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Major Recommendations by the 2nd Narasimham Committee on Banking Sector Reforms In early 1997, Mr.Narasimham was again asked to chair another committee to review the progress based on the 1st Committee report and to suggest a new vision for Indian banking industry. In April, 1998, Narasimham Committee submitted its report and recommended some major changes in the financial sector. Many of these recommendations have been accepted and are under process of implementation. These recommendations can be broadly classified into following categories :- (A) Strengthening Banking System (B) Asset Quality (C) Prudential Norms and Disclosure Requirements (D) Systems and Methods in Banks (E) Structural Issues (A) Strengthening Banking System RECOMMENDATION PRESENT STATUS Capital adequacy requirements should take into account market risks in addition to the credit risks RBI has already implemented the same as market risks already taken into account for investment portfolio. In the next three years the entire portfolio of government securities should be marked to market and the schedule for the same announced at the earliest (since announced in the monetary and credit policy for the first half of 1998-99); government and other approved securities which are now subject to a zero risk weight, should have a 5 per cent weight for market risk. More stringent norms under Basel II already implemented. Risk weight on a government guaranteed advance should be the same as for other advances. This should be made prospective from the time the new prescription is put in place. This has already been implemented by RBI. Foreign exchange open credit limit risks should be integrated into the calculation of risk weighted assets and should carry a 100 per cent risk weight. More stringent norms under Basel II already implemented. Minimum capital to risk assets ratio (CRAR) be increased from the existing 8 per cent to 10 per cent; an intermediate minimum target of 9 per cent be achieved by 2000 and the ratio of 10 per cent by 2002; RBI to be empowered to raise this further for individual banks if the risk profile warrants such an increase. Individual banks' shortfalls in the CRAR be treated on the same line as adopted for reserve requirements, viz. uniformity across weak and strong banks. There should be penal provisions for banks that do not maintain CRAR. More stringent norms under Basel II already implemented. Public Sector Banks in a position to access the capital market at home or abroad be encouraged, as subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources. Public sector banks are already accessing the capital market, e.g. PNB, Canara Bank, UCO Bank, Union Bank etc. have already successfully launched IPOs. (B) Asset Quality An asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been identified but not written off. These norms should be regarded as the minimum and brought into force in a phased manner. NPA norms have been implemented For evaluating the quality of assets portfolio, advances covered by Government guarantees, which have turned sticky, be treated as NPAs. Exclusion of such advances should be separately shown to facilitate fuller disclosure and greater transparency of operations These are yet to be implemented. For banks with a high NPA portfolio, two alternative approaches could be adopted. One approach can be that, all loan assets in the doubtful and loss categories, should be identified and their realisable value determined. These assets could be transferred to an Assets Reconstruction Company (ARC) which would issue NPA Swap Bonds First Asset Reconstruction Company was established during June, 2002. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital, backed by government guarantee to make these instruments eligible for SLR investment by banks and approved instruments by LIC, GIC and Provident Funds Tier II bonds are being issued by the Banks, but these are not eligible for SLR investments by banks. The interest subsidy element in credit for the priority sector should be totally eliminated and interest rate on loans under Rs.2 lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and cooperative credit institutions (C) Prudential Norms and Disclosure Requirements In India, income stops accruing when interest or installment of principal is not paid within 180 days, which should be reduced to 90 days in a phased manner by 2002. Implemented w.e.f. year ending 31/03/2004. Introduction of a general provision of 1 per cent on standard assets in a phased manner be considered by RBI. Already implemented As an incentive to make specific provisions, they may be made tax deductible (D) Systems and Methods in Banks There should be an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs. Banks may evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping in view their risk profile as revealed through credit rating and other relevant factors The major banks have already implemented these exposure limits. Slowly other banks are also progressing in this field. Banks and FIs should have a system of recruiting skilled manpower from the open market Banks are already recruiting specialist officers from the open market. Public sector banks should be given flexibility to determined managerial remuneration levels taking into account market trends. This is partially being implmented There may be need to redefine the scope of external vigilance and investigation agencies with regard to banking business. There is need to develop information and control system in several areas like better tracking of spreads, costs and NP&S for higher profitability, accurate and timely information for strategic decision to identify and promote profitable products and customers, risk and asset-liability management; and efficient treasury management. Risk Management, Asset Liability Management and improvement in treasury have already been introduced in banks. (E) Structural Issues With the conversion of activities between banks and DFIs, the DFIs should, over a period of time convert themselves to bank. A DFI which converts to bank be given time to face in reserve equipment in respect of its liability to bring it on par with requirement relating to commercial bank. The process has already started. ICICI Ltd. Has converted itself into a bank by merger with ICICI Bank Ltd. IDBI, SIDBI too have followed the same. Mergers of Public Sector Banks should emanate from the management of the banks with the Government as the common shareholder playing a supportive role. Merger should not be seen as a means of bailing out weak banks. Mergers between strong banks/FIs would make for greater economic and commercial sense. Indian Banks have yet to take cue from this recommendation and are apprehensive of the mergers. ♦Weak Banks' may be nurtured into healthy units by slowing down on expansion, eschewing high cost funds / borrowings etc. Government is already taking steps in this direction. The minimum share of holding by Government/Reserve Bank in the equity of the nationalised banks and the State Bank should be brought down to 33%. The RBI regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest These are yet to be implemented There is a need for a reform of the deposit insurance scheme based on CAMELs ratings awarded by RBI to banks. Inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks; only exception to be made is primary dealers. RBI has already taken number of seps in this direction. Non-bank parties be provided free access to bill rediscounts, CPs, CDs, Treasury Bills, MMMF. RBI should totally withdraw from the primary market in 91 days Treasury Bills. The Narasimham committee on banking sector reforms plays a vital role in the Banking sector growth and the government directed this committee 2 times once in 1991 and 1998 to improve the efficiency of the banking sector in the country.In 1969, RBI has Nationalized from then the expansion took place in a vast geographical area through the financial system. Within 1 year of time, many public sector banks and financial institutions were faced with losses. There were many problems and could not sustain in a competitive world, hence the government of India took a decision to set up a committee under the chairmanship of former Governor Mr. M. Narasimham to suggest suitable changes in the banking sector.Aims of the Narasimham CommitteeThe main aims of Narshimha Committee of 1991 are as follows:Operational flexibility was the first aim ensuring in a greater degree.Public sector banks to stand autonomously in the process of Decision Making.Professionalism in Banking operationsRecommendations of the Narasimham Committee of 1991In 1991, the 9 member committee on the financial system submitted their report in November 1991 with the following recommendations.1. Statutory Liquidity Ratio (SLR)The committee recommended that the government must reduce the SLR from 38.5% to 25% over the next five years.2. Cash Reserve Ratio (CRR)The cash reserve ratio must be reduced from 15% to 3-5%. So that the banks can use more funds for advancing loans.3. Directing Credit ProgrammesThe Narshimham committee of 1991 recommended that the system of directed credit programs should be gradually phased out.The priority was given to farmers, rural, artisans, village and cottage industries, etc. to fix 10% aggregate bank credit.4. Structure of Interest RatesOn the level and structure of interest rates, the committee recommended that they should be determined by market forces and all controls and regulations on interest rates should be eliminated.5. Structural Reorganization of the Banking SectorThe committee recommended that the banks should be restructured so as to create.a) 3 or 4 major and large banks that could have an international character.b) 8 to 10 national banks with a nationwide branch network, local banks for regional operations, and rural banks at the bottom end.6. Nationalization of BanksThe committee recommended that there should be no Nationalization of banks in the future.7. Setting up of new BanksThe committee said that RBI should allow the creation of new banks in the private sector, as long as they meet the minimum capital and other requirements.8. Removal of Dual ControlThe Narasimham committee recommended that the dual banking system between RBI and the Banking Division of the Ministry of Finance should be ended immediately.9. Foreign BanksThe Narasimham committee recommended that the government should allow foreign banks to open offices in India, either as branches or as subsidiaries.10. Autonomy to BanksThis committee recommended that the public sector banks should be made free and autonomous.11. DisinvestmentThe committee recommended that a percentage of the shares of public sector banks should be disinvested like other PSU's.12. Rural Banking SubsidiariesEver public sector should set up one or more rural banking subsidiaries to take over all its rural branches.13. Recruitment of StaffThe committee stated that appointments to the key posts should be kept safe from political favors and that the CEO of a bank should be appointed by a group of the independent panel of experts. They should be appointed by the panel of experts.14. ComputerizationThe committee recommended speeding up the computerization of banking services to improve their efficiency and to boost competition.Also read: Functions of Reserve Bank of IndiaRecommendations of the Narasimham Committee of 1998This committee was set up under the chairmanship of Narasimham with the name "Committee on Banking Sector Reforms" which is also known as "Second Narasimham Committee".This committee submitted its report on 23rd April 1998. It covers various issues like bank mergers, recasting of bank boards, changing rules, and more...1. Strengthening Banking SystemThe committee examined the strengthening of the banking system in the context of the convertibility of the Capital Account Convertibility "CAC".This would imply important inflows and outflows of capital and the consequent complications for the management of the exchange rate and internal liquidity.Hence, it recommended the merger of strong banks, point to be noted here is they were against the merger of strong and weaker banks.2. Narrow BankingThe committee was focusing on the rehabilitation of weaker public sector banks with the accumulation of a high percentage of non-performing assets(NPA).The concept of narrow banking indicates that weak public sector banks should only invest in short-term risk-free assets, and match their demand deposits with liquid assets.It also said narrow banking may not be helpful to rehabilitate weak branches and closure of such banks should be examined.3. Capital Adequacy RatioThe Committee discussed the issue of increasing the capital adequacy ratio required to improve the intrinsic strength of banks and their ability to absorb risk and to propose higher capital adequacy requirements for banks and create an asset reconstruction fund to take over the bad debts of the banks.4. Bank OwnershipThe committee argued that the ownership of the government and the administration of the banks did not improve the authority and flexibility of the operation of public sector banks.Therefore, the committee recommended that the functions of the banking board be reviewed so that they retain the responsibility of improving the value of the shareholders through the formulation of corporate strategies.5. Review of banking lawsThe Committee suggested an urgency to review and amend the main laws that govern the banking sector in India, such as the RBI Act, the Banking Regulation Act, the Bank of India Act, the Bank Nationalization Act, etc. these up-gradation helps to meet the needs of present-day conditions.

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