtues of privatization and competition did not exist at all in the business and financial sectors in India.

It was, therefore, necessary for the Committee to counteract or disprove the earlier findings, or to show how and why the private sector business units will not return now to their undesirable, restrictive, monopolistic, exploitative, and fraudulent practices, and why banks and financial institutions will no more participate, aid, abet, and collude in these practices. Given the most serious ethical and moral crisis afflicting our country today, there should not be an iota of doubt that these practices are likely to certainly multiply manifold.

In fact, an alarming number of many types of such practices have come to light in the recent past. It is highly unfortunate that the Committee has not touched upon such weighty and complex issues, and has not cared to understand the Indian praxis before recommending marketization. The problems of India, including those of her financial sector, are more fundamental, and, therefore, are incapable of being solved by the dogmatic advocacy of competitive market mechanism.

The Committee's faith that the entry of foreign banks and financial institutions would have a beneficial impact on our financial system is difficult to sustain. It is simply not true that foreign banks and foreign financial institutions are functioning as paragons of efficiency and rectitude. For example, more than 25 per cent of banks in the USA are in the red at present. Financial scandals, frauds, and failures have assumed vast and international dimensions on account of the single-minded pursuit of competitive profit and greed (Adam, 1992).

In any case, there is also the question of feasibility of application of the principle of competition to the Indian financial sector. Unlike the real sector, the financial sector is almost entirely owned by the state, and, under ideological pressures, it has now been agreed that banks would not be denationalized. In such a situation, what would be the meaning and nature of competition, and how would it be operationalized in practice? To what extent deregulation, operational flexibility, autonomy, and integrity can really be introduced in state monopolies? Is state monopoly compatible with competition? Thus, the Committee's proposal is over-optimistic and riddled with logical contradictions.

Some Other Recommendations
The Committee has made the following recommendations about the role and organization of the RBI, the IDBI, and the Controller of Capital Issues (CCI):

(i) Hereafter, the IDBI should undertake only the apex and refinancing role and its direct lending function should be transferred to a separate institution incorporated as a company, (ii) The CCI should be abolished
and the SEBI, in its place, should issue prudential norms to protect the investors, (iii) The regulatory and supervisory functions of the RBI should be separated, and a separate new quasi-autonomous institution should be set up to take over the supervisory functions of the RBI. (iv) The duality of control over the banking system between the RBI and the Banking Division of the Ministry of Finance should end and the RBI should be the primary agency for regulation of the banking system.

While we fully agree with the Committee's view that the RBI should have dignity, autonomy, and authority in the discharge of functions enjoined on it by law and expected of it by the public, it is difficult to understand why the RBI and the IDBI should be split. The two types of functions which are sought to be separated in the case of each of these institutions are complementary and should be performed together. For example, the financial sector regulation would involve a supervisory role also. Moreover, there is already a plethora of institutions in India and any further increase in their number should be strictly avoided.

Concluding Remarks

The model of development underlying the Narasimham Committee is pretty obvious to any discerning analyst. But whether the model being proposed will bring the kind of outcomes envisaged by its proponents is not borne either by the diagnosis employed by the Committee nor by the experience of other third world countries which have experimented with the model.

The nagging question remains — Are we on the right track? Do we not have the capability to devise an appropriate model keeping in view our social and economic needs and experiences?

References


